EMEA

Performance

A triannual topical digest for investment management professionals, issue 10, January 2013

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Real estate senior debt funds

Embracing technology — A crucial element in transforming private equity and real estate business operating models

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Consolidated financial statements and the control concept — Ten discussion areas for investment managers

Constant NAV money market funds under regulators' spotlight — Breaking or not breaking the buck; that is the question!

Deloitte.

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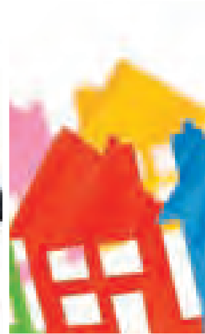

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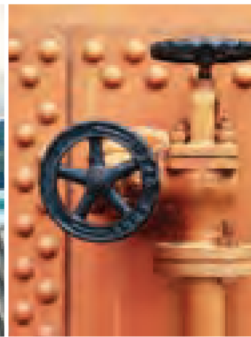

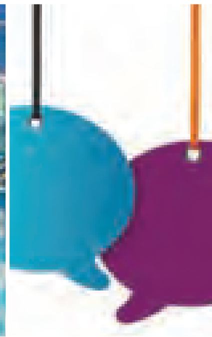

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Foreword

Dear investment management practitioners, loyal readers and newcomers to our magazine,

First of all, Happy New Year to you and your families! 2012 was quite a challenging year for our industry and we expect this new year will call for the same level of strategic, operational and functional attention from our industry's decision makers. Perform*ance* has reached its 10th edition! What started in late 2009 as part of the EMEA Financial Services Industries (FSI) 'As One' initiative has established itself as the leading, unique Deloitte global and sectorial publication. This would never have happened without the growing response we have received from edition to edition. The continuity and sustainability of Perform*ance* is thanks to you, the readers and contributors of the magazine.

A few weeks ago, we spent a considerable amount of time within Deloitte's EMEA investment management leadership team to brainstorm about the strengths, weaknesses, challenges and opportunities of our industry. We believe our key strengths lie in the steadiness of our AUM despite the turmoil, its international orientation, our talent and innovation. As we have done in recent years, we shall continue to improve our lobbying capabilities, operational efficiency, infrastructure standardisation and rationalisation of product ranges.

At the same time, we must keep in mind the opportunities offered to the investment management industry which instil confidence in us about the investment management outlook going forward. Macroeconomic GDP outlooks promise continuity for global stabilisation. We are also convinced that the regulatory measures challenging our industry will result in a strengthening effect for our industry's positioning within the FSI.

Deloitte's Global FSI leadership has recently rolled out its ambition plan for the next few years. One of our main objectives is to become our clients' and prospects' entrusted adviser in innovation. We know that innovation and talents have always been and will forever remain one of the key drivers of growth in investment management. Our global leadership's commitment to generating new ideas will obviously benefit our investment management practices and facilitate Deloitte's leading role in driving our industry further to the top.

Vincent Gouverneur
EMEA Investment Management Leader

Roger Dassen
DTTL Global Managing Director of Clients, Services and Talent

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

Editorial

Here we are, Perform*ance* is celebrating its tenth edition. Time has flown by and our global investment management magazine has come to be an established and unique publication of Deloitte Global.

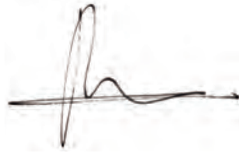
Deloitte's Global FSI Leadership has set the target for FY15: we must consolidate in Americas and EMEA and further grow in Asia Pacific. For the investment management stake, we will ensure that Perform*ance* will play a key role in the ongoing coordination of the investment management worldwide network at both Deloitte
and client levels.

In this edition, we are happy to offer insight and perspectives on target operating models, cross-border rationalisation for UCITS, secure yield, private equity and real estate, AIFMD, extensive tax updates, IFRS 10, constant NAV money market funds and investment management regulation in China.

We would also like to take this occasion to invite our worldwide investment management clients to continue participating in our publication. Since the very beginning, we have greatly appreciated external contributions and pursue our objective to increase these contributions in 2013.

In the meantime, Happy New Year 2013 and thanks again for your support.

Sincerely,



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Market buzz

Refining the target operating model

Increasing benefits from Lean and Six Sigma initiatives

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Though many banks pursue Lean and Six Sigma initiatives only few are able to reap the full benefit from those. This article will show how looking at your operating model will allow you to define an integrated set of initiatives to increase their total return well above a level where it becomes visible not only in your P&L.

Low industry growth and ineffective initiative-based cost cutting

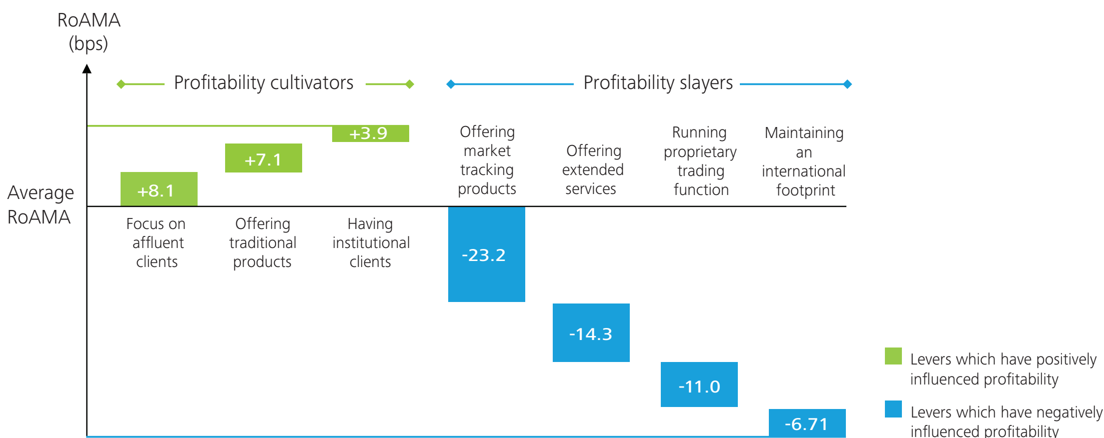
Since 2008 the asset management industry has been confronted with cautious private investors and, on average, net outflows of invested money in retail funds. Retail fund managers are additionally confronted with a situation where private investors no longer favour managed funds with traditionally high margins for the asset managers—with fees of around 110 bps on average—but passive products (such as ETFs) with lower margins of around 45 bps on average. As a consequence the basis on which to generate management fees is decreasing across the retail business.

This outflow of money from private investors is partially compensated by institutional investors whose investments reached an all-time high in 2011. With traditionally lower management fees—which range around the 45 bps charged for passive products—the average profitability is decreasing over all investments.

On the other hand, capital requirements and regulatory requirements are increasing. As a result, the cost of implementing and complying with new regulations on a day-to-day basis is raising the cost base for asset managers. This shift in assets to low-margin, passive products, coupled with higher costs originating from regulatory requirements, is resulting in pressure on profitability across the industry.

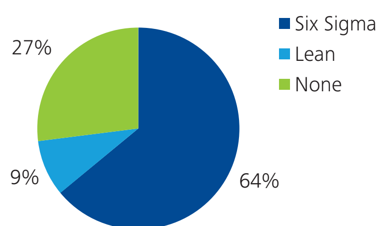
This is in line with Deloitte's internal research depicted in graph 1 which summarises the key elements of a business operating model acting either as profitability levers or factors to reduce profitability. The results of Deloitte's research indicate that traditional products (active retail funds) and a focus on affluent retail clients are the two most important profitability drivers as measured by their impact on Return on Assets under Management and Administration (RoAMA). Offering passive market tracking products and an extended service offering have the biggest negative impacts on RoAMA.

Graph 1: Bottom line impact of individual profitability levers



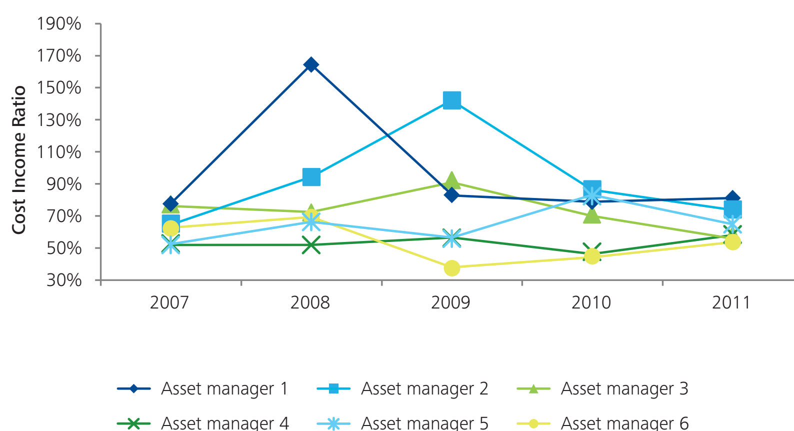
Source: Deloitte research

Graph 2: Use of process optimisation techniques among German asset managers



Source: *Deloitte research of 47 asset managers, custodians and asset service providers (2012)*

Graph 3: Cost-income ratios of six leading German asset management companies

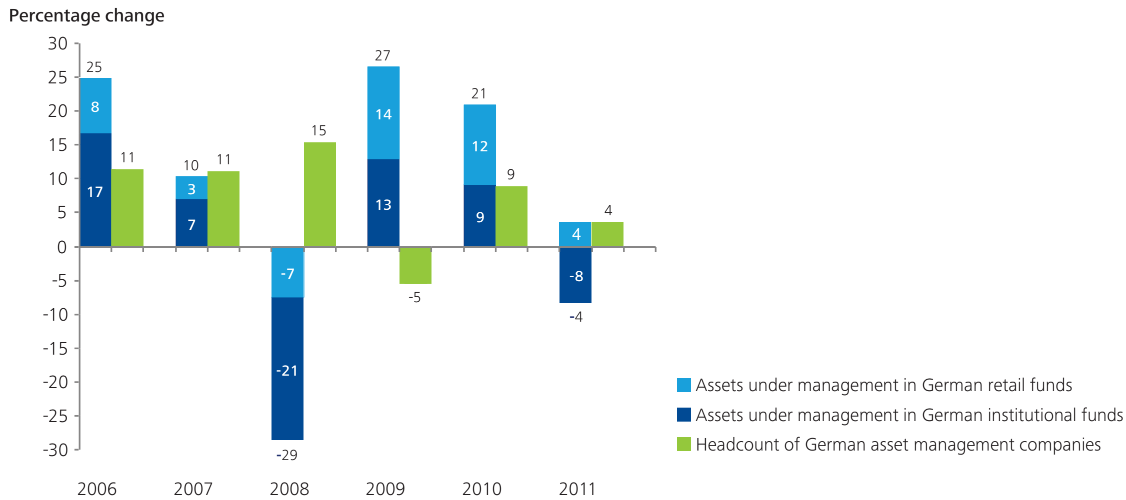


Lean as well as Six Sigma should allow organisations to adapt to volatile market environments in a timely manner

Asset managers have started to react and many have launched either comprehensive efficiency initiatives or at least one-off cost-cutting projects. Among the ongoing efforts, Lean and Six Sigma-related initiatives especially are among the favoured actions to counter pressures on profitability. Only 27% of the analysed asset managers did not show any institutionalised initiative like Lean or Six Sigma. However, looking at the balance sheets in graph 3, these initiatives have not had a significant impact so far.

The positive effect of these Lean and Six Sigma initiatives on CIR might be absorbed by other external effects. Hence, looking at the cost-income ratio only might not show whether these were successful or not. Looking at the Assets under Management (AuM)—as the biggest source of revenue—and the headcount of asset managers—as one of the two biggest cost contributors (next to IT)—provides an additional indication.

Graph 4: Percentage change in assets under management and headcount



Source: BVI

Depicting the growth in AuM against the rise in headcount shows that headcount follows AuM growth with a time lag of one to two years (compare graph 4): this is not timely. In its extent it is nearly equal to the change in assets over time: it is not reduced in scale. These findings are exactly what one would not expect of a Lean organisation or of one applying Six Sigma.

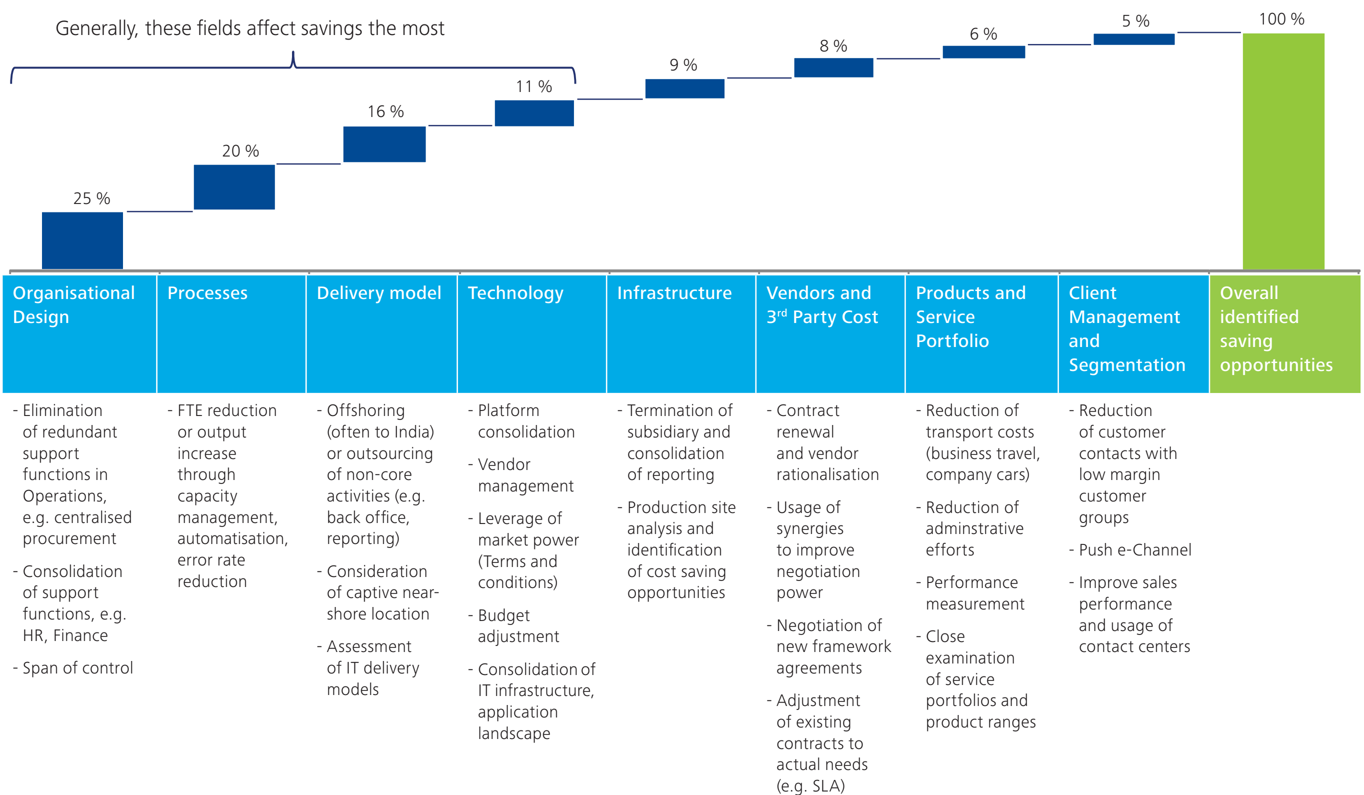
Lean as well as Six Sigma should enable organisations to adapt to volatile market environments in a timely manner. Tools like productivity KPIs, flexible and utmost scalable processes, and other instruments which are at the heart of any Lean and Six Sigma initiative provide the basis for this.

For example any increases and decreases in AuM should be mainly absorbed by Lean organisations. Lean organisations leverage external service providers or have implemented highly automated processes to increase their scalability. Either way, changes in headcount would stay well behind AuM growth. As another example, Six Sigma initiatives should increase the process quality and continually reduce manual effort, e.g. for re-work or error handling.

Hence the required headcount should be reduced over time, independent of any AuM growth. Therefore we should expect headcount to remain mainly stable or to be reduced constantly over time. Only permanent growth would justify a headcount increase. Any required adjustments in headcount which cannot be offset should take place on a timely basis as KPIs would provide an early warning.

So, the probability is high that it is not as a result of compensatory effects overruling the savings from Lean and Six Sigma that we cannot see an impact on CIR. It is much more likely that these methodologies were not implemented correctly so as to generate an effect. Optimising an organisation should not start with looking at internal processes only, like many Lean and Six Sigma initiatives did. The first step should be on a higher level, looking at the overall organisational landscape—your (Target) Operating Model (TOM). A TOM comprises customers, channels, products, information flow, technology, organisational structures, people and locations in addition to processes.

Graph 5: Main levers to generate cost savings



Source: Deloitte project results

Large-scale efficiency or cost-savings programmes need to look at all levers which have an influence on operational efficiency to be successful

Fear of tampering with the operating model

There are two reasons why any asset manager needs to look at their TOM first if they want to generate savings effectively. The first is that optimisation of the organisational structure alone—e.g. span of control, team structures and work allocation—promises even higher savings than process optimisation on its own. The second reason is that addressing one lever only disregards several others which can contribute to increasing the total savings.

Graph 5 shows the eight main levers which contribute to savings. In Deloitte's projects in the asset management industry 'Organisational Design' usually contributes 25% to any savings generated compared to only 20% for 'Process Optimisation'. Subsuming changes in the 'Delivery Model' under 'Organisational Changes', these two initiatives usually contribute more than 40% to any savings generated compared to 20% for 'Process Optimisation'.

If organisational changes are not addressed first, though, process optimisation would generate fewer savings than stated in graph 5. As organisational changes often contribute to the optimisation of interfaces between departments they also contribute to process optimisation. All mentioned levers can only gain as much as 60% of all possible savings. This leaves room to increase savings significantly by addressing other means such as (information) technology or third-party spend.

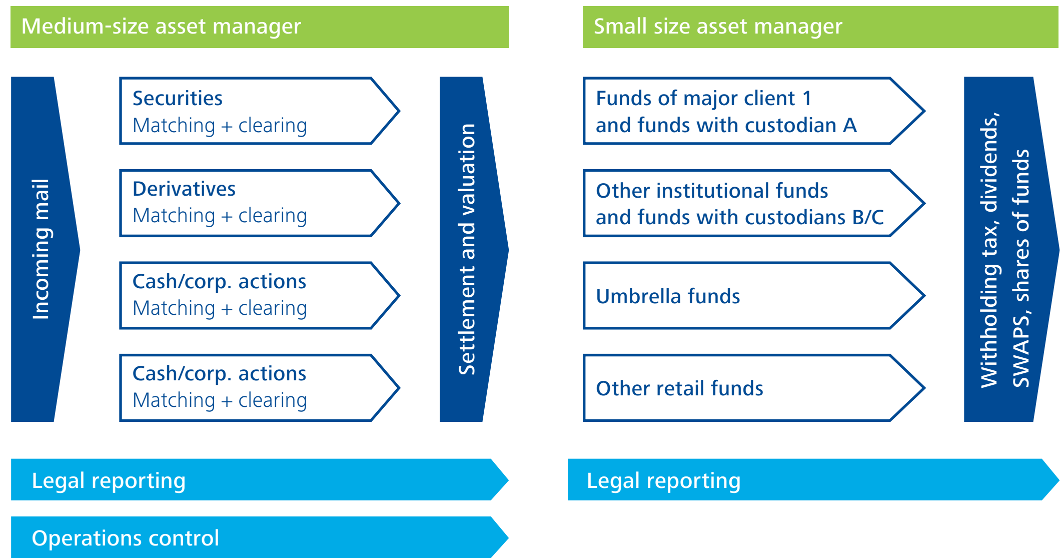
Hence, large-scale efficiency or cost-savings programmes need to look at all levers which have an influence on operational efficiency to be successful. To ensure that all levers are considered adequately, we recommend a three-step approach starting with designing the TOM. While developing the TOM blueprint, all levers shown in graph 5 are examined to determine their impact on the different levels of the target operating model (stage 1).

After having finished blueprinting, Organisational Design, Delivery Model, 3rd Party Relations and Product and Client Portfolio are considered in more detail (stage 2). During this phase, a significant portion of savings will already be achieved by simply reducing overhead and management costs as well as leveraging specialised (captive or external) sourcing providers and external partners for process delivery.

Addressing the 'Organisational Design' provides opportunities for all asset managers independent of their individual size. Economies of scale from reorganising can be generated even at small asset managers, for example by reorganising the fund administration department so that activities which are similar are grouped together. This way economies of scale can be leveraged. The bigger the organisation in terms of headcount, the more design options need to be considered. Graph 6 (see following page) shows two different organisation structures for the fund administration departments of one small and one medium-sized asset manager which were developed for Deloitte's clients.

At the medium-sized asset manager teams were grouped around different kinds of transactions with the type of funds playing no role. A small-sized asset manager with smaller numbers of transactions to distribute across teams grouped its staff around the different kinds of funds they serviced.

Graph 6: Alternative organisation structures for fund administration departments



Only transactions which were regarded as particularly complex were grouped and processed in a dedicated team across all funds. This way both companies were able to develop specialised and specially trained employees while generating economies of scale from repeating similar working steps. Only then were the specialised teams asked to work on their processes applying Six Sigma methodology and entering stage 3 as depicted in graph 7. A key success factor is to enable internal functional experts to identify and execute the required optimisation steps under the guidance of Six Sigma navigators. Self-empowered employees will become multipliers for ongoing process improvements once they have been trained. However, an ongoing strategic review of the production setup (stage 1 and 2 in graph 7) needs to be ensured, overseen and steered by senior management. With a lack of senior management supervision, a full transfer of organisational and process improvements into line organisations will not help to achieve ambitious savings targets.

As stated above, organisational improvements are the biggest contributor to savings and together with sourcing/shoring decisions contribute up to around 40% of the total savings potential on average. Process improvements are most efficient once the organisation is stabilised and processes can be aligned to the new organisational structure. Following this holistic approach will create more satisfying and sustainable results than traditional stand-alone initiatives.

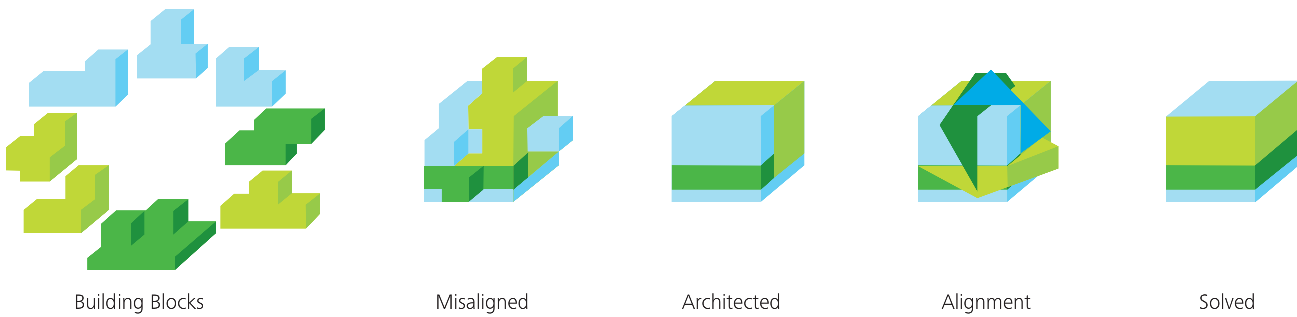
Process improvements are most efficient once the organisation is stabilised and processes can be aligned to the new organisational structure

Graph 7: Proceeding to reach optimal results in efficiency improvements

	Strategic target blueprint	Organisational and operational framework implementation	Process and infrastructure alignment
Organisational Design	●	●	
Processes	●		●
Delivery model	●	●	
Technology	●		●
Infrastructure	●		●
Vendors and 3rd Party Cost	●	●	
Products and Service Portfolio	●	●	
Client Management & Segmentation	●	●	

Source: Deloitte

Graph 8: TOM approach



Bringing the pieces together

The biggest challenge in re-designing the entire operating model is to configure the components in such a way that they work together smoothly.

We observe that many organisations struggle to simultaneously manage initiatives that each have different objectives, ignoring interdependencies between various functions. In particular, necessary interaction between top line growth and efficiency improvement programmes is often ignored. Many organisations are also overwhelmed by the complexity of their business model and simply give up aiming for coherence across all layers.

The TOM method's main goal is to seamlessly align all components of the business model, thereby eliminating inefficiencies. Business complexity is reduced by de-constructing the organisation into its constituent parts, enabling management to clearly map and visualise interdependencies and to understand the key gaps between the current and target state.

The Deloitte TOM methodology breaks the operating model down into its nine key constituent layers, starting from customers/channels through to the processes that will be required to deliver the strategic objectives such as organisation, technology and people. This approach ensures that Lean and Six Sigma projects are combined with other performance improvement initiatives to form a single model where interdependencies, conflicts and overlaps can be better managed, resulting in greater and more effective cost reductions.

The TOM method's main goal is to seamlessly align all components of the business model, thereby eliminating inefficiencies

Graph 9: TOM layers

Customer segments	which customers: e.g. high net worth individuals, institutional investors or retail clients
Channels	via which channels: e.g. call-center, key-account, adviser teams, internet
Product/ services	offering which products: e.g. retail funds, index funds, closed funds or sector funds
Processes	supported by which processes: standardised, standardised and automated, manual or segmented
Information	requiring what information, e.g. customer details
Technology	using which enabling technologies: e.g. SWIFT, Fax, paper copies vs. electronic fund files, automated vs manual settlement, etc.
Organisation	organised in which way to deliver, e.g. shared services
People	requiring what resources and skills, e.g. FTEs, roles, costs, culture
Physical locations	in which locations, e.g. properties, costs

To the **Point**:

- Asset managers are confronted with lower revenues and higher costs arising from regulation
- Discrete cost-reduction and performance-enhancing initiatives like Lean and Six Sigma have been initiated but are not enough to significantly affect the CIR
- To achieve significant CIR improvements more cost-reduction levers than affected by Lean and Six Sigma need to be addressed
- Refining the Target Operating Model helps to address all available levers for cost reductions and achieve a significant impact on CIR as well as operational efficiency

Real estate senior debt funds

Edouard Guibert
Director
Real Estate Debt Advisory
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The global financial crisis has its roots in several interlinked events. The first phase began with the bursting of the subprime bubble and the collapse of Lehman Brothers in 2008-2009, and has led to a loss of trust in the 'too big to fail' view that previously prevailed in the markets.

Financial institutions, unsure about the quality of their counterparties, stopped lending to each other, massively disrupting the interbank lending market. In the second phase, countries had to bail out their banking systems, which led rating agencies to reassess their ratings on sovereign risk. This was a particular issue in the Eurozone, where Greece soon appeared to be close to default with a risk of contagion to other over-indebted countries, which became known as the PIIGS (Portugal, Ireland, Italy, Greece and Spain). The third phase was a 'flight to quality', with a complete decoupling of the cost of debt of Southern European countries from that of countries in Northern Europe. The 10-year German federal bond yield has now fallen to 1.2% (with short maturities offering negative coupons), while the cost of debt for Italy and Spain is unsustainable.

Regulatory response

While the Eurozone countries were struggling with the sovereign debt crisis, regulators were asked to address the failures in the previous supervisory systems. The result is the forthcoming Basel III and Solvency II regulations. Basel III essentially doubles banks' Core Tier 1 capital requirements, and imposes liquidity ratios (Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR)) that will profoundly transform their Asset and Liability Management (ALM) models. This will have an even bigger impact on Corporate and Investment Banks (CIB), which largely relied on market funding.

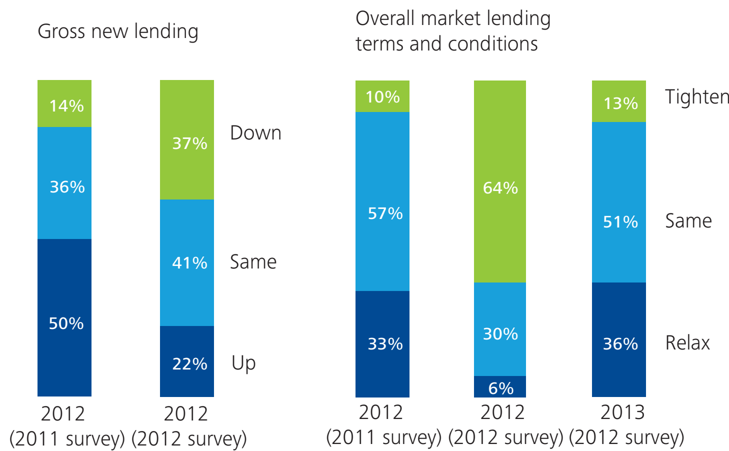
Lending was faced with both the need to hold more regulatory capital and to absorb market funding costs through more effective matching of ALM maturities. Banks are therefore being forced to reduce their balance sheets to meet the regulatory capital hurdle, and to increase their margins to combat increased liquidity costs. Solvency II essentially reassesses insurers' regulatory capital consumption according to risk, thus obliging them to shift their investments away from equity (either listed or unlisted) and towards best-rated debt instruments.

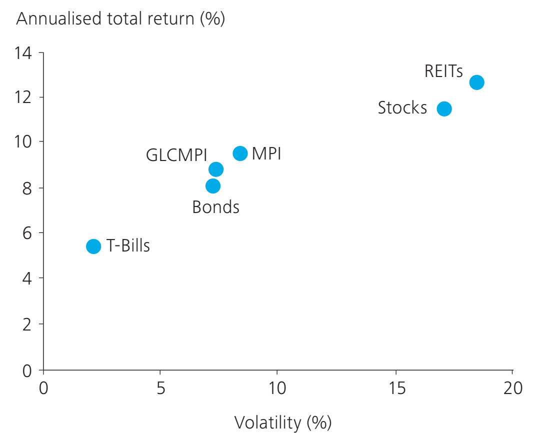
Consequences

Hard-pressed banks have had to reconsider some of their activities, cutting down their exposure to riskier or longer-term lending segments. Real estate lending has been particularly hard hit, with very significant players completely withdrawing from the market, and others refocusing their activity on historical clients, with the aim of bringing in additional fee-generating business (M&A, equity and bond issuance, etc.). All the same, bank liquidity is still available for risk-free investments in central business districts, albeit at a 4-5% cost. The biggest listed real estate investment trusts have massively reduced their leverage and turned to the bond market, where longer maturities are offered at a cheaper cost. Nevertheless, this leaves smaller or leveraged investors out in the cold, facing a stretched funding market. At the same time, Solvency II presents insurers with the challenge of reducing their risk profile while generating decent returns, e.g. to meet obligations to life insurance policy holders.

Filling the void

Equity investment in real estate is capital-consuming as a volatile first loss exposure. Bond investments are unsecured and register lower recovery rates than traditional bank lending. Banks are engaging in massive deleveraging despite reasonably attractive returns. This situation led insurers to start filling the gap, beginning with those already active in this field in the U.S. (e.g. Axa, Aviva, Allianz, Prudential). However, investing in mortgage loans is not as simple as it would seem at first sight: (i) loans are not traded on regulated markets and suffer a disadvantage due to their illiquidity; (ii) loan monitoring needs real portfolio management organisation, and (iii) fund flow settlements are specific (e.g. early repayments). In other words, while global insurers can invest time and money in setting up their own business, smaller players are still weighing up the pros and cons.





Source: DTZ research

Senior loan debt funds

Meanwhile, real estate asset managers, facing institutional client base issues and used to monitoring debt from a borrower perspective, soon proposed to reduce their clients' costs by setting up funds specialised in loan investment. As compared to insurers, they had to overcome one more hurdle: contrary to mezzanine funds, regulatory approval with regard to banks' lending monopoly had to be addressed. This was largely managed by using same-group fronting banks. The banks' loans are then sold to a securitisation vehicle, directly funded by participating investors. It may seem ironic that financial techniques largely responsible for the financial crisis are part of the solution to it.

Although this article has focused on real estate, debt funds are being organised on many fronts to address the challenges in other sectors, e.g. infrastructure, SMEs, LBOs, local authorities. These initiatives obviously need to be undertaken using a highly professional approach, but there is no doubt that this could represent an excellent opportunity for well-advised investors.

To the **Point**:

- Sovereign yields are at all-time lows in safe haven Northern European countries
- Solvency II pushes insurers down the risk curve, but risk-free yields cannot feed their balance sheets
- Basel III leads to bank deleveraging, especially on long-term financing
- Asset managers respond to this context by setting up debt funds:
  - Filling the bank funding gap
  - Responding to insurers' quest for long-term secure yields
- This context creates opportunities for well advised borrowers and investors

Hard-pressed banks have had to reconsider some of their activities, cutting down their exposure to riskier or longer-term lending segments

Embracing technology
A crucial element in transforming private equity and real estate business operating models

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This article discusses cognizance of the rise of the alternative fund industry, and technology, systems and automation being the focal points in the much-needed transformation of business operating models across private equity and real estate managers, institutional investors and service providers to cope with changing industry norms.

The recent financial turmoil has heavily dented the fiscal health of investment companies and adversely impacted the performance of traditional investments in money markets, bonds and equities. The ensuing lacklustre markets, exacerbated by the persistent economic woes in the United States and the Eurozone, have subsequently amplified awareness and interest in alternative investments, including private equity and real estate, not only as a means of portfolio diversification but as part of core investment strategies. Asset managers and institutional investors predominantly initiated and sustained this trend towards other asset classes and new geographical markets in their quest for higher yields to meet the performance expectations of their end-clients, a justifiable move given how alternatives have fared better than traditional investments in these turbulent times. As a prime example, pension funds, which historically allotted their capital largely to the safer realms of equities and fixed income securities, have in the past few years upped their alternative asset allocation to almost 20%, a threefold increase from levels posted in 2006, thereby giving credence to and signifying acceptance of this shift in investment approach.

While the growing attention to alternatives is immensely positive for the private equity and real estate industry, challenges abound in this sector—from protracted liquidity problems, passive fund raising, sharp decline in deal volume and sluggish deal closing, operational requirements and changes, to intensified demands and more complex queries from investors. Moreover, there is heightened regulatory scrutiny with the introduction by global fiscal watchdogs of several stringent, far-reaching industry laws and regulations championing investor protection and aimed at curbing the mounting problems afflicting the international economy.

The aforementioned developments in this post-crisis economy have undoubtedly altered the alternative investments landscape—the onslaught of extensive regulatory requirements from the information collection mandate of the Dodd-Frank Act in the United States to the transparency provisions of Europe's Alternative Investment Fund Managers Directive (AIFMD), and the burgeoning informational needs of investors such as those embodied in the Institutional Limited Partners Association (ILPA) reporting standards have all compelled private equity and real estate firms and their service providers to assess their existing business operating models in order to identify the tactical and strategic modifications and enhancements needed to cope with these escalating demands and challenges.

In evaluating current organisational set-ups and infrastructure, asset managers and service providers placed emphasis on key focus areas including data management, enhanced transparency and compliance, risk management, industry expertise and proficiency, and technology requirements. In our conversations with market players, many have recognised and acknowledged that the operating models currently in place are certainly inadequate or even outmoded and would essentially need to be restructured, streamlined and updated to boost commercial and functional efficiencies and to reinforce their business' viability, competitiveness and ability to survive and flourish despite these harsh conditions.

At the forefront of an operational model redesign is technology, and private equity and real estate companies, accustomed to the industry's predicaments in terms of limited automation, manual reporting and processing, are focused on this aspect.

In our interview with Lauren Iaslovits, Chief Operating Officer of private equity technology provider SunGard Investran, she stated that *"The increasing reporting requirements both from regulators and investors would necessitate standardisation around the collection, storage and reporting of far more data than historically required of private equity firms in the past. As a result, firms are now rethinking their approach to data management, especially around portfolio investment data that ultimately feeds into investor reports, regulatory filings and key investment decisions. Hence, firms are favouring more robust solutions with workflow and controls for the types of data where a purely spreadsheet-based approach would have worked in the past."*

"Over the past year," she added, *"there have been a significant number of institutional investors adopting a dedicated portfolio management system, enabling them to become more sophisticated and independent in their approach to portfolio analysis and reporting. Investors recognise that it is ultimately in their interest to keep tabs on the underlying portfolio holdings of the funds in which they are invested and putting the proper solutions in place is paramount to providing this level of transparency and to scaling the overall operation of the alternative investment programme."*

Most of the abovementioned views have been echoed by Richard Gerritsen, European regional sales director of Yardi Systems, Inc., the software provider for real estate investment and property management businesses, adding that sweeping regulations have driven industry players to refocus attention on internal controls and processes, automation and systems evaluation and how to quickly adapt these to meet multiple compliance and transparency requirements. *"Five or six years ago, it was normal to report almost everything in Excel,"* he said, *"Now, investors require and expect more detailed and automatically generated information, pushing firms to find an appropriate technology platform that would complement their business strategies."*

Business reorganisation and outsourcing

Compliance with new laws and demands from increasingly perceptive investors is undoubtedly quite taxing for general partners, asset managers and institutional investors already embroiled in a quandary of a tightly competitive business environment along with huge pressures on costs and margins. The shift in their focus from portfolio and fund management to operational capacity is a clear recognition by these market players that middle-to-back office functions are also crucial to the operational value chain and integral to the successful implementation of alternative business strategies. Some of the more prominent and larger firms have had success in restructuring or expanding their organisations, setting up specialised teams and in-house infrastructures to handle new developments and requirements affecting their global operations. But for most, the lack of internal resources, expertise and suitable software has compelled them to outsource administrative functions to competent third-party providers, aiming to redeploy resources and refocus efforts on their core fund management business.

At the forefront of an operational model redesign is technology, and private equity and real estate companies, accustomed to the industry's predicaments in terms of limited automation, manual reporting and processing, are focused on this aspect

On the fund services front, both SunGard's and Yardi's representatives also share a common view—that the aforementioned industry trends provided significant opportunities for service organisations to look for new growth and revenue drivers and broaden their existing service offering beyond the current outsourced solutions for the middle-to-back-office operations of general and limited partners. On this, Ms Iaslovits added that *"SunGard has observed a growing number of historically purely hedge fund service providers adopt its platform in order to opportunistically target private equity funds as a growth area for their business, or in some cases to serve their existing customer base of asset managers that no longer have only hedge funds, but also, closed-ended committed capital-based private equity funds or real estate funds.*

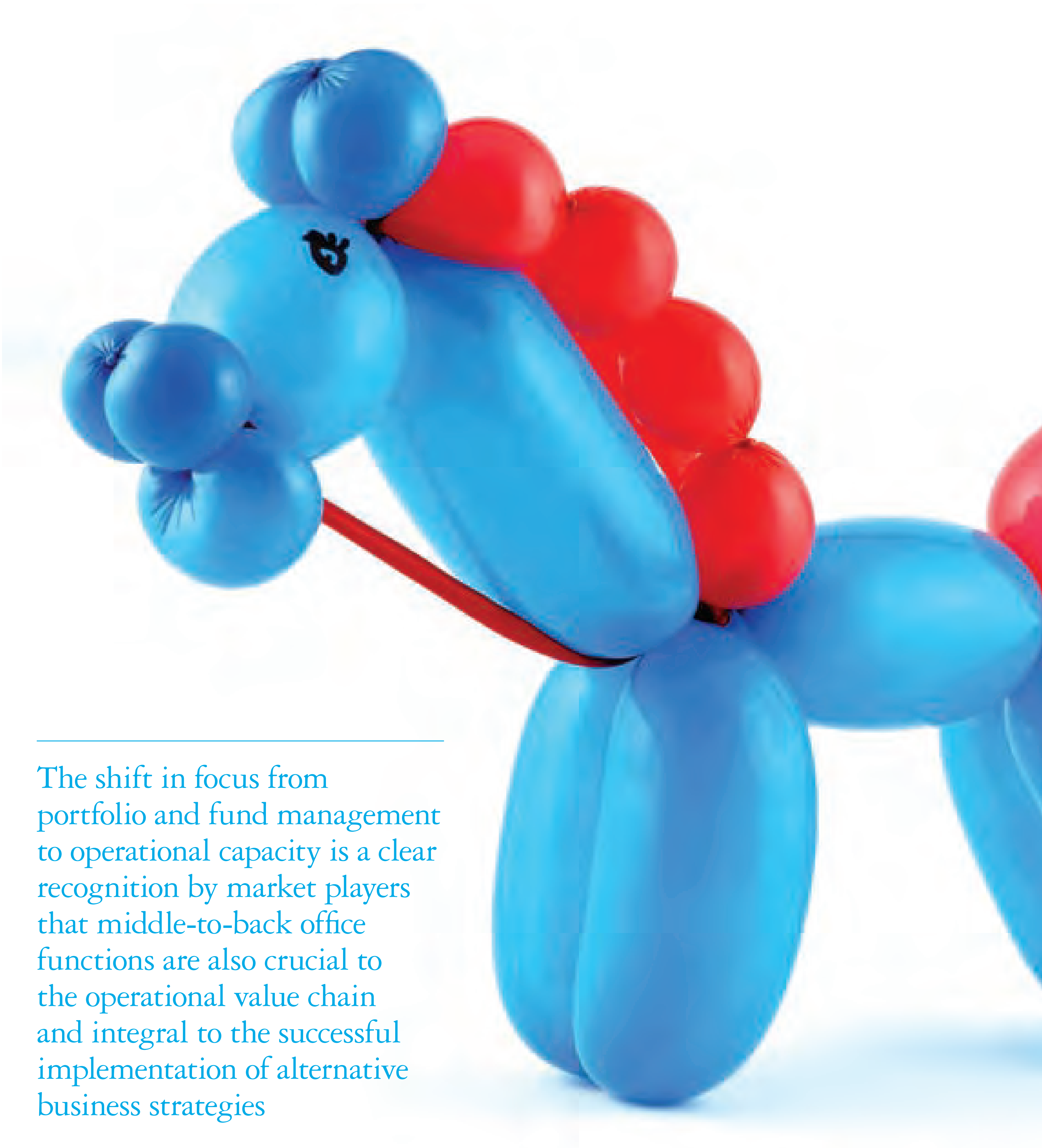
Mr Gerritsen inferred that leading investment firms seeking outsourcing partners have a preference for larger service organisations. With their own set of integrated and modern technologies, customised and varied services, coordinated internal procedures and skilled personnel, larger service firms are perceived as reliable and essential business partners supporting investment firms to cope with increased and changing industry requirements, while offering competitive fee structures to an increasingly cost-conscious clientele. *"What may happen, in the future,"* he concluded, *"is the consolidation of niche and smaller-sized fund administration, transfer agency, tax and reporting service providers in order to achieve the size, capital and scale that would enable them to compete with their larger and more established competitors".*

Key considerations in transforming operating models

The growth and development of the private equity and real estate business is expected to continually be fuelled by demands from investors and regulators for more transparency, risk management and asset diversification, the increasing flexibility in alternative strategies allowed for regulated funds, the increased competition among managers to attract reallocation from funds held in traditional asset classes and the progressive and gradual institutionalisation and globalisation of this sector. Transforming operating models to adapt to new norms is not an overnight process—it can require a considerable amount of time and resources and focused project management commitment, from the initial enterprise-wide assessment phase to the management decision-making process up to the full implementation of adopted changes and enhancements to current technology and existing organisational structures. Whether choosing the right platform or software, setting up specialised teams or selecting a reliable third-party service provider to support business operations, it is extremely important that firms take the time to analyse key elements ranging from costs, efficiencies, business requirements and functional analysis to third-party due diligence, and to vigilantly oversee all infrastructure modifications and manage the integration of outsourced processes to ensure that these are all aligned with business objectives and strategic plans. Indeed, this can be a burdensome task that can take months or years to fully realise or implement, but it has become an inevitable prerequisite to success and prosperity in this evolving industry.

To the **Point**:

- The financial crisis has unpredictably benefitted the alternatives industry—with increasing awareness and acceptance of this asset class as part of core investment strategies
- Investors and regulators are driving the trend towards a transformation of operating models in investment firms, institutional investors and service providers
- The developments in the industry and the refocusing on operating infrastructures has renewed interest in outsourcing functions to reliable third-party service providers
- Transforming business operating models is vitally important for firms to remain competitive and to succeed in the alternatives market



The shift in focus from portfolio and fund management to operational capacity is a clear recognition by market players that middle-to-back office functions are also crucial to the operational value chain and integral to the successful implementation of alternative business strategies

Ongoing changes to regulatory regimes need to be understood

Harvey Kalman*
Equity Trustees Limited

Australia's financial services regulatory regime is unique and requires particular compliance and expertise from organisations seeking to operate in this market. Asset managers considering expanding into Australia will need to understand and comply with existing stringent requirements as well as the ongoing changes anticipated over the next few years.

Since the start of the North American credit crunch, there has been much questioning of the processes and systems that were supposed to prevent the kinds of corporate collapses and investment scheme defaults that have cost investors millions over the last few years.

Compared to most of the developed world, Australia has performed relatively well. We have not escaped completely unscathed from the worst of the crisis, with failures such as Storm Financial and Trio Capital posing major problems for both investors and regulators, but these have not been on the same scale as, for example, the collapse of Lehman Brothers or the Bernie Madoff scheme.

As a result of the relative stability in Australia's financial system, combined with the country's well-established superannuation system, Australia is often seen as an attractive area of expansion for overseas asset managers.

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The Australian investment landscape

Australia has one of the largest and fastest growing fund management sectors in the world, with over AU$1.9 trillion[1] in funds under management. This growth has been bolstered by Australia's government-mandated retirement scheme, superannuation, which was introduced in 1992. Currently, all Australian employees must put aside 9% of their salary into superannuation; this is set to increase gradually to 12% of salary by 2019-2020.

Australia therefore has a substantial and increasing pool of investments—by some estimates, the fourth largest in the world—which has resulted in a number of international asset managers setting up operations here.

Currently, there are over 130 investment management firms, both domestic and international, operating in Australia, as well as approximately 200 smaller hedge and boutique fund managers. The top 30 investment management firms control over 85% of the industry's funds under management.

Two-thirds of the investable funds come from wholesale investors, such as pension funds and insurance firms, and one-third from the retail investor market. The retail investment management market is dominated by large domestic institutions, with 23 out of the 30 largest retail fund managers being of local origin.

The total of these domestic companies' unconsolidated assets is almost AU$390 billion, accounting for around 90 percent of the retail market.

Therefore, while there are attractive opportunities for fund managers, the complexities of the existing regulatory regime in Australia, as well as the changes currently being made to improve investor protection, need to be understood, as the system is quite different to that used in any other country.

1 Australian Bureau of Statistics, as at 30 June 2012

Responsible Entity regime

The current Responsible Entity (RE) regime was established in Australia 12 years ago to replace an antiquated 'independent trustee' system, which itself was introduced in 1951 in response to significant investor losses arising from the failures of timber plantation schemes.

The RE regime was mandated through the Managed Investment Act, which came into force in 2000 as a new model for collective investment schemes such as managed funds.

It enhanced the concept of an 'independent trustee' by giving legislative power and responsibility to an entity whose primary objective is the protection of investors in collective investment schemes.

The RE is entrusted with the management of a collective investment scheme (including its governance and control framework) and has the ability to appoint authorised agents (for example an investment manager, administrator, custodian and registry provider) to manage the fund's affairs on a daily basis.

REs must be incorporated as Australian public companies (whether listed or unlisted), must hold an Australian Financial Services Licence (AFSL) and are required to maintain mandated levels of Net Tangible Assets (NTA).

This investor protection approach is unique to Australia. In many ways, it has proved to be a successful mechanism for market stability; nonetheless, the global financial crisis was its first real test and some aspects of the system have been found wanting.

Recent changes

Despite the relative stability of Australia's financial and regulatory environment, further changes have recently been introduced to the RE system to enhance investor protection and regulatory oversight.

Towards the end of 2010, the Australian Securities and Investments Commission (ASIC), Australia's corporate, markets and financial services regulator, released a Consultation Discussion Paper (CP140) calling for industry participants' feedback on ways to strengthen the financial resources of REs.

Australia has a substantial and increasing pool of investments – by some estimates, the fourth largest in the world – which has resulted in a number of international asset managers setting up local operations

Following ASIC's review of the responses received, it issued a new regulatory guide in November 2011, with the following key requirements introduced to the RE regime:

1. A requirement that REs prepare (rolling) 12-month cash flow projections which must be approved by the directors at least quarterly
2. A new NTA calculation whereby REs must hold the greater of:
   - AU$150,000
   - 0.5% of the average value of scheme property (capped at AU$5 million) or
   - 10% of the average RE revenue (uncapped)
3. New minimum liquidity levels whereby REs must hold the greater of AU$150,000 or 50% of their NTA requirement in cash or cash equivalents
4. A requirement to exclude from the NTA calculation any potential liability under any personal guarantees provided by the responsible entity
5. A requirement to exclude from the calculation of the NTA requirement any listed parent entity's eligible undertakings

A proposed solution is to ensure that smaller fund managers who are unable to adequately resource their own RE function, are obligated to use an external RE

Future changes

While these changes are worthwhile, it is unlikely that we have seen the last of the tweaks to the regulatory system in Australia. There are still discussions underway that may see additional amendments introduced over the next few years—in particular, to further strengthen Australia's regulatory environment given the increasing complexity of products and ease of global capital mobility, and to enhance Australia's position as a significant investment and trading hub in the Asia-Pacific region.

In my view, there are still three main areas that need examination. They are: potential conflicts of interest; size and resources of promoters; and complexity of investment products now being offered. In Australia, managers have the option of becoming RE of their funds themselves, or appointing a specialist external RE.

Larger managers with more extensive control environments and resource capabilities clearly have no problems managing the two roles internally, with their compliance teams completely separated from those handling the money.

However, problems can occur, and clearly have, when the people handling the money also run the RE function.

Unlike large financial institutions, small managers generally do not have adequate capabilities to establish and resource an effective in-house RE separately from those who manage the money. They are therefore more likely to become conflicted.

The answer, to me, must be to ensure that smaller fund managers that cannot resource a completely separate RE function are obliged to use an external RE.

Benefits of external responsible entities

External REs provide greater independence to the fund management value chain. They are also more likely to have stronger policies and processes to perform appropriate due diligence on potential investors and service providers so as to ensure that parties that evoke suspicion are avoided—another level of investor protection.

It only requires a relatively simple change to existing definitions in the regulations to define whether a manager is 'large' or 'small', and the latter to seek out the assistance of an external RE.

This should improve compliance and investor protection and remove the conflicts of interest that have been exposed with some in-house REs. In addition, the RE regime has benefited overseas fund managers and promoters through the reduced compliance burden of setting up their own compliance framework in Australia to meet local regulatory requirements. Overseas fund managers' operational risks and business costs can be reduced through the economies that are typically available from working within the RE's established and active compliance framework.

In summary

Specialist companies offering independent RE services, such as Equity Trustees, have processes and due diligence approaches in place which allow them to say 'no' to some of the entities wanting to set up an investment vehicle in Australia, such as Bernie Madoff and other overseas entities that have since collapsed.

Investment managers considering setting up operations in Australia should make sure they have fully considered the implications of the RE regime on their business, and have considered how best to manage the compliance, regulatory and management undertakings required of them.

To the **Point**:

- Australia has not been immune from the challenges caused by the 'North American credit crunch' and subsequent market impacts
- Regulators continue to seek ways to improve investor protection, placing a higher level of regulation on asset management companies operating in Australia
- An understanding of these requirements, as well as how they are likely to change over the next few years, is vital for any fund managers considering expanding into Australia

Cross-border master-feeder structures

A way of adapting your product development strategy to new market challenges

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This article is aimed at giving you some insight into the use of cross-border master-feeder structures, which have so far prompted a mixed response from market players

Time to streamline

Since the introduction of UCITS IV in July 2011, the asset managers have spent their time and effort producing Key Investor Information Documents (KIIDs) and adapting their risk management processes to comply with the 'requirements' side of the directive.

This first step was heavy and costly, but unavoidable. It did not leave much room to look at the opportunities offered by the regulation (management company passport, cross-border merger and master-feeder structures). Indeed, the european industry is facing challenges: margins are continuing to decrease, competitiveness is becoming fiercer—making it a good time to improve the cost/income ratio of the product ranges, and to have fewer and larger portfolios to manage, as it is the case in the U.S. market.

Streamlining projects are now emerging everywhere, mainly with the aim of reducing costs, optimising fund management (i.e. to avoid having two funds with the same investment strategy) and having a coherent range of funds available.

Cross-border structure is an appealing solution for asset managers to streamline their existing product range and generate economies of scale.

This article is aimed at giving you some insight into the use of cross-border master-feeder structures, which have so far prompted a mixed response from market players.

When are master-feeder structures appropriate?

Investment managers who have ranges in several countries may have products with similar or even the same strategies. To achieve cost reductions, two such funds could be merged, or a master-feeder structure could be created. To achieve vehicle reduction, a cross-border merger could be more efficient, but in this case, investors of the merging fund would have to accept that their investment has moved to a different country and vehicle, which may have different conditions and characteristics. Given many drawbacks for investors, the master-feeder structure may be an appropriate solution.

Let's take as an example a French SICAV invested in by an insurance company. Merging the SICAV in another SICAV based in another country, means that insurer will have to change the name of the funds in all insurance-linked contracts, which may create complexity, cost and risk for the insurance company to implement the change and does not show immediate benefit for the insurer. On the contrary, a master-feeder structure, will not create any system impact for the insurance company as the investor's contract is linked to the future feeder investment fund.

In other words, one of the very first steps when streamlining is under consideration is to analyse the impact on the client. In most cases, there is a lesser impact on the client when a master-feeder structure is created than with a merger.

Below, we give an example of what will change for an investor in a fund that is to become a feeder:

- The 'new' and 'old' prospectuses may not have the same wording to designate the same criteria in the investment strategy and the risk sections, so an amendment will be needed—though this can be explained in simple terms
- The feeder fund will no longer be eligible for funds of funds investment. Therefore the candidate to become a feeder must be analysed from a registrar angle, and the funds investing in it need to agree to transfer directly in the master or to redeem their positions
- There are some particular characteristics of certain countries that cannot be aligned. For example, a UK fund generally releases its NAV on the calculation day, with the cut-off and snapshot at midday. If the fund becomes a feeder of a Lux master fund, it will be impossible for the feeder to receive the master fund's NAV on the same day. In this specific example, investors will have to accept these new conditions or leave the fund

This shows that cultural aspects of the industry need to be taken into consideration too. A UK investor who only wants to invest in UK vehicles can use a feeder based in the UK that invests in a master fund based in a country with a international service level, i.e. a fund that offers wider distribution.

It is also important to remember that from an investor point of view a number of characteristics remain the same when a fund becomes a feeder fund. For example, the fund keeps the same name, ISIN code, track record, entry/exit fees, dividend distribution policy, cut-off, reporting (for which a look-through approach must be adopted), etc. It may therefore be the preferred solution for investment managers and their clients.

What benefits can be expected, are we creating concrete savings?

The first and immediate visible effect is the decrease of the asset servicing in the feeder fund. If the investment manager pays service providers, the decrease of the invoice will be quickly become apparent. In case of in-house asset servicing one can review, enhance and streamline its operating model concerning the feeder. Given the 15% liquidity, the feeder fund is composed of one security account (units or shares of the master) and one cash account. The feeder can then be operated with a light touch, e.g. placements from the feeder to the master can be automated and there will be a maximum of one transaction per day. The NAV can be controlled using a light approach—if the cash buffer remaining in the feeder is well established, the security line is already monitored as the master fund's price is based on a standard control setup.

In most cases, there is a lesser impact on the client when a master-feeder structure is created than with a merger

It may even be possible to remove the middle office function. The asset manager must consider whether a hands-on or hands-off approach is appropriate.

A hands-on approach means continuing to operate as if the feeder fund is a standard fund, with the same level of monitoring and control, as well as middle and front office access. A hands-off approach means the NAV is controlled because it derives from the control structure of the master, the cash buffer is controlled on a daily basis and the order placed from the feeder to the master is based on a set-up which takes into account remaining cash—in this case, no middle office function is needed, and no front office activity remains. The set-up needs to be well designed but the hands-off approach will bring major direct and indirect savings for the asset manager.

On the custody side, the workload—and therefore the associated costs—will be reduced, with a maximum of one transaction being settled each day, while custody of units or shares of a foreign fund cost less than direct line securities.

Nonetheless, the feeder's ongoing charges will not completely disappear. The fees can be aggregated at the level of the master, and at some point, some of the costs—which did not exist before—will be passed on to feeder investors. For example, if the master is in Luxembourg and the feeder is in France, French investors will have to pay of the Luxembourg subscription tax (*taxe d'abonnement*).

As for the indirect portion of the costs to be borne by feeder fund investors, given that in all cases the legal vehicle continues to exist, all the marketing and distribution costs also continue to exist—and therefore the time spent on such activities by the fund manager will be considerably reduced: the feeder funds clearly require less workload. This can become a source of efficiency real savings once the asset manager concentrates on one portfolio rather than duplicating the same strategy in several portfolios.

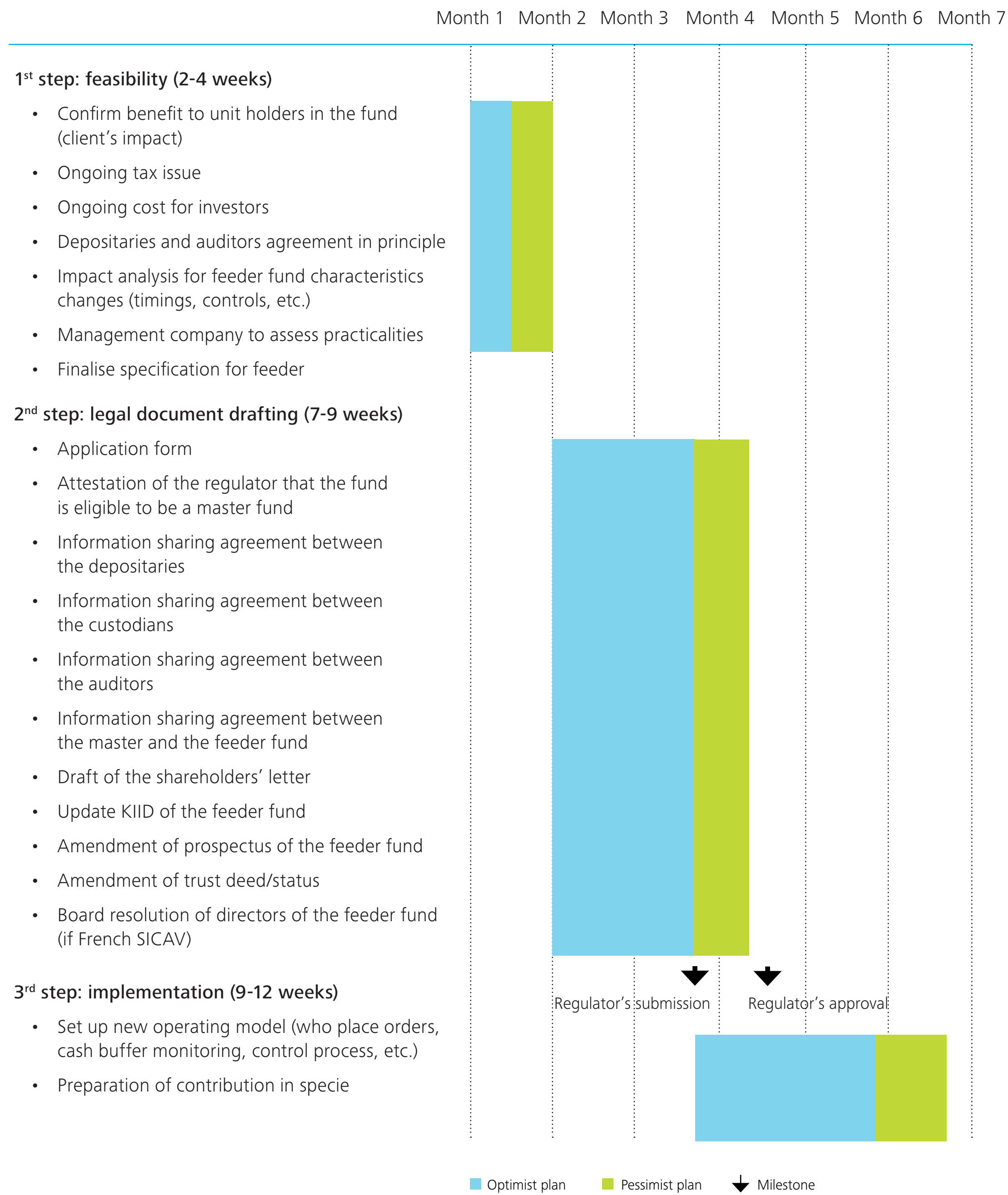
Before starting the implementation, let's have a look at the common operational issues

Master-feeder restructuring strategy: frequent operational issues

Regulatory/ legal	• Prepare master/feeder information sharing agreements and ensure both master and feeder meet UCITS IV requirements • Check if master/feeder rules and country laws allow contribution in kind, direct investments by the feeder in OTC derivatives, etc. • Ensure auditors and custodians agree on the information sharing policy • Define process to deal with different compliance constraints in master and feeder countries and report compliance breach • Compilation of the full regulatory package (different from one country to another)
Change management	• Transfer full investment decisions at the master level • Calculation and monitoring of the minimum cash buffer in the feeder • Management of the 15% liquidity pocket • Lighten the control process (even with the possibility to outsource or remove it) • New order routing process to automate the orders between feeder and master • Potential new distribution process
Other considerations	• Ensure that cut-off, valuation point, NAV release, settlement cycles and end-of-year closing are aligned or can be aligned between master and feeder • Determine if the feeder will invest in a 'no-load' or 'loaded' share class • Potential increase of ongoing charges of the feeder (depends on fee policy) • Ensure Forex management, in case master and feeder have different currencies • Funds invested in the feeder may invest directly in the master (potential revenue impact) • At conversion, ensure securities are priced on a same policy (mid/bid/ask) and apply swing pricing

Fees: when adding the master's administrative costs to the feeder's ongoing charges, the estimated ongoing charges of the feeder could increase. For commercial reason the asset manager has to work on the estimation of the ongoing charges for the feeder.

What needs to be done to implement a cross-border master-feeder structure?



** Assuming that both future master and feeder funds are existing funds*

Conclusion

Creating master-feeder structures can lead to major savings in the long term. Although at first sight it seems that the creation of such structures requires a significant effort, they can be applicable to the strategies of certain asset managers, which have a large fund range in various domicile and wish to limit the impact of their streamlining initiatives at the client level.

To the **Point**:

- The master-feeder can generate direct and indirect savings for asset managers
- The feeder's operating model can be enhanced and can become lighter
- Impact in client's side of a master-feeder is smoother than a merger
- Thanks to these portfolio structures master portfolios will become larger and will be sold more easily

The AIFMD
A regulatory directive with tax implications

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"If it moves, tax it. If it keeps moving, regulate it (...)" is a well-known quote by Ronald Reagan. This quote aptly describes the impact of the 2008 financial crisis on the financial sector (including the alternative investment fund industry), an industry which has become the subject of greater scepticism and scrutiny from public authorities, regulators and the political community[1].

The Alternative Investment Fund Managers Directive (AIFMD), which was adopted by the European Council on the 27 May 2011, is not a 'tax' directive per se, unlike the EU Parent-Subsidiary Directive[2], for example. However, in practice, the AIFMD will impact the business model of Alternative Investment Fund Managers ('AIFMs') by introducing a number of requirements or opportunities having a strong impact on their tax positions both on a domestic and cross-border basis. The European Commission also published on 19 December 2012 the level 2 regulation that will provide the basis for implementing the AIFMD across the EU.*

The AIFMD has not yet been implemented in the various domestic laws of the EU member states[3], even though discussions have begun in several countries.

** Please note that the European Parliament and Council of Ministers now have a 3 month period in which to object to the Commission's Regulation. As the level 2 regulation was issued simultaneously to the drafting of the present article, further details re. the level 2 measures were not included*

1. Substance considerations for AIFMs and capital requirements

Generally speaking, a company should be considered as 'tax resident' in a country where it has its statutory seat or its place of effective management. It means that a company might be tax resident only by virtue of its place of incorporation in some countries or circumstances.

Even though the concept of tax residency is not unique and differs from one country to the next, the AIFMD will set out a minimum level of substance for all management companies qualifying as AIFMs irrespective of the above.

The following specific substance conditions will indeed be required: a minimum level of capital[3], core functions[4] to be mandatorily performed by the AIFM and the need to have sufficient skilled human resources and technical competencies to carry out management activities.

These substance requirements combined with cross-border management opportunities (see next page) should encourage fund managers to re-think their business model and rationalise their cost structure (i.e. reduce the number of management companies similar to the UCITS environment) instead of duplicating compliance costs in multiple jurisdictions[5]. This potential trend could lead to the setting-up of management companies performing many functions loaded with a high level of substance and carrying a wide range of responsibilities potentially on a cross-border basis.

The tax environment offered by EU member states should play a major role in that respect.

1 *Cf. e.g. proposal for a Directive on a common system of Financial Transaction Tax (known as 'FTT') which is notably aimed at sharing the cost of the economic crisis with the financial sector*

2 *Directive 90/435/EEC dated 23 July 1990, as amended from time to time*

3 *Minimum capital of €125,000 plus, when the portfolio value exceeds €250 million, additional funds of 0.02% of the amount over €250 million with a €10 million cap*

4 *The investment and risk management functions will have to be provided by the AIFM in order to qualify as such*

5 *The cost related to the use of multiple management companies could however be balanced by other considerations*

2. Cross-border management of AIFs and delegation

Multiple questions are raised at the level of AIFMs with regard to the possibility to delegate some functions externally and to manage AIFs located in a foreign jurisdictions.

Cross-border management

Similar to what UCITS did for products and their management companies, an authorised AIFM established in a member state should be allowed to manage AIFs established in other EU member states or in third countries (directly or through a branch).

However, the AIFMD does not address tax impacts of cross-border management.

The management passport opportunities afforded by the AIFMD are likely to trigger taxation issues very similar to those experienced in the UCITS environment which could become (in practice) an obstacle to the effectiveness of the passport. For example, Luxembourg has attempted to address such issues in its draft law transposing the AIFMD (the 'Draft Law'[6]) by providing that AIFs established outside Luxembourg and which have their effective centre of management or central administration in Luxembourg should notbe considered as subject to Corporate Income Tax,Municipal Business Tax and Net Wealth Tax in Luxembourg[7].

A limited number of other member states implemented similar provisions for UCITS and it is not yet known whether AIFMD will be implemented in the other countries with such a similar tax-efficient provision. Whether Luxembourg AIFs managed by foreign AIFMs will benefit from the same favourable tax provisions in other countries is therefore still an open question.

From a Luxembourg perspective, such AIFs would continue to benefit from the Luxembourg tax regime[8] but the country where the AIFM is located might also claim the tax residency of the Luxembourg AIF[9]. Considering that each EU member state has its own tax system without harmonisation[10], such Luxembourg AIF would then be fully subject to the foreign corporate income tax regime, possibly without any exemption. This situation could also lead to adverse tax implications at investor[11] and investment level.

The Alternative Investment Fund Managers Directive is not a 'tax' directive per se

Simultaneously, it could also be anticipated that cross-border management would, under certain circumstances, trigger the recognition of a taxable presence (known as 'permanent establishment'[12]) where such an AIF is located and with respect to the revenue generated by the activities performed by the AIFM in that country.

Permanent representative

A non-EU AIFM wishing to perform marketing activities in the EU will be required to obtain authorisation in a member state of reference in the EU. It is this member state that will issue the AIFM's passport. The choice of member state of reference is not a free choice however. There are a number of selection criteria set out in the Directive based primarily on the locations of the AIFs and assets managed and/or where they are marketed. The AIFM must then appoint a legal representative in the member state of reference who acts as the contact person for investors, ESMA and the member states' competent authorities.

The legal representative must be sufficiently equipped to perform at least the compliance of the AIFM in the EU, which raises the question as to whether this will create a local taxable presence. At this stage, it is difficult to anticipate how such a concern will be dealt by the EU member states.

External delegation

The AIFMD also authorises the external delegation of some of its responsibilities to the AIFM (including core functions such as the investment management, as long as the AIFM does not become a letter box entity) thus raising not only tax residency or permanent establishment issues (see above) but also transfer pricing concerns.

6 *A draft transposition law was submitted to the Luxembourg Parliament in August 2012*

7 *A similar provision (article 179) is foreseen by the Law dated 17 December 2010 implementing the UCITS IV Directive*

8 *As an example, a SICAV would be still tax-exempt (but subject to subscription tax) and an FCP would also still be considered as tax transparent from a Luxembourg tax perspective. A SOPARFI qualifying as an AIF would still benefit, for example, from the parent-subsidiary Directive as implemented under Luxembourg law*

9 *The place of effective management is usually prevailing over the registration seat within an international context*

10 *The potential tax-exempt regime offered locally is generally offered only to domestic funds complying with purely national requirements*

11 *E.g. investors in a mutual fund could lose the benefit of the tax transparency of the fund or could be subject to taxation on unrealised gains*

12 *Generally, a permanent establishment is materialised where a company located in country A is carrying out non-ancillary activities through a fixed place of business in country B. This concept is defined by the OECD model convention and gives rise to much case law throughout the world*

Transfer pricing

Since the financial crisis, EU tax authorities have, generally speaking, become more sensitive with respect to the pricing of services between related entities established in different member states. This has led to them challenging transactions from a transfer pricing perspective, arguing that the pricing results in an artificial transfer of profit to a low-tax jurisdiction.

Similar challenges could arise for alternative investment funds especially if the AIF itself, the AIFM and the delegated entity are located in three different countries all claiming the right to tax a certain share of the management fees. In some circumstances, the fee structure would potentially have to be justified by transfer pricing studies.

VAT

From a VAT perspective one of the key questions is whether an AIF will be eligible to the fund management VAT exemption in the different EU member states.

The VAT aspects will generally need to be carefully monitored in a context where the cross-border flows of services will significantly increase.

3. Carried-interest

The AIFMD also affects the remuneration policy of AIFMs, which policy should now be consistent with effective risk management and do not encourage inappropriate risk-taking.

To achieve this result, the AIFMD and the Draft Law state, inter alia, that at least 40% of the variable remuneration should be deferred over the life-cycle and redemption period of the AIF and (ii) at least 50%[13] of the variable remuneration shall consist of shares/units in the AIF or other types of instruments linked to shares/ units in the AIF.

The definition of variable remuneration is still subject to many discussions at domestic and EU levels[14]. In the absence of a definite position, the related tax implications in all EU member states remain difficult to assess.

A non-EU AIFM wishing to perform marketing activities in the EU will be required to obtain authorisation in a member state of reference in the EU

13 There are exceptions where this threshold is not applicable

14 In particular, on 25 September 2012, the European Securities and Markets Authority (ESMA) held an open hearing on the consultation paper on the proposed remuneration guidelines for AIFMs released on 28 June 2012

4. Migration of offshore funds or management activities to the EU

Although no significant trend has yet been identified, the level of compliance stipulated by the AIFMD for non-EU AIFs distributed within the EU could lead to the migration of some offshore AIFs to onshore jurisdictions.

In general, there are multiple migration techniques, such as: the transfer of domicile of an offshore fund with the continuity of legal personality; the contribution of the assets and liabilities of an offshore fund to a new onshore fund followed by the liquidation of the former and the merger of an offshore fund with an onshore fund.

These migration possibilities involve different levels of complexity and/or tax implications depending on the EU Member States at stake and are sometimes only feasible for corporate funds.

5. Conclusion

We expect that asset managers will closely monitor how AIFMD will be implemented in the coming months under domestic laws.

The tax regime applicable locally and on a cross-border basis both to the AIFs and the AIFMs should impact the business models of a number of fund managers and create relocation opportunities.

It is not certain that all member states will propose a tax-efficient response to the alternative fund industry, which is viewed with suspicion.

The tax regime applicable locally and on a cross-border basis both to the AIFs and the AIFMs should impact the business models of a number of fund managers and create relocation opportunities

To the **Point**:

- The AIFMD is not a tax directive
- It will, however, be introducing a number of requirements or opportunities for AIF and AIFM that should greatly impact their tax positions both on a domestic and cross-border basis
- It is not certain that all member states will propose a tax-efficient environment to the alternative fund industry impacted by the AIFMD, thus creating relocation opportunities

Reclaiming withholding tax in France
Operational difficulties

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Continuing along the same lines of the Aberdeen case law, the Court of Justice of the European Union (CJEU) confirmed on 10 May 2012 in their Santander decision that withholding tax levied in France on dividends paid to non-French investment funds was discriminatory[1]. This was the main piece of good tax news in France in 2012!

This means, of course, that asset managers have an opportunity to reclaim tax overpaid in France and throughout Europe. Although statutes of limitation may vary among member states, several years of overpaid withholding tax can still be claimed in about 13 countries across Europe for both European and non-European funds.

In France, withholding tax levied since 1 January 2009 can potentially be reclaimed. It is, of course, important that all reclaims are filed with the French tax authorities before this window of opportunity closes.

Further to the Santander case, the legislation was amended so that dividends paid to non-French investment funds after 17 August 2012 would be exempt.

France is now compliant. Or at least its legislation is. A practical problem remains: how do you actually apply the exemption and how do you reclaim?

The 'exemption at source' process has not been updated and therefore administrators and custodians are at a loss in terms of putting in place a process that would allow them to pay their investors the full French dividend. Regarding the reclaims, there was no

1 See Performance issue 9

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information on what type of evidence and documents would be required by the tax authorities in order to process the claims. Or rather, that is until now. A few days ago, the French tax authorities communicated information on the reclaim process though a letter sent to some non-French investment funds that have already filed reclaims, and their French tax advisers. These elements should soon be issued as official administrative guidelines (not published as we go to print).

In the meantime, a quick overview of what the tax authorities would be looking for in order to support the reclaims is set out below. The paperwork and administrative burden of the reclaim may prove great. There is no doubt that the format of the reclaims will be as important as their substance. The tax authorities appear keen to reject any claims that do not meet the very prescriptive formal requirements.

In this unofficial communication, the French Tax Authorities (FTA) have provided guidance on the information and documentation required to support withholding tax reclaims:

- Relatively vague comments on elements supporting the comparability of foreign investment funds with similar French UCITS-compliant funds
- Very detailed information on documentation (on both the content and format of the documents) evidencing payment of the withholding taxes for which a refund is being reclaimed

Elements supporting the comparability

The situation of EU UCITS and non-UCITS, as well as non-EU investment funds is addressed with examples of acceptable documentation to support the comparability.

EU UCITS should be considered comparable as long as a proof of authorisation can be provided (certificate from the regulatory authority or stamped prospectus).

Non-authorised EU UCITS should also be treated as comparable if it can be proved that they are structured in a similar way to a UCITS IV compliant fund.

This can be evidenced through a number of factors (e.g. use of a custodian, manager, investor information and communication, risk spreading, no debt financing, redemption of units, etc.).

Non-EU funds also have to demonstrate that they are similar to a French investment fund. The same criteria as listed above can be used.

The lack of clear elements allowing objective comparability (as stated in the French Tax Authorities' document) is disappointing. Comparability is fundamentally the key factor in assessing whether a fund is entitled to a reclaim or not and in turn whether the reclaim may be viable.

France is now compliant. Or at least its legislation is. A practical problem remains: how do you actually apply the exemption and how do you reclaim?

The amended Law that provides for the exemption of dividends paid to foreign investment funds is just as vague with relatively loose criteria to follow. It will therefore be the responsibility of asset managers and advisers to gather as many comparable elements and present them in a way that demonstrates the comparability. This is certainly a flexible solution that may potentially allow a wider range of funds to apply. Nevertheless, some uncertainty remains regarding what will be accepted by the tax authorities and ultimately the French courts.

Evidence of payment

Once comparability is established, the funds need to produce proof of payment of the dividends and of the withholding tax and this is where the practical aspects of the reclaims may become tricky.

Supporting documentation may be needed from three main parties:

- The paying agent
- The (global) custodian
- The fund reclaiming the withholding tax

The type of documents needed may vary depending on the chain of intermediaries for each investment. However, the tax authorities consider the following scenario in their document:

Paying agent
A summary table or tax vouchers issued and stamped by the French paying agent must be provided.

This summary table should provide details on the dividend and withholding tax, including, inter alia, the name of the paying agent, the name of the beneficiary, the name of the distributing company, the gross and net amount of dividends, the rate of withholding tax, the total amount of withholding tax paid and a reference to form 2777 (potentially to be provided on a monthly basis).

Moreover, a document should be provided from the local paying agent confirming the net payment made to the global custodian and proving the filing of form 2777.

Global custodian/local custodian
In the event that the documents issued by the paying agent do not refer to the beneficiary, but to the global custodian, the global custodian will be required to produce documents to allow the tax authorities to reconcile the data provided by the paying agent in order to support the reclaims. In addition, payment advice to the beneficiary should also be produced.

Funds reclaiming the withholding tax
A summary table of the amounts reclaimed with relevant information on the dividends and any potential treaty reclaims already filed should be produced, as well as the information enabling the refund (e.g. bank details, etc.).

The tax authorities mentioned in their letter that a claim that does not include all of the necessary elements may be rejected.

Non-EU funds also have to demonstrate that they are similar to a French investment fund

Conclusion

According to this communication, the documents to be provided to the tax authorities will have to follow a very specific standardised format (some models provided by the tax authorities) and must be provided in electronic format, where possible.

It is clear from the approach adopted by the tax authorities that they will place an emphasis on the importance of the format of the reclaims and that they will use this as grounds to reject claims that do not meet the standards they have set. They will, however, need to ensure that the conditions they stipulate are not too stringent, as it could contravene the tax payer's rights under EU law and case law.

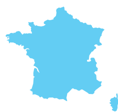
Finally, we also hope that in the official guidelines, guidance will be provided on the application of the 'exemption at source', otherwise the lack of efficient procedures in order to apply the law may be in breach of the EU principles.

To the **Point**:

- France has finally recognised that withholding tax (WHT) charged to foreign investment funds comparable to French investment funds was discriminatory
- Funds are entitled to 0% WHT since 17 August 2012
- The tax authorities are yet to issue official guidelines but have communicated further details on the supporting documentation required to process a WHT reclaim to a group of investors and their advisers
- The comparability test is still very vague which does not give much certainty to foreign funds that have or want to file a claim
- On the other hand, the tax authorities have been very specific on the documents they require to support the claim (in the content, origin and format). The volume of paperwork and administrative complications is not for the faint hearted, but should be worth it in the end
- Process to apply exemption at source that should have been applied from 17 August 2012 is still to be issued, which causes questions for custodians under pressure from their investors and asset managers' clients

France, Germany, Ireland, Luxembourg,
Netherlands, United Kingdom

This article mainly focuses on the amendments to regulations and fiscal consequences for the taxation of investment fund units held by investors in the respective jurisdictions. The amendments to the existing taxation rules for investment funds comprise of regulations which are aimed at fine-tuning the tax assessment provisions as well as correcting clerical errors in previous tax legislation and preparing amendments for future tax assessment periods.



France

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The second half of 2012 has seen a significant number of tax changes, though some of these have yet to be finalised as we go to print. We will have to wait until the final vote of the revised finance bill for 2012 and the 2013 budget to have the complete picture of what the new French tax landscape will look like. However, based on the changes that have already been introduced and the draft proposals under discussion, it is fair to say that there are tougher times ahead for the asset management industry in France.

Many of the tax updates for France focus on personal tax and are still being debated and modified as we go to print. Accordingly, these changes will be discussed and analysed in the next issue of Perform*ance*. Below, we set out a summary of the main changes made to the French tax landscape in the second half of 2012.

Financial Transaction Tax (FTT)

In 2011, Europe embarked on a race to implement a Financial Transaction Tax. As an agreement between the majority of EU member states was proving time-consuming and difficult to achieve, France decided to go ahead with the implementation of a local FTT while the European negotiations were ongoing.

The French FTT introduced on 1 August 2012 covers three types of transactions:

1. Acquisition of listed shares issued by French companies with a market capitalisation over €1 billion
2. CDS trading on EU sovereign debt
3. High frequency trading

The FTT rate on CDS and high frequency trading is 0.01%. These two areas have not been the priority concern of the industry, as they are limited to transactions entered into by French residents. However, the FTT on acquisitions of French listed shares has a much broader application and the rate is far higher, at 0.2%.

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Although the FTT is similar to the UK Stamp Duty Reserve Tax (SDRT), the mechanisms of taxation and collecting the tax are more complex. It is worth noting at this stage, that unlike with the EU proposal, the French tax applies solely to shares and equity instruments and does not include debt instruments or derivatives—unless they give rights to shares in a listed company covered by the FTT regulations. Whereas brokers are primarily concerned by this tax, it does also have an impact on custodians, asset managers and investors. Custodians are at the centre of the investment cycle and would be affected due to their role in the reporting process; in addition, they may be an 'accountable party' in OTC transactions.

It is particularly important for custodians to understand which trades are liable for the FTT and which are not, and to identify the transactions for which they could be the accountable party (e.g. OTC transactions executed without a broker). Furthermore, even if a custodian is not the accountable party, it will play a key role in the reporting and payment of the tax. The responsibility and obligations of custodians will differ depending on the transaction.

Although asset managers may not have to deal with the more cumbersome filing obligations, they will be affected by other aspects of the tax. In particular, they may want to make sure that any exemptions available are correctly applied. Lastly, investors will ultimately bear the cost of the FTT and therefore have an interest in ensuring that their asset managers are applying the rules appropriately.

Changes regarding dividends

- **Withholding tax reclaims and withholding tax exemption on dividends**

  One piece of good news for asset managers in France is that dividends paid by French companies to collective investment funds are exempt from withholding tax. This was established by the decision issued by the CJEU on the Santander case in May 2012[1].

  Asset managers will therefore have the opportunity to reclaim withholding tax paid in France and across Europe. Statutes of limitation may vary between member states; however, several years of withholding tax payments can still be reclaimed in some 13 countries across Europe for both European and non-European funds.

  The Santander case specifically ruled that there should be no discrimination between EU funds and non-EU funds. As a result, French withholding tax can be reclaimed on dividends paid from 1 January 2009. Reclaims should be submitted to the French tax authorities before the official deadline of 31 December 2014. It is however recommended that reclaims are filed as soon as possible.

  Further to the Santander case, French legislation was amended to comply with European law by extending exemption to dividends paid to non-French investment funds. As from 17 August 2012, dividends paid to collective investment schemes should not be subject to withholding tax. A letter containing further clarification of the reclaim process has recently been sent to certain investment funds and their French advisors (and should soon be reflected in guidelines issued by the French tax administration). In this letter, the tax authorities provide somewhat vague guidance on the comparability criteria and a very thorough description of the formal evidence to be produced in order to support the claims. However, there is no information on the application of the exemption going forward. In any event, on the basis of the law, any withholding paid by an investment fund (UCITS or equivalent) after 17 August should be refunded.

- **3% surtax on distribution**

  The response to the withholding tax exemption on dividends paid to investment funds was the introduction of a 3% surtax on distributing companies subject to corporate income tax. This surtax applies to dividends and deemed dividends (for tax purposes) paid from 17 August 2012.

  This is not a withholding tax, and is therefore not discriminatory for EU purposes. It is borne by the company making the distribution, and may affect the yield on investment in French companies.

1 *See Performance issue 9*

One piece of good news for asset managers in France is that dividends paid by French companies to collective investment funds are exempt from withholding tax

Germany

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Following the postponement of a major reform to Germany's Investment Tax Law, the Finance Committee of the upper house of parliament has proposed changes to the Annual Tax Law. The Finance Committee made recommendations for various amendments during consultations on the draft of the 2013 Annual Tax Act during June and July 2012.

At the time of writing (beginning December 2012), none of the proposed amendments to the Investment Tax Law have made it into the 2013 draft Annual Tax Act. Given that this is a provisional stage of the legislative procedure, it remains unclear whether the legislator will pursue all of the Finance Committee's recommendations. Some of the comments are merely in the form of a 'request for review' as to whether changes to existing legislation should be made. Nonetheless, the requested amendments are highly likely to come into force during the 2013 tax assessment period.

Proposed changes to the Investment Tax Law

Cost allocation

There is a request pending in relation to the allocation of 'general costs' for the purposes of German investment taxation. These are generally not directly attributable to a particular source of investment fund income. Under current rules, it is possible to allocate general costs predominantly to ordinary taxable ordinary income (e.g. dividends, interests) and thus reduce the investor's taxable deemed distributed income derived from fund investments.

According to the new rules, general costs would be allocated to taxable ordinary income as well as to capital gains. If the ordinary income and the sum of capital gains and losses are both negative, there is a fixed ratio of 50% for the allocation between ordinary income and capital gains. This means that the option to categorise 10% of the indirect costs as non-deductible expenses would be abolished. However, there will be no changes to the allocation of direct costs, i.e. costs that are directly attributable to a particular income source.

Mandatory source order to use fund income for distributions

The requested amendments include a mandatory order to use fund income for distributions to investors subject to taxation in Germany. Any distribution would be deemed to have been sourced from (1) all ordinary income and capital gains for the current or previous financial year if a distribution is made within four months from the financial year-end; (2) deemed distributed income
(i.e. ordinary income that has already been taxed) from previous financial years; (3) realised capital gains for previous financial years prior to 2004 (under KAGG or AuslInvG); or (4) substance.

The rule would be aimed primarily at restricting the ability of foreign investment funds to distribute substance, i.e. effectively repaying investor capital, even though the fund accumulates realised capital gains. A decree issued by the Ministry of Finance previously contained a related ruling.

Anti-abuse rules applicable to bond-stripping structures

There is a request pending to prevent certain structures involving the change in ownership rules of bond coupons, known as 'bond-stripping structures'. Until now, these structures have been used to generate taxable income from the disposal of stripped interest coupons at the fund level, which can be used as deemed distributed income to be offset against other losses of the investor and therefore avoid forfeiture of the investor's tax losses under the special regulations of the Corporate Income Tax Law. Future losses from the disposal of the fund units could be offset against other taxable income.

Tax exemption of dividends and capital gains

A possible change within the Corporate Income Tax Law regarding the tax exemption of dividends and capital gains for corporations will have implications for the Investment Tax Law as well. In the future, the 95% tax exemption for dividends and capital gains will only be applicable to shareholdings greater than 10%. This will also apply to fund investments. Thus the daily tax figure in relation to the equity gain for corporate investors might need to be adjusted.

The requested amendments are highly likely to come into force during the 2013 tax assessment period

Ireland

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Irish regulated funds in the form of corporate funds, unit trusts or an investment limited partnership are treated as tax opaque or tax 'look at' structures. These regulated funds do not pay tax in Ireland on their income and gains where the fund units are all held by non-Irish residents. For that reason, Irish regulated funds are commonly referred to as 'gross roll-up funds' because of this tax efficiency. The Irish Common Contractual Fund (CCF), which has been used for a number of years for asset pooling (including pension pooling) is the one Irish regulated fund structure that is recognised as tax transparent in both Ireland and in numerous jurisdictions around the world.

Many of the tax changes involving funds in the last few Irish Finance Acts have focused on ensuring that Ireland was ready for European legislation such as UCITS IV and the Alternative Investment Fund Managers Directive (AIFMD).

Irish regulated funds in the form of corporate funds, unit trusts or an investment limited partnership are treated as tax opaque or tax 'look at' structures

The main changes made to Irish tax legislation in 2012 are set out below.

Mergers: a clarification was introduced in Irish tax legislation such that in the case of a merger between an Irish fund and a 'good offshore fund[1], Irish investors are not deemed to have made a disposal of their units as a result of the merger. Instead, the new holding of shares or units in the merged entity is effectively treated as 'stepping into the shoes' of the old holding. In this way, it makes mergers under the UCITS framework tax neutral from the point of view of an Irish investor. Investors are taxed in Ireland when they dispose of those merged units, but with the cost for the purpose of calculating any gain being that of the 'old' units. For non-Irish investors, it was always the case that such investors were not taxed in Ireland on a merger scenario involving an Irish regulated fund. This is on the basis that such non-Irish investors have no tax liability in Ireland on any gains made on the disposal of their units/shares in Irish funds.

Reorganisations/amalgamations: Irish tax legislation was also amended to confirm that switching from one sub-fund to another sub-fund of the same umbrella is not a disposal for Irish tax purposes for an Irish investor in a good offshore fund. Legislation has been in place for several years which states that a switch between sub-funds of the same Irish umbrella is not a disposal for Irish tax purposes.

Master feeder structures: where assets are transferred from a good offshore fund to an Irish master, and in return the units in the Irish master fund are issued directly to the good offshore fund, the transfer of the assets can benefit from various reorganisation exemptions. While such stamp duty and direct tax exemptions already applied to situations where the units were issued directly to the investors in the fund, they have now been expanded to include cases in which the units are issued to the good offshore fund. The effect of the above changes on Irish tax legislation was to further enhance the Irish tax framework, so that fund groups can restructure and reorganise their fund offerings in a tax-efficient way from both an investor and a fund perspective.

One change signalled this year—which is still a work in progress—concerns a new corporate structure for the funds industry which will meet the US 'check-the-box' tax requirements. The Minister for Finance has approved in principle the regulatory proposals for this new structure, and part of this initiative will also see the introduction of accompanying tax legislation. The intention of the Irish funds industry is that this new corporate structure will be in place before AIFMD comes into effect in July 2013. To date, much of the preparation and groundwork for the tax changes needed for the implementation of AIFMD has already been completed in the last few Finance Acts.
The annual Irish Finance Bill is expected in the first quarter of 2013, so it will be interesting to see what further changes or enhancements are made to tax legislation for funds at that time.

1 A fund regulated to an equivalent level of an Irish fund and tax resident in the EU or in a country with which Ireland has a double taxation treaty

Luxembourg

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In Luxembourg the transposition process for AIFMD started last summer.

The government, having consulted with various working groups and industry bodies, drafted a law and submitted it to the Luxembourg parliament on 24 August 2012. The parliament must review, discuss and—if necessary—modify this draft before it can be approved. Adoption of this law would strengthen Luxembourg's position as a fund centre, as achieved under UCITS, and help position it as a location of choice for alternative fund managers. The draft law includes the following fiscal measures:

- **Overhaul of the partnerships law, including creation of the 'special limited partnership'**
  The draft law proposes notable changes to the Law of 10 August 1915 on commercial companies, including:
  - A modernisation of the legal regime applicable to the common limited partnership (Société en Commandite Simple or SCS) based on practices developed over time and on the Anglo-Saxon partnership model, emphasising the broad principle of freedom of contract
  - The creation of a new vehicle—the special limited partnership (Société en Commandite Spéciale or SCSp)—which is in most aspects similar to the SCS regime but differs from the latter in its absence of legal personality. In addition to unregulated funds, it would also be possible for SIFs and SICARs to be set up in this new legal form
  - Amendment of the law on the partnerships limited by shares (Société en Commandite par Actions or SCA)

From a tax standpoint, a key measure of the draft law consists of an amendment of the income tax law and municipal business tax law to limit the application of the '*Geprägetheorie*' tax principle for SCS and SCSp to cases where at least one of the general partners is a Luxembourg capital company owning a minimum of 5% of the partnership interests in the SCS/SCSp. This measure would achieve full tax transparency, including for municipal business tax (unlike the current regime) for any new SCS/SCSp with the general partner below the 5% threshold (which is typically the case for an alternative investment fund) while preserving the possibility of benefiting from the *Geprägerechtsprechung* in some specific cases.

In Luxembourg the transposition process for AIFMD started last summer

- **Introduction of a new tax regime for carried interest**
  A key point of the draft law is the introduction of a temporary regime for the employees of AIF managers and of management companies of an AIF ('employees'). The income that employees derive from their right to share in the profits of the AIF will be taxed at a reduced rate (a maximum of 10.90%) under certain conditions. The regime will apply to employees who (i) transfer their residence to Luxembourg during the year the law enters into force or during one of the five following years, and who (ii) have neither been tax resident in Luxembourg nor subject to taxation on their professional income in Luxembourg during the five-year period preceding the year the law enters into force. Eligible employees will be able to benefit from this regime for 11 years from the year in which they take on the position in Luxembourg that entitles them to the carried interest.

  Moreover, the capital gains that the employees may derive from the sale/redemption of their shares/units of the AIF will be taxable according to the usual tax regime applicable to capital gains (i.e. exemption if the shareholding did not exceed 10% at any point during the five-year period prior to the sale, and the holding period exceeds six months). In addition to the advantages granted by its tax regime to highly-skilled workers (the two regimes have conditions in common), Luxembourg—which is a long-standing location for investment funds—will become a location of choice for fund managers as well. Whereas the tax regime for highly-skilled workers may already lead, on average, to yearly savings of personal income tax ranging from €40,000 to €50,000 for an executive whose compensation package is properly structured, this executive would also save around 30% tax on carried interest through the temporary regime.

- **Cross-border management of AIF**
  In a similar way to the arrangements for UCITS and as per the provisions of the AIFMD, the draft law provides that an authorised AIFM established in Luxembourg is allowed to manage AIFs established in other EU member states. From a tax viewpoint, these cross-border management services should not create any management and control issues, since the draft law specifically exempts from tax cludes the subjection to Luxembourg tax of these AIFs established outside Luxembourg but with their central administration or management in Luxembourg.

Netherlands

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Finnish investment funds entitled to full refund of Dutch withholding tax?

The Court of Appeal in Den Bosch has decided that a Finnish investment fund was entitled to a refund of the Dutch withholding tax deducted on portfolio dividends. The investment fund is exempt from taxation on profits in Finland. As a result, the Dutch withholding tax could not be credited. A request for a refund was denied by the Dutch tax authorities. However, the Court of Appeal considered that the situation of the Finnish investment fund was comparable to the domestic situation of exempt corporations which are entitled to a refund of Dutch withholding tax on dividends. The court therefore reached the decision that the denial of a refund infringed the free movement of capital. The case is currently pending before the Hoge Raad, which is the highest tax court in the Netherlands.

Dutch and U.S. tax authorities reach agreement on FGRs

The Dutch and U.S. tax authorities have entered into an agreement with regard to the tax treatment of Dutch FGRs (fund for joint account or besloten fonds voor gemene rekening). The authorities have agreed that the FGR is not the beneficiary of the income. Instead, the income is (proportionately) considered to be that of the participants in the FGR. This is good news for beneficiaries who are entitled to a reduced tax rate or exemption from withholding tax under a tax treaty or national tax law in the United States.

The Netherlands has previously reached similar agreements with Canada, Denmark, Norway and the UK, whereas—without entering into an agreement—a similar understanding has been reached with Austria, Belgium, South Africa and Taiwan. Moreover, the most recent Dutch tax treaties, such as those with Ethiopia (2012), Germany (2012), Japan and Switzerland, contain a specific clause about the treatment of tax transparent entities (e.g. FGRs).

The implementation of the AIFM Directive is entering its final phase. It is currently pending before the Dutch Senate

Full refund of Dutch withholding tax on distributions by FBIs

The Dutch FBI (fiscal investment institution or *fiscale beleggingsinstelling*) is widely favoured for investments in equity and real estate, whereas it is also used for funds that make use of a high dividend policy. In addition, FBIs are entitled to a payment reduction for any Dutch dividend withholding tax and foreign withholding taxes on dividend and interest. Any distributions by a FBI are subject to dividend withholding tax. The 2013 Budget Law includes a proposal for withholding tax to be fully refundable in at least EEA situations if the beneficiary of the dividend is exempt from taxation on profits and would also be exempt from tax if a resident of the Netherlands.

FATCA: Netherlands negotiates an intergovernmental agreement with the U.S.

At the time of writing, the Netherlands was in negotiations with the United States on an intergovernmental agreement that would provide for a government-to-government approach regarding the exchange of information under the U.S. Foreign Account Tax Compliance Act. An advantage of the 'government-to-government approach' is the lower administrative cost for financial institutions in the Netherlands. Financial institutions would not have to enter into individual agreements with the IRS. Instead, the exchange of information would take place via the Dutch tax authorities in accordance with new national legislation.

The Netherlands is among the first countries to implement the AIFM Directive

The implementation of the AIFM Directive is entering its final phase. It is currently pending before the Dutch Senate. The proposed legislation stipulates that an alternative investment fund is—for tax purposes—considered to be a resident of the country in which it is authorised. This provision would make it possible for Dutch management companies to take full advantage of the 'management company passport', which ensures that the licence granted by the management company's residence state is valid in the entire European Union. The proposed legislation avoids any discussion about the residence of alternative investment funds managed from a different member state to that in which the management company is established (the home state). Last year, a similar rule for UCITS was added to Dutch legislation.

United Kingdom

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UK tax transparent fund

The UK is in the process of introducing a tax transparent authorised contractual fund, designed to provide the UK investment management industry with a competitive alternative to European tax transparent funds such as the Luxembourg FCP or Irish CCF. There will be two possible legal forms of the UK authorised contractual vehicle: a co-ownership scheme (which will be transparent only for the purposes of income) and an authorised limited partnership (which will be transparent both for income and capital gains).

There are a number of expected uses of the UK authorised contractual fund:

- **Fund rationalisation**—one use of the fund would be to pool the assets held by multiple funds to achieve greater efficiencies and economies of scale in portfolio management

- **UCITS IV master funds**—UCITS IV permits cross-border master-feeder structures, which enable fund managers to offer a single portfolio of investments to different types of investors in multiple jurisdictions through different feeder funds. In order for the investors to be in the same tax position as they would have been if their feeder fund had held the underlying master fund's investments directly, the master fund needs to be tax transparent

- **Pooling for investors with favourable tax treaty benefits**—the fund will be attractive to investors who wish to obtain the benefits of a pooled fund but to retain their tax profile, such as favourable double taxation treaty benefits

- **Solvency II solution for life company reinsurance arrangements**—the fund may also offer an appropriate alternative to life company reinsurance arrangements to reduce/eliminate capital adequacy requirements under Solvency II (the fundamental review of the capital adequacy regime for the European insurance industry)

The UK authorised contractual fund is primarily designed to be UCITS-compliant, but it can also be established as a Non-UCITS Retail Scheme (NURS) or Qualified Investor Scheme (QIS). Indeed, given the nature of the expected uses of the fund detailed above, we might well see more UK contractual funds authorised as NURS and QIS.

The UK tax authorities consulted last year on the draft regulations to bring the vehicles into existence, and on the associated capital gains tax, stamp duty and VAT regulations required for their effective functioning. The final regulations should be laid this month and will come into force on 1 April 2013. As a result, fund providers should now begin assessing whether the UK authorised contractual funds might be an attractive option.

The final regulations should be laid this month and will come into force on 1 April 2013

Recent asset management regulatory changes in China

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In 2012, the financial regulatory bodies introduced a number of policies that in our view will have a significant impact on the asset management sector. In this issue, we will provide an overview of the important changes introduced by three of the most recent new regulations to be announced.

In late June, the People's Congress of China began to debate a draft of a revised version of the 'Law of the People's Republic of China on Funds for Investment in Securities'. The draft revision is an amendment to the law on the same subject that was introduced in 2003, and which has been used to regulate the fund industry in China since then.

Besides clarifying and amending parts of the existing law, the draft revision, as we see it, introduces the most significant changes in three areas: an expanded definition of securities; an increase in the number of legal forms for funds; and clearer guidance on effective operational controls for fund management companies.

Firstly, with regard to the expanded definition of securities—the draft revision defines 'securities' as including listed and unlisted equities shares, debt instruments, other securities and their derivatives. With this newly-expanded definition, private equity funds, venture capital funds, trusts, variable life insurance plans and broker collective asset management plans would all be covered by this regulatory framework, thus creating some overlap in terms of the regulatory scope of the China Banking Regulatory Commission (CBRC), the China Securities Regulatory Commission (CSRC), the China Insurance Regulatory Commission (CIRC) and the National Development and Reform Commission (NDRC). Each of the above-mentioned regulatory bodies regulates one or two of the products which are now included in the definition of securities, and would theoretically be regulated by the CSRC if the draft revision is adopted. This would also give fund management companies greater latitude in creating a more diversified product mix to attract investors instead of simple and straightforward listed equities and bonds.

Secondly, concerning the increase in the number of legal forms for funds—in addition to corporations, the draft revision introduces two further legal forms for funds, the 'board fund' and 'unlimited liability fund'. For board funds, members of the board would be responsible for the fund shareholders' general meetings and would oversee the execution of the resolutions passed at those general meetings. The board would also be responsible for supervising the fund's management and custodians.

Proposals for the replacement of fund managers or custodians would also be made by the board. For unlimited liability funds, the fund's manager or institutions which have a control relationship with the fund managers would bear the unlimited liabilities of the fund. In our opinion, the increased number of legal forms gives fund managers and investors more choice in balancing out the rights and obligations of each party when creating a new fund.

In late June, the People's Congress of China began to debate a draft of a revised version of the 'Law of the People's Republic of China on Funds for Investment in Securities'.

Thirdly, as regards clearer guidance on effective operational controls for fund management companies—a series of provisions have been proposed in relation to the operations of open-ended funds. For example, the majority shareholders of the fund management company cannot interfere with the operations of the fund in an inappropriate manner; and insider trading is strictly prohibited. These provisions also address whether an employee of the fund management company can engage in equity trading. According to the draft revision, with proper pre-clearance, an employee of a fund management company can trade equities on his/her own account, which was strictly prohibited prior to this draft revision.

Between July and October, the CIRC issued: *"Notice on Issues Related to Insurance Companies Investing Equity and Real Estate based on Tentative Measures for Equity Investment of Insurance Companies, Tentative Measures for Insurance Companies Investing Real Estate" and "Implementing Rules for the Tentative Measures on the Administration of Overseas Investment of Insurance Proceeds"* (referred to collectively below as 'the Notice'), and relaxed restrictions on insurance companies investing in private equity funds.

The Notice gives clear implementation guidance on the original rules, which were published in 2007 but rarely followed due to lack of implementation guidance. The Notice relaxes CIRC restrictions on insurance companies investing in private equity funds, which are mainly reflected in the following aspects:

1. **Investment threshold lowered for insurance companies**
   According to the Notice, investment in equities or real estate by insurance companies is no longer subject to regulations on profitability in the previous fiscal year, while the basic requirement for the net assets of the previous fiscal year has been reset at RMB 100 million and the threshold for the solvency adequacy ratio was redefined as a minimum of 120% in the previous quarter, meaning that more insurance companies will qualify for equity and real estate investment and therefore be licensed.

2. **Increased proportion of equity and real property by insurance companies**
   According to the Notice, insurance companies investing in unlisted companies or private equity funds—among other relevant financial products—may determine the investment mode at their own discretion, with a proportion of 10% of the company's total assets in the previous quarter rather than 5%.
   Here, the equity of insurance companies directly invested by the insurance company with its own funds must be excluded from the book value. Insurance companies investing in real estate (except for their own use), infrastructure credit investment plans and financial products related to real estate may determine their investment objective at their sole discretion, while the total book balance must not exceed 20% of the company's total assets in the previous quarter, indicating more financial flexibility for insurance companies in equity and real estate investment.

3. **Better structured capital requirements for GP**
   According to the Notice, for insurance companies investing in private equity funds, the capital requirement for GP is modified to a minimum of RMB 100 million in registered or committed capital. The notion of committed capital is added, with the consideration of the fact that partnerships are generally adopted by private equity firms.

4. **Further clarification on private equity fund types and investment objectives**
   According to the Notice, types of private equity funds invested in by insurance companies include growth capital funds, buyout funds, emerging strategic industry funds and funds of funds, with the above private equity fund as investment objective, where the investment objective of buyout funds may include publicly-traded shares but is limited to non-transaction transfers such as strategic investments, designated placements and block trades, while the scale of investment must not exceed 20% of the asset balance of such fund. The investment objective of emerging strategic industry funds may include financial service companies, senior citizen service companies, medicine and health companies, modern agricultural companies and construction and management companies of public rental or low-rent housing. It is stated in the Notice that buyout funds may invest in the secondary market and that insurance companies are allowed to invest in funds of funds.

In our opinion, the increased number of legal forms gives fund managers and investors more choice in balancing out the rights and obligations of each party when creating a new fund

5. **Clarification on the qualification of private equity firms**

   According to the Notice, for private equity funds invested in by insurance companies, the baseline requirement for a deal exit for private equity firms refers to the total number of deal exits where professionals of such institutions act as main players in the investment; and the balance of their managed assets refers to the balance of paid-in assets and capital in RMB in China, which means that the '3 billion' threshold has not been lowered this time.

6. **Regulations on overseas investment are further clarified**

   - Article 7—The private equity firms which launch and manage USD private equity funds that insurance companies invest in should meet the following requirements:
     - The paid-in capital or net assets should be no less than USD 15 million or an equivalent amount of other convertible currencies
     - Total private equity assets under management should be no less than USD 1 billion or an equivalent amount of other convertible currencies, with an outstanding track record and good reputation
   - Article 12—The overseas private equity funds that insurance companies invest in should meet the following requirements:

     Private equity funds

     The deals of private equity funds should be at the growth or maturity stage or have high M&A value. They are not limited to the countries and regions listed in Appendix 1. The committed capital should be no less than USD 300 million or an equivalent amount of other convertible currencies, and the paid-in capital should be in place in accordance with the prescribed contribution ratio.

They should have more than ten professionals with experience in private equity investment and relevant fields; at least two of the senior managers should have over eight years of work experience in relevant fields, comprehensive experience in fund-raising, management and exit, and have led at least five projects which have been successfully exited (excl. funds of funds); at least three of the professionals should have worked together for over three years; they should have a sophisticated governance structure, an efficient incentive and retention mechanism and an interest protection mechanism; they should have a Key Man Clause to ensure the exclusivity of the management team.

Insurance companies can also invest in funds of funds which have a portfolio of private equity funds that complies with the provisions of the preceding clause. The funds of funds should have a simple and clear structure and should not invest in other funds of funds.

Financial institutions or their subsidiaries should neither control the management and operation of such private equity funds, nor be the GPs of such private equity funds.

- Article 14—The outstanding balance of the overseas investments of insurance companies should not exceed 15% of the total assets as of the end of the previous year. For the overseas investments in emerging markets listed in Appendix 1, the outstanding balance should not exceed 10% of the total assets as of the end of the previous year.

Even though CIRC might take a more than cautious step towards the actual implementation and practice of the Notice, given the fact that insurance companies in China had approximately RMB 7 trillion in total assets as of Q3 2012, the Notice proved something of a surprise among asset managers in China, and gives foreign fund managers plenty to think about.

China's finance industry regulatory bodies have been urging the country's financial institutions to transform or grow their asset management businesses for a very long time now

In late October, the Shanghai Finance Administration Office of Shanghai Municipal Government introduced a pilot scheme called RMB Qualified Foreign Limited Partners (RQFLP). The RQFLP means that offshore investment institutions which hold RMB funds can directly establish a legal presence in Shanghai after being granted a QFLP licence.

The RQFLP scheme has several advantages: first, there is no limit on the amount of the investment (no quota); second, RMB cross-border flows under the RQFLP are regarded as foreign capital while there is no need for currency exchange (not subject to the SAFE quota for currency conversion); third, unlike with the RQFII programme, which only allows investments in the equity and bond markets, the RQFLP allows investments in unlisted companies, listed companies, non-publicly-traded equities, convertible bonds and industry funds.

China's finance industry regulatory bodies have been urging the country's financial institutions to transform or grow their asset management businesses for a very long time now. With the rapid introduction of new rules and regulations, which bring more institutional investors to the market, and clearer guidance on the operations and governance of the asset managers, we believe that asset management will become a vibrant sector in the capital markets arena in China.

Consolidated financial statements and the control concept

Ten discussion areas for investment managers

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The change to the definition of control introduced in IFRS 10, Consolidated Financial Statements {"IFRS 10"} is expected to have a significant effect on investment managers applying IFRS.

Managers may be required to consolidate certain investees for the first time or more entities may fall within the existing consolidation scope. This will not only have an impact on the financial reporting process but it will also affect how users of the financial statements such as regulators, finance providers and shareholders will understand and interpret these changes in the financial statements.

Investment managers will have to apply the more comprehensive scope and guidance in IFRS 10 when determining whether they control the entities they are involved with and consequently, whether they will need to consolidate those entities in their own financial statements. IFRS 10 supersedes the consolidation requirements in IAS 27, *Consolidated and Separate Financial Statements* ["IAS 27"] and SIC-12, *Consolidation—Special Purpose Entities* ["SIC-12"] (together, the 'current Standards') and is effective for annual periods beginning on or after 1 January 2013, with earlier application being permitted. For companies that prepare their financial statements in accordance with IFRSs as adopted by the European Union, the mandatory effective date of IFRS 10 is 1 January 2014 , although earlier application is permitted.

This article focuses on the practical challenges that will need to be addressed by investment managers when applying the new control definition in IFRS 10 and provides a number of examples that will assist them in the successful implementation of this Standard.

1. Background information on IFRS 10

IFRS 10 defines the principle of control and establishes control as the basis for determining which entities are to be consolidated. It addresses (a) the divergence that exists in practice when applying the control concept in the current Standards; (b) the perceived conflict of emphasis between IAS 27 (emphasis on the power to govern so as to obtain benefits) and SIC-12 (greater emphasis on risks and rewards); and (c) the lack of transparency that was highlighted during the financial crisis about the risks to which investors are exposed from their involvement with certain vehicles.

2. The control definition

An investment manager controls an investee if and only if it has all the following: (a) power over the investee; (b) rights or exposure to variable returns from involvement with the investee; and (c) the ability to use power over the investee to affect the amount of its returns.

The remainder of this article provides an explanation of each of these three elements and matters to consider in their application. For investment managers, the first two elements are relatively easy to assess and are more than likely to be met. However, more in-depth analysis and judgement is required in reaching a conclusion on the third element, which is particularly relevant to the investment management industry.

3. The purpose and design of the investee

When considering the purpose and design of an investee, the control assessment may be clear in cases where an investee is controlled by means of equity instruments that give the holder the majority voting rights. However in more complex cases an investee may be designed in a manner that voting rights relate only to administrative tasks and that relevant activities are directed through contractual arrangements. In such cases further consideration would need to be given to the risks to which the investee was designed to be exposed, the risks it was designed to pass on to the parties involved with it and the risks to which the investor is exposed.

4. The relevant activities of the investee

The control assessment is made by reference to an investee's relevant activities. Relevant activities are activities of the investee that significantly affect the investee's returns. Examples of relevant activities may include managing the underlying investments or obtaining financing.

5. An investment manager shall determine whether it has power over an investee

An investment manager has power over an investee when it has existing rights that give it the current ability to direct the investee's relevant activities.

For the purpose of assessing power, only substantive rights (that is, having the practical ability to exercise that right) shall be considered.

Factors that an investment manager will need to consider in determining whether rights are substantive include the following:

(a) Whether there are any barriers that prevent the holders from exercising their rights
(b) Whether a mechanism is in place that provides the holders with the practical ability to exercise their rights collectively
(c) Whether the holders would benefit from exercising their rights

Protective rights (that is, those rights that protect the interest of the holder), however, should not be considered.

6. An investment manager shall determine whether it has rights or exposure to variable returns from its involvement with the investee

An investment manager has these rights or exposures when its returns from its involvement have the potential to vary as a result of the investee's performance.

An investment manager's involvement will generally take the form of one or more of the following—a fixed percentage of management fees, performance fees, direct investments, loans receivable and obligations to provide credit support and guarantees with respect to the investee's performance. Thus, the determination of whether this condition is satisfied is likely to be fairly straightforward for investment managers.

(5) Examples

When other parties have the right to remove the investment manager but the right is exercisable only for breach of contract, then this right is not considered to be substantive.

When the investment manager can be removed from acting as manager of a fund by a simple majority of the fund's investors but a simple majority requires a large number of widely dispersed and unrelated third party investors to act together, then this right will not necessarily be considered to be substantive.

When the holder of these rights would benefit from exercising them by realising synergies with the investee, then these rights are likely to be substantive.

7. An investment manager shall determine whether it has the ability to use power over the investee to affect the amount of its returns

This step in the control assessment considers the interaction between the first two elements of the control definition and requires an investment manager to determine whether it acts as a principal or an agent. A significant element of judgement will sometimes be required in making this assessment.

An agent is a party primarily engaged to act on behalf and for the benefit of another party or parties (the principal(s)). An agent does not control an investee when it exercises decision-making rights delegated to it.

The investment manager is an agent if there is a single party that holds substantive rights to remove it without cause. In the absence of this, the investment manager has to consider the following factors in determining whether it is an agent or a principal:

(a) The scope of its decision-making authority over the investee

(b) The rights held by other parties (including the investee's board of directors (or other governing body))

(c) The remuneration to which it is entitled

(d) Its exposure to variability of returns from other interests that it holds in the investee

(7) Example
(extracted from Appendix B of IFRS 10)

An investee is created to purchase a portfolio of fixed rate asset-backed securities, funded by fixed rate debt instruments and equity instruments. The equity instruments are designed to provide first loss protection to the debt investors and receive any residual returns of the investee. On formation, the equity instruments represent 10% of the value of the assets purchased. The asset manager manages the active asset portfolio by making investment decisions within the parameters set out in the investee's prospectus. For those services, the asset manager receives a market-based fixed fee of 1% of assets under management and performance-related fees of 10% of profits if the investee's profits exceed a specified level. The fees are commensurate with the services provided. The asset manager holds 35% of the equity in the investee. The remaining 65% of the equity, and all the debt instruments, are held by a large number of widely dispersed unrelated third party investors. The asset manager can be removed, without cause, by a simple majority decision of the other investors.

Although operating within the parameters set out in the investee's prospectus, the asset manager has extensive decision-making rights that give it the current ability to direct the relevant activities of the investee. Therefore, it has power over the investee. The asset manager's fees and its equity interest expose the asset manager to variable returns from its involvement with the investee.

In the absence of a single party that holds substantive rights to remove the asset manager without cause, all the factors in IFRS 10 need to be considered in determining whether the asset manager is acting as a principal or whether he is acting as an agent. The combination of the asset manager's equity interest with the fees (despite these being commensurate with the services provided) creates exposure to variability of returns from the activities of the investee that is of such significance that it indicates that the asset manager is a principal. The removal rights held by the other investors receive little weighting in the analysis because those rights are held by a large number of widely dispersed investors. In this example, the asset manager places greater emphasis on its exposure to variability of returns of the investee from its equity interest, which indicates that the asset manager is a principal, and concludes that it controls the investee.

The weighting that is placed on these factors is based on the individual facts and circumstances. An investment manager may need to consider the following in making this assessment:

(a) The discretion that it has when making decisions

(b) The existence of substantive removal rights (kick-out rights) held by other parties

(c) The existence of rights held by other parties that restrict its discretion

(d) Whether its remuneration is commensurate with the services provided

(e) Whether the remuneration agreement includes only terms, conditions or amounts that are customarily present in arrangements for similar services and level of skills negotiated on an arm's length basis

(f) Whether it holds other interests in the investee

(g) The magnitude of, and variability associated with, its remuneration and other interests

(h) Whether its exposure to variability of returns is different from that of other investors and, if so, whether this might influence its actions

(7) Example
(extracted from Appendix B of IFRS 10)

A fund manager establishes markets and manages a fund that provides investment opportunities to a number of investors. The fund manager must make decisions in the best interests of all investors and in accordance with the fund's governing agreements. Nonetheless, the fund manager has wide decision-making discretion. The fund manager receives a market-based fee for its services equal to 1% of assets under management and 20% of all the fund's profits if a specified profit level is achieved. The fees are commensurate with the services provided. The fund manager also has a 20% pro rata investment in the fund, but does not have any obligation to fund losses beyond its 20% investment. The fund has a board of directors, all of whose members are independent of the fund manager and are appointed by the other investors. The board appoints the fund manager annually. If the board decided not to renew the fund manager's contract, the services performed by the fund manager could be performed by other managers in the industry.

Although the fund manager must make decisions in the best interests of all investors, the fund manager has extensive decision-making rights that give it the currrent ability to direct the relevant activities of the fund. Therefore, it has power over the investee.

The fund manager's fees and its 20% investment expose the fund manager to variable returns from its involvement with the investee.

In the absence of a single party that holds substantive rights to remove the fund manager without cause, all the factors in IFRS 10 need to be considered in determining whether the fund manager is acting as a principal or whether he is acting as an agent. The combination of the fund manager's 20% investment with the fees (despite these being commensurate with the services provided) creates exposure to variability of returns from the activities of the fund that is of such significance that it indicates that the fund manager is a principal. However, the investors have substantive rights to remove the fund manager through the board of directors, which indicates that the fund manager is an agent. In this example, the fund manager places greater emphasis on the substantive removal rights and concludes that it does not control the fund.

Investment managers will have to apply the more comprehensive scope and guidance in IFRS 10 when determining whether they control the entities they are involved with and consequently, whether they will need to consolidate those entities in their own financial statements

8. **An investment manager shall consider whether it treats a portion of an investee as a deemed separate entity and, if so, whether it controls the deemed separate entity.**

   A deemed separate entity is often called a 'silo'. In substance, all the assets, liabilities and equity of silos are ring-fenced from the overall investee. If the investment manager concludes that it controls a silo, then it treats that portion as a subsidiary in its consolidated financial statements.

(8) Examples

An investment manager is involved in a legal entity (a fund) which was established in a particular jurisdiction. The investment manager concludes that it does not control the legal entity. If the legal entity includes portions that meet the definition of a deemed separate entity, the investment manager will need to assess whether it controls one or more of these portions. As an example, the investment manager will need to consider whether certain sub-funds in an umbrella structure meet the definition of a deemed separate entity in IFRS 10. In making this assessment, the investment manager may need to consider the laws and regulations in the specific jurisdiction in which the legal entity is established.

9. **An investment manager shall reassess whether it controls an investee if facts and circumstances indicate that there are changes to one or more of the three elements of control.**

   Examples of such facts and circumstances include changes in decision-making rights, changes affecting the investment manager's rights or exposure to variable returns from its involvement with the investee and changes which indicate that the investment manager's status as a principal or an agent has changed.

10. **Investment managers will need to determine whether the exception to consolidation introduced by the October 2012 Amendment to IFRS 10, entitled Investment Entities, applies.**

    The Amendment defines an investment entity and introduces an exception to the principle that all subsidiaries shall be consolidated. The Amendment stipulates a requirement for a parent that meets the definition of an investment entity to measure its investments in particular subsidiaries at fair value through profit or loss. A parent that does not meet the definition of an investment entity would, however, be required to consolidate all of its subsidiaries, even if those subsidiaries meet the definition of an investment entity. The Amendment is effective for annual periods beginning on or after 1 January 2014, with earlier application being permitted.

To the **Point**:

- The change to the definition of control introduced in IFRS 10 is expected to have a significant effect on investment managers applying IFRS. Investment managers will have to apply this new definition when determining whether they control the entities they are involved with.
- An investment manager controls an investee when it has the following: (a) power over the investee; (b) exposure, or rights, to variable returns from involvement with the investee; and (c) the ability to use power over the investee to affect the amount of its returns
- The control assessment requires an understanding of the purpose and design of the investee and of its relevant activities
- Only substantive rights are taken into consideration when making this assessment; in other words, protective rights are disregarded
- An investment manager will need to apply the new guidance in IFRS 10 to determine whether it is acting as a principal or as an agent. Significant judgement may be required in making this assessment

Constant NAV money market funds under regulators' spotlight

Breaking or not breaking the buck; that is the question!

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Money Market Funds (MMFs) are investment funds whose investment objective is to provide investors with capital protection, a low-volatility return and daily liquidity. Typically, MMFs invest in a diversified portfolio comprising high-quality, short-duration instruments such as corporate commercial papers, floating rate notes, government bills and short-term deposits.

MMFs are viewed as a safe alternative investment to bank deposits and are often used by institutional and retail investors as a way to manage cash efficiently. MMFs offer investors a larger diversification than regular bank deposits and generate higher returns.

In terms of the broader economy, MMFs play a key role between corporates seeking funding sources and investors looking for investment opportunities. MMFs generate returns from the credit, maturity and liquidity mismatch between their assets and liabilities. Investors can redeem their investments on a daily basis while the time horizon of the investments is typically stated in months. In that respect, MMFs perform bank-like operations in that they play a maturity transformation role. Therefore, they are what are known as shadow banking players.

Two distinct forms of collective investment schemes exist for MMFs: the constant NAV (CNAV) and the variable NAV (VNAV). CNAV MMFs are marketed primarily in the U.S. and in some parts of Europe (mainly in the UK). In the U.S., MMFs are regulated under Rule 2a-7 of the Investment Company Act. CNAV MMFs are allowed to sell or redeem shares at a stable NAV, typically one dollar per share. They are also allowed to value their holdings using the amortised cost method or share price rounding method. In return for this accounting treatment, CNAV MMFs are required to comply with strict rules regarding the credit quality, liquidity, diversification and duration of the portfolio. Moreover, the Board of Directors of the fund must monitor any deviations in the value of the portfolio using the amortised cost and the market values of the portfolio holdings. The market values produced by the two methods must not differ significantly as existing shareholders may see their holdings diluted and redeeming/purchasing investors may be penalised.

As a bank-like business model, MMFs are inherently exposed to the following risks: credit, interest rate and liquidity risk

In contrast, a VNAV is a fund where the portfolio holdings are marked-to-market, i.e. valued at market prices, resulting in a fund price that fluctuates more compared to the amortised cost method. Another significant difference lies in the liquidity provided to investors: while VNAV offers T+1 liquidity, meaning that investors asking for redemption at T would be refunded on the next business day, the CNAV, in some jurisdictions, offers same-day liquidity, which enables investors to manage their MMF holdings with no discontinuity.

Long considered to be an investment with almost-zero volatility, the subprime crisis in 2007-2008 and the European debt crisis in 2011 revealed them to be not as safe as they were supposed to be. As a bank-like business model, MMFs are inherently exposed to the following risks: credit, interest rate and liquidity risk. During the subprime crisis in 2007, several MMFs marketed as ‘enhanced’ or ‘dynamic’ suffered significant losses on their underlying investments, resulting in sharp declines in Net Asset Value (NAV). This was mainly the result of investments in senior tranches of asset-backed securities backed by subprime mortgages which suffered greater-than-expected losses resulting in write-downs on the safest tranches. In some cases, bank sponsors provided financial support to the troubled MMFs by injecting cash to compensate for the losses or by purchasing certain troubled investments.

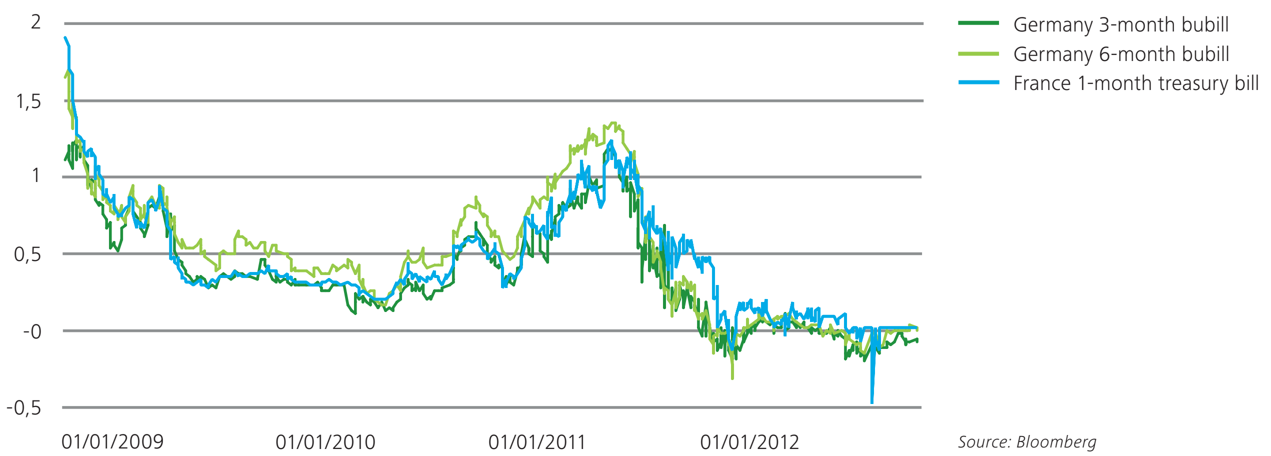
After the collapse of Lehman Brothers in October 2008, many MMFs faced liquidity issues. The liquidity problems appeared in two distinct ways. First, on the asset side, liquidity, i.e. investors' appetite for the assets held by MMFs, dried up. Bid-ask spreads widened significantly and selling certain securities at their fair price under pre-crisis standards was no longer possible without incurring a loss (e.g. slippage cost). For example, at the height of the crisis, the liquidity of floating rate notes issued by certain investment banks completely disappeared. Second, on the liability side, several MMFs faced greater-than-normal redemption requests. There was a 'flight to quality' (i.e. a sudden shift of assets to highly rated securities such as U.S. Treasury bills or German Bubills). As a result, several MMFs experienced a run, putting even more downward pressure on asset prices in an adverse feedback loop. Faced with heavy redemptions, combined with the impossibility of selling assets quickly to generate the required liquidity, several MMFs had to suspend redemptions.

The European sovereign debt crisis has highlighted another risk to which MMFs were exposed: interest rate risk

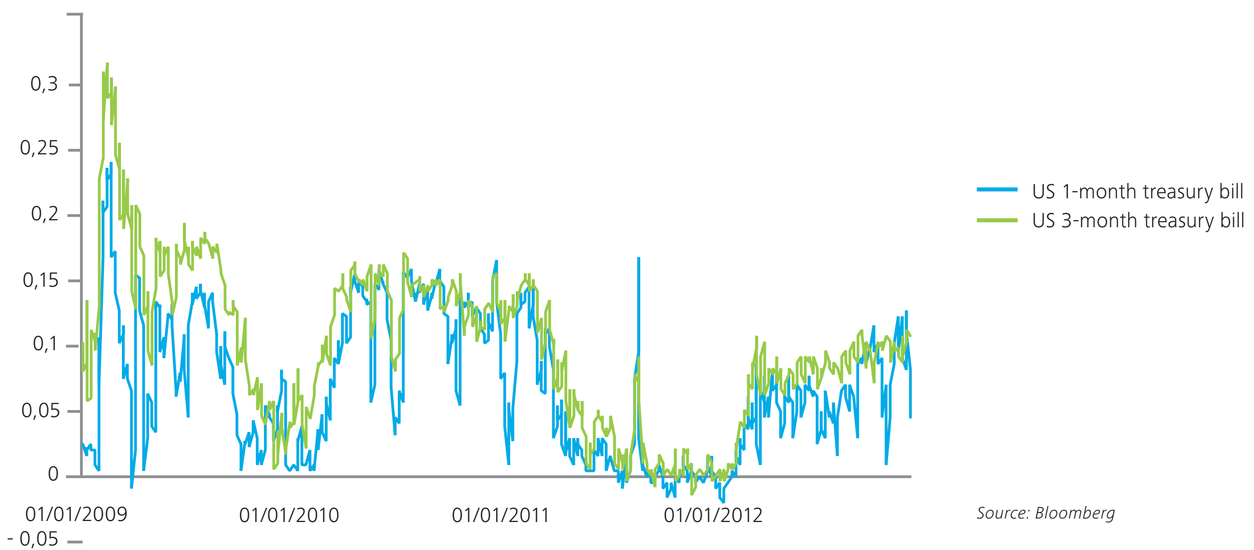
A prime example was the case of the 'Alpha' MMF, which was exposed to short-term debts issued by Lehman Brothers. After the collapse of the investment bank, the 'Alpha' MMF was forced to recognise a loss on its investment. As a result, the NAV went below one dollar a share (phenomenon known as 'breaking the buck'). On top of that, the contagion spread to other MMFs not exposed to Lehman Brothers. The fund was hit with massive redemption requests and had to suspend redemptions. One direct consequence of the run on several MMFs was the reduction in commercial paper holdings. These short-term securities, issued by corporates to finance their operating expenses, play a vital role for the economy. Suddenly, the market for commercial papers was shut down leaving many companies in financial distress.

The European sovereign debt crisis has highlighted another risk to which MMFs were exposed: interest rate risk. In an effort to boost the economy, the European Central Bank (ECB) slashed the interest rate on its deposit facility from 25 basis points to zero. In the turmoil of the EU sovereign debt crisis, investors dumped lower-rated government bonds such as Greece, Portugal, Italy, Spain and Ireland to buy higher-rated government bonds such as Germany, Netherlands and France in another 'flight to quality'. As a direct consequence, the yield offered on these short-term sovereign debts moved close to zero and sometimes even into negative territory (see graph 1). The same phenomenon could be observed in the U.S., where yields on treasury bills approached the zero mark (see graph 2).

Graph 1



Graph 2



As a result of extremely low or even negative short-term yields, generating positive returns became more and more difficult for MMFs after management and transaction fees were deducted

As a result of extremely low or even negative short-term yields, generating positive returns became more and more difficult for MMFs after management and transaction fees were deducted. Some MMFs chose to tackle this issue by taking on more credit and interest rate risk, lengthening their maturity profile and investing in lower-rated names. This issue was especially acute for CNAV MMFs as negative investment yields increased the risk of 'breaking the buck'. To mitigate this risk, several MMFs cut or waived their management fees to cover the losses. Some bank sponsors also chose to step in and inject cash to compensate investors.

These recent developments have shown the systemic risk that MMFs can pose to the broad economy. MMFs act as a channel between the financial markets and the so-called real economy by matching investors' liquidity supply and corporates' liquidity needs. A run on one MMF can trigger a run on other funds and could create a ripple-effect capable of toppling the entire financial system. This phenomenon is known as 'breaking in the link'. For that reason, the mutual fund industry and regulators are currently debating whether there is a need to reform MMFs to make them more resilient and less prone to runs.

In the next table we will review the regulatory environment of MMFs. More particularly we will draw a comparison between U.S. and European Union regulation in that respect; the latter decided to make a distinction between short MMF and MMF in order to protect the name MMF and reinforce investors' protection. Next, we will review the different options available to mitigate the risk posed to MMFs as suggested by the International Organisation of Securities Commissions (IOSCO), the worldwide umbrella group for securities regulators and other regulatory bodies.

Regulatory landscape

	Rule 2a-7	Short-term money market funds	Money market funds
Body	SEC	ESMA	ESMA
Maturity	• The weighted average maturity of the portfolio is limited to 60 days[1] • The maximum weighted average life[2] of any security is limited to 120 days • Individual securities (except for U.S. government floating rate securities) can have a maximum maturity of 397 days	• The weighted average maturity of the portfolio is limited to 60 days • The weighted average life of the portfolio is limited to 120 days • The residual maturity of any single security is limited to 397 days portfolio	• The weighted average maturity of the portfolio is limited to 6 months • The weighted average life of the portfolio is limited to 12 months • The residual maturity of any single security is limited to 2 years provided that the time remaining until the next interest rate reset date is less than or equal to 397 days
Credit quality	• Maximum 3% of assets invested in second-tier (i.e. A2/P2 rating) securities as rated by nationally recognised rating agencies • Maximum 0.50% of assets invested in second-tier securities of a single issuer • The maturity of second-tier securities may not exceed 45 days	• Requirement to invest in securities having one of the two highest short-term credit ratings awarded by a recognised rating agency • If the security is not rated, the securities should be of equivalent quality as determined by the management • Credit quality should be monitored on a regular basis and not only when the security is added to the	• Requirement to invest in securities having one of the two highest short-term credit ratings awarded by a recognised rating agency. As an exception to this principle, money market funds may hold sovereign issues rated at least investment grade by one or more recognised credit rating agencies • If the security is not rated, the securities should be of equivalent quality as determined by the management • Credit quality should be monitored on a regular basis and not only when the security is added to the portfolio
Liquidity	• Daily portfolio liquidity of 10% in liquid assets (i.e. cash, U.S. treasuries) • Weekly portfolio liquidity of 30% in liquid assets (i.e. cash, U.S. treasuries) • Maximum 5% of the portfolio in any single security as measured at the time of purchase	• The management company should consider the liquidity profile when making an investment decision. No specific guidelines are indicated	
Stress tests	• Requirement to stress test the ability of the fund to maintain a one-dollar NAV in the event of stressed scenarios related to the deterioration of the credit quality of the portfolio, larger-than-normal redemptions or a shift in the yield curve		
Other	• MMFs must make their holdings public on a monthly basis • Holdings must be available for at least six months after the date of publication	• Both Variable and Constant NAV are allowed	• Only Variable NAV is allowed

1 Weighted average maturity is calculated considering the reset date of a floating rate security

2 Weighted average life is calculated considering the final maturity of any security

Proposed solutions to tackle such drawbacks

In this section, we will review the different options available to mitigate the risk of CNAV MMFs breaking the buck. These were formulated by the IOSCO and other regulatory bodies. Where possible, we will point out potential caveats.

a) Mandatory move from constant NAV to variable NAV

The first solution proposed is to move from a constant NAV to a variable structure. It essentially boils down to forcing MMFs to value their portfolios at market value using mark-to-market accounting. Investors would therefore redeem/subscribe at a variable NAV instead of a fixed one-dollar NAV. Over time, this will reduce the sentiment of safety and demonstrate that MMFs are actually exposed to credit, interest rate and liquidity risks. It will raise investors' awareness that MMFs are not impervious to losses.

VNAV MMFs also reduce the shareholder's incentive to run when a fund has experienced a loss. A variable NAV provides price transparency as the NAV embeds the market value of the assets. As a result, it will reduce the 'first mover' advantage by forcing redeeming shareholders to redeem at a NAV that reflects current losses. This will prevent the transfer of losses to remaining shareholders.

> MMFs offer investors a larger diversification than regular bank deposits and generate higher returns

Many argue that the move to variable NAV could be detrimental to the investor's community. Some investors (e.g. pension funds) are legally prohibited from investing in non-constant NAV funds. The move from CNAV to VNAV would force them to shift their money to regular bank deposits. As a result these investors would lose the benefit of diversification that MMFs aim to achieve. This measure would actually create the opposite effect—increasing the exposure to financial institutions that, as history has shown, are never too big to fail.

The U.S. regulator, the Securities and Exchange Commission (SEC), looked into this mandatory move and eventually backed down in August 2012 due to internal disagreements on the matter, urging other policymakers such as the Financial Security Oversight Council (FSOC) to step in. Meanwhile, the SEC is considering further study of the industry and market impacts.

b) Creation of a NAV buffer and redemption restrictions

A second solution is to create a buffer to absorb losses and restrict the possibility of redeeming shares of the fund. A MMF would have to constitute a reserve by retaining a percentage of the income. To some extent, these reserves could be used to offset losses and thus prevent the NAV of CNAV MMFs from going below one dollar. Along with a capital buffer, restrictions on redemptions could be put in place. Redemption restrictions aim to mitigate the liquidity risk of MMFs. During times of stress, the fund would be allowed to suspend or 'gate' redemption requests.

Opponents to this measure have argued that restricting the liquidity of MMFs would defeat the objective of providing liquidity to retail and institutional investors. As a result, MMFs would no longer be considered as an efficient cash management tool.

After the collapse of Lehman Brothers in October 2008, many MMFs faced liquidity issues

c) Subscription suspension

A third possibility is to close the MMF to new subscriptions from investors. As a consequence, the manager would not have to invest in newly issued securities that offer lower yields than the assets already in the portfolio, something which dilutes the MMF yield and increases the probability of breaking the buck.

However, this approach could only be effective in the short term (until maturity of existing investments) and MMF managers would then face the same issue as today. Furthermore, from a commercial point of view, this may lead investors to consider moving to other managers.

d) Sponsorship

Another possibility would be for bank sponsors to make an explicit commitment to cover the losses and therefore guarantee that the fund does not break the buck. While this measure may appear to decrease the risk of the fund, it may actually increase it. The fund manager has less incentive to monitor the credit risk of the portfolio as he knows the fund will be bailed out if it suffers losses. This would introduce a 'moral hazard' issue where risk takers do not bear full responsibility for their investments. It would create an asymmetry where gains accrue to shareholders of the fund whiles losses accrue to shareholders of the bank sponsors.

However, regulators and in particular the European Systematic Risk Board (ESRB) are now reflecting on whether sponsor support for MMFs should be outlawed so as to prevent from risk spreading contagion to sponsors. A Moody's study highlighted that 62 MMFs in the U.S. and Europe were rescued by their sponsor during the financial crisis at a cost of US 12.1 billion.

e) Waiving of fees

As already discussed in the first part of this article, reducing or even waiving the management fees entirely would reduce the likelihood of breaking the buck. These management fees could be used as a buffer to absorb losses just like we explained above. One caveat of this solution is that even waiving the management fees completely may still not be enough to prevent the fund from breaking the buck. Indeed, looking at graphs 1 and 2, we can observe that yields on short-term treasuries of highly rated governments are in negative territory. This means that the performance of the fund is doomed to be negative irrespective of management fees.

In terms of the broader economy, MMFs play a key role between corporates seeking funding sources and investors looking for investment opportunities

f) Reverse split

Another solution could be to act on the number of outstanding shares of the fund in order to maintain a one-dollar NAV. By cancelling a certain number of outstanding shares (reverse split), the value of the NAV will mechanically increase. The proportion of shares to be cancelled for each investor would be directly linked to the yield the manager wants to compensate. For instance, a negative yield of -0.10% on the fund's assets could be compensated by the cancellation of 0.10% of outstanding shares, leaving the NAV price unchanged at 1 dollar per share. The reverse split is pure accounting artefact as no wealth is lost or created. Indeed, the total NAV remains unchanged.

However, careful attention needs to be paid when considering this solution as it may be in conflict with terms of the prospectus and/or articles of incorporation of the MMF.

To the **Point**:

- Money Market Funds (MMF) used to be seen as safe investments offering low volatility and interest risk combined with daily liquidity and credit diversification. Thus, they are a main part of so-called shadow banking activities; being less regulated (than banks) and may contribute to systemic risks
- They are under the spotlights of regulators; especially $1 (Constant NAV) MMFs as they appeared to poorly perform under current market environment, which combines low interest and greater credit risks leading such funds' managers to struggle in order to get positive performance and ultimately maintain stable NAV
- Several possibilities have been considered or could be envisaged to not 'break the buck' such as migrating to Variable NAV (facing strong opposition resulting in a step back from the SEC), suspending subscription to new investors (could be damageable from a commercial point of view), restricting redemptions (this will repudiate the liquidity characteristic of such funds) covering of losses by sponsors (EU regulators currently considering possible ban of this to prevent from contagion to banks), waiving of management fees (could not be sufficient to preserve the buck) or cancelling of existing shares (but losses are still suffered by investors)

AIFMD Level 2 Measures

The Level 2 Regulation, providing the detailed measures for compliance and the basis for implementing the AIFMD, was made public on 19 December 2012.

Key impact areas:

- Delegation of investment management functions 'to an extent that exceeds by a substantial margin the investment management functions performed by the AIFM itself' will be prohibited and qualitative criteria is provided to assess the extent of delegation. AIFMs will have to perform at least functions relating to either risk or portfolio management and be involved in the delegation decision-making process, as well as review existing delegation arrangements. ESMA is charged with ensuring a consistent application of the delegation criteria across EU member states
- Collateral, both received and pledged by the fund, will face new rules, falling into the depositary’s strict liability regime and some Prime Brokers becoming 'sub-custodians' as well as affecting their ability to re-use assets
- Concerning leverage, changes in calculation methodologies and investor information requirements will trigger additional leverage reporting

It is anticipated that the Commission will clarify in 2013 the transitional arrangements for compliance. AIFMD must be transposed nationally by 22 July 2013, while pre-existing AIFMs are required to submit an application for authorisation by 22 July 2014.

ESMA publishes its guidelines on ETFs and other UCITS issues

On 18 December 2012, ESMA published its guidelines on ETFs and other UCITS issues which introduce new risk management and transparency requirements for UCITS management companies and self-managed UCITS.

The purpose of these guidelines is to:

- Protect investors by providing guidance on information that should be communicated by 'index-tracking UCITS' such as their tracking techniques and associated risks, anticipated and realised tracking error level and leverage policy, and by 'UCITS ETFs' such as their portfolio composition, NAV calculation methodology, actively or passively managed status and treatment of secondary market investors
- Provide new guidance for UCITS on risk management and information disclosure requirements when entering into 'Total Return Swaps like' transactions and when using Efficient Portfolio Management techniques (EPM) such as securities lending and repurchase agreements
- Provide new guidance regarding management of collateral for OTC financial derivative transactions and EPM techniques such as eligibility, diversification, valuation and stress testing requirements
- Set out more stringent criteria that should be fulfilled by financial indices in order to be eligible, in particular regarding their diversification, transparency and valuation

These guidelines will apply immediately from 18 February 2013 for new UCITS while existing funds benefit of a grandfathering period of 12 months. However, any change in the prospectus, the KIID or any marketing communication occurring within the transitional period or any reinvestment of cash collateral would trigger the compliance with the relevant guidelines.

FSB recommendations on shadow banking: the way is paved for regulation

On 18 November 2012, the Financial Stability Board (FSB) published for consultation its initial recommendations to strengthen oversight and regulation of the shadow banking(*) system. The FSB focused its recommendations on spill-overs from the regular banking sector, mitigating systemic risks within the shadow banking sector, strengthening money market funds (MMFs) to limit possibility of 'runs', and dampening risks associated with securitisation, repos and securities lending.

The workstreams focusing the risks associated to MMFs and risks associated to securitisation are led by IOSCO which already published reports containing final policy recommendations in October and November 2012. IOSCO—endorsed by the FSB—recommends that stable NAV MMFs should be converted into floating NAV where workable or alternatively, safeguard should be introduced to improve resilience and ability to face important redemptions.

Regarding securities lending and repos, the FSB makes 13 recommendations—relating to enhancing disclosure and information-gathering by authorities, regulation and structure of the securities financing markets—and poses 22 questions for comment by mid-January 2013. Other areas for reform included enhanced capital requirements for banks exposed to the shadow banking sector and avoiding 'mechanistic reliance' on external credit ratings.

The FSB will, in September 2013, outline the progress of each workstream and provide final recommendations. It will then work on procedures to ensure that the policy recommendations are implemented appropriately.

(*) The "shadow banking system" is defined by the FSB as credit intermediation involving entities and activities outside the regular banking system, or non-bank credit intermediation in short.

EU finalises VC regime

The VC Regulation will allow managers of Venture Capital Funds (VCF) (known as 'VCF Managers') to raise capital freely throughout the EU from certain types of investors.

This is optional, and available to those who do not require authorisation under AIFMD, and may consider opting for this to benefit from marketing passport and a lighter touch Regime than AIFMD.

This regulation is only available to Managers for funds established in EU only, and total AUM do not exceed €500M.

To qualify VC Managers must ensure that VCF invest 70% of aggregate in qualifying investments (no leverage at fund level). However, short term borrowing and cash advances from investors are permitted. It is not intended for typical PE strategies, but does not impose any limitations on use of remaining 30% of capital.

VCFs only marketed to investors who possess relevant experience, knowledge and expertise to make their own investment decisions. Marketing is also permitted to investors who invest at least €100,000, provided they self-certify on awareness of the risks associated with such investments.

Regulatory obligations

- Reporting and disclosure
  - Service providers
  - Investment techniques
  - Pricing methodology
- Treat customers fairly with no preferential treatment
- Assets valued properly and calculated once a year
- Annual report mentions
  - Money and assets are in the name of the VCF and adequate records and controls were maintained
  - Details of profits made and distributed by the fund

Other benefits

- Assessment of investor not required
- Review period reduced from four years to two years
- No depository requirements
- Delegation permitted to third parties

ECJ Case follow-up : C–275/11 GfBk VAT exemption for investment advisory services for funds?

On 8 November 2012, the General Advocate Pedro Cruz Villalón published his opinion in the case C–275/11 GfBk Gesellschaft für Börsenkommunikation.

Dispute

This case focuses, in particular, on the possible application of VAT exemption for investment advisory services provided by GfBk to a company managing the respective fund. Within this role GfBk (i) advised in the management of a fund and (ii) constantly monitored the fund and made recommendations for the purchase and sale of fund assets. When advising the fund GfBk is also required to comply with the principles of risk diversification, statutory restrictions and investment restrictions.

The recommendations were communicated to the management company by phone, fax or over the internet. The management company, after checking whether they contravened any statutory limits, implemented them.

General Advocate's opinion

In his written opinion, the General Advocate (AG) summarised the conditions for VAT exemption of the management of funds within the meaning of the EU VAT Directive. Based on this the services provided by a third party manager 'must, viewed broadly, etc. form a distinct whole, and [be] specific to, and essential for, the management of those funds'. From this definition the AG derives certain criteria that have to be met in order to apply for the VAT exemption. This criteria includes (i) the specific function of the outsourced services for the management of the funds, (ii) the autonomy of the outsourced service and (iii) continuity of the service. From the perspective of the AG the first condition is met (i.e. investment advisory services are specific and essential for the management of investment funds) and it is up for the national court to decide whether the condition of autonomy and continuity is also fulfilled.

Furthermore, for the purpose of considering the VAT exemption for the management of funds it should not be relevant whether the outsourced services lead to a change in the financial and legal position of the fund. Considering how the background of the dispute is described, in our view, the AG is rather in favour of the VAT exemption of such investment advisory services (subject to the confirmation of the two characteristics of a VAT exempt management service) – even though not explicitly mentioned in the opinion.

We would like to emphasise that AG's opinion is used by the Court as a guidance and is not legally binding. The final decision of the Court should come in the beginning of the year 2013.

Link'n Learn 2013

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

Agenda

17-Jan Introduction to hedge funds

24-Jan Introduction to private equity funds

28-Jan Introduction to derivative instruments (part 1)

31-Jan EURO: preparing 'What if?' scenarios

04-Feb Introduction to derivative instruments (part 2)

18-Feb Transactions cycles and net asset value calculations

25-Feb The fund registration process (r)evolution after the KIIDs – practical lessons learned & best practices

28-Feb MiFID II

14-Mar Evolution of the custody framework: a focus on target 2 securities and UCITS V

21-Mar EMIR

08-Apr Introduction to Islamic Funds

11-Apr Risk and capital from Basel II to Basel III

22-Apr Introduction to asset management and portfolio investment techniques

25-Apr Share class FX hedging

29-Apr Introduction to risk management (1/2): principles, concepts & techniques

02-May Introduction to risk management (2/2): investment funds

06-May Evolution and latest developments on UCITS funds regulation

16-May Session AIFMD (1/4): introduction, general principles

06-Jun AIFMD (2/4): focus on direct & indirect tax aspects of the implementation of AIFMD

13-Jun AIFMD (3/4): focus on level II measures – ManCos, delegation, valuation ad remuneration

20-Jun AIFMD (4/4): custodian responsibilities – latest developments based on AIFMD and UCITS V

24-Jun Tips to succeed in FATCA implementation

23-Sep Introduction and latest updates to ETFs and Index tracker funds

26-Sep Impacts of Basel II – III and Solvency II for the asset management

14-Oct Introduction to IFRS for funds

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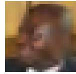

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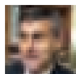

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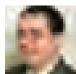

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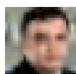

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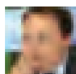

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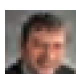

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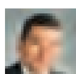

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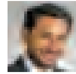

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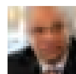

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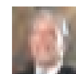

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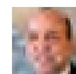

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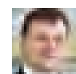

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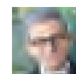

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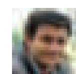

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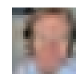

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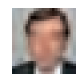

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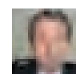

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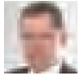

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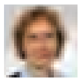

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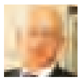

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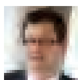

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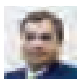

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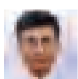

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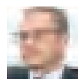

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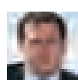

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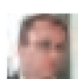

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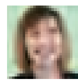

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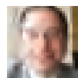

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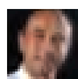

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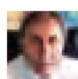

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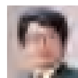

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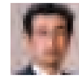

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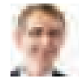

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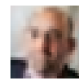

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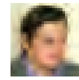

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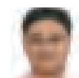

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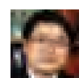

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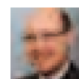

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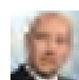

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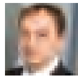

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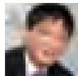

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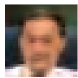

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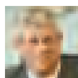

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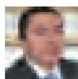

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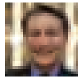

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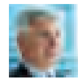

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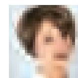

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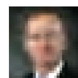

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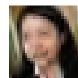

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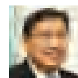

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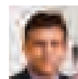

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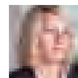

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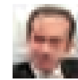

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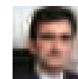

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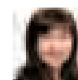

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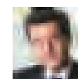

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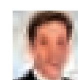

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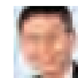

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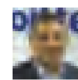

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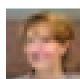
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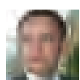
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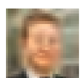
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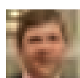
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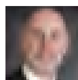
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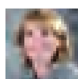
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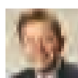
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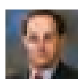
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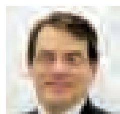

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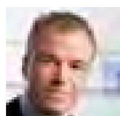

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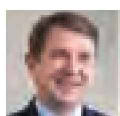

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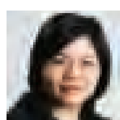

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