

# Performance

A quarterly topical digest for asset management professionals, issue 2, April 2010



## Market buzz

A short summary of cross border distribution of collective investment schemes in the United States

The introduction of an extended Qualified Intermediary program: what is the impact for the fund industry?

## External perspective

ETF - A trillion dollar baby

Current securities lending market themes

Applying multi-boutique strategies in the quest for alpha

UCITS: the battle for Asia

## Tax perspective

Sunshine on the distressed debt market

Emerging countries tax constraints: or why you should pay attention to our tax news alerts

## Regulatory angle

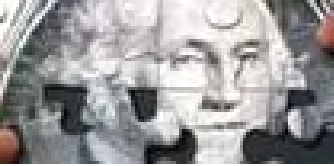
Investment funds: liquidity risk and the supply-&-demand paradigm

Some food for growing appetites: new rules, new opportunities with Master-Feeder UCITS

The evolving regulatory landscape and the long term goal for UCITS funds in the European Union

Deloitte, Sword FircoSoft and Dow Jones launch a new service to ease Know Your Customer procedures

**Deloitte.**



4



10



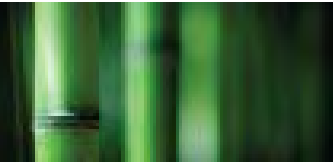
14



18



20



24



30



36



40



46



50



54



55



# In this issue

## Market buzz

A short summary of cross border distribution of collective investment schemes in the United States 4

The introduction of an extended Qualified Intermediary program: what is the impact for the fund industry? 10

## External perspective

ETF - A trillion dollar baby 14

Current securities lending market themes 18

Applying multi-boutique strategies in the quest for alpha 20

UCITS: the battle for Asia 24

## Tax perspective

Sunshine on the distressed debt market 30

Emerging countries tax constraints: or why you should pay attention to our tax news alerts 36

## Regulatory angle

Investment funds: liquidity risk and the supply-&-demand paradigm 40

Some food for growing appetites: new rules, new opportunities with Master-Feeder UCITS 46

The evolving regulatory landscape and the long term goal for UCITS funds in the European Union 50

Deloitte, Sword FircoSoft and Dow Jones launch a new service to ease Know Your Customer procedures 54

## Hot off the press

To be covered in our next edition 55



## Expanding our aims

A warm welcome to the second edition of *Performance*, Deloitte's quarterly digest of articles focused on important developments in the Investment Management arena. We thank you for the encouraging feedback following the publication of the first edition; heartened by this we have expanded the circulation and reach to cover the EMEA region. We hope that you will find this edition as informative and interesting.

In 'Market buzz' this quarter we have focused on developments in the U.S. which are sure to have ramifications to most in the investment management community. Within our section entitled 'External perspective' you will find a broader range of topics where external contributors take the temperature and add their opinion on a selection of today's issues and opportunities. 'Tax perspective' draws attention to the opportunities in the distressed debt market and words of warning on tracking evolutions in tax legislation a little further from home. This edition's 'Regulatory angle' provides opinion and perspective on themes relating to fund management, design and distribution.

We are very grateful to the external contributors to this digest, we believe that their expert opinion and views illuminate the subjects and provide a counterpoint voice on the challenges and opportunities faced in the industry.

Our ambition is to make this publication as fresh and exciting as possible and we eagerly await your contributions and suggestions for future articles. We hope you will find this publication useful and look forward to engaging in discussions centered on the various topics covered.

Sincerely,

A handwritten signature in blue ink, appearing to read 'Vincent Gouverneur', written in a cursive style.

Vincent Gouverneur  
Partner - EMEA Investment Management Leader

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

# A short summary of cross border distribution of collective investment schemes in the United States

**Stuart E. Fross<sup>1</sup>**  
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This short article seeks to summarise the regulatory framework for cross border distribution of collective investment schemes into the United States.

## Background

The US regulatory environment is fragmented. Unlike the United Kingdom, for example, there is no legislation comparable to the Financial Services Act 2000 and there is no one regulator similar to the Financial Services Authority. Instead, the US regulatory environment has accumulated by means of legislation designed to address narrowly defined markets, often by establishing regulators with limited jurisdiction to supervise specific markets. In particular, market supervision of the distribution of collective investment schemes is fragmented amongst securities regulators (primarily the Securities and Exchange Commission), regulators of employer sponsored retirement plans (the Department

of Labor) and banking regulators including, for example, the Office of the Comptroller of the Currency. There is no over-arching logic to US regulation of collective investment schemes or to their distribution. Accordingly, distribution of collective investment schemes into the US from outside the US has to be considered separately by distribution channel<sup>3</sup>. This article addresses distribution of 'private funds', distribution of funds to employer sponsored retirement plans, and distribution of funds to the US retail investing public.

## Private funds

There is a species of unregulated collective investment schemes in the US referred to as 'private funds'. The universe of private funds is typically considered to be made up of 'hedge funds' and 'private equity funds', but also may include non-US based collective investment schemes, such as Luxembourg SICAVs. As a regulatory

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<sup>2</sup> K&L Gates LLP comprises over 1,800 lawyers who practice in 36 offices located on three continents: America, Europe and Asia. K&L Gates represents leading global corporations, growth and middle-market companies, capital markets participants and entrepreneurs in every major industry group as well as public sector entities, educational institutions, philanthropic organisations and individuals.

<sup>3</sup> Justice Oliver Wendell Holmes, Jr. stated in an often quoted lecture given in November of 1880 that 'The life of the law has not been logic; it has been experience. ...The law embodies the story of a nation's development through many centuries, and it cannot be dealt with as if it contained only the axioms and corollaries of a book of mathematics.'



matter, the critical common feature for these so called private funds is that the fund's participations are offered in a 'private placement'. That is, if there is a prospectus or offering memorandum, it will not have been filed with the SEC and the securities offered will not be 'registered' under the Securities Act of 1933, as amended (the '1933 Act'). This is perfectly legal in so far as the US federal law requires registration of offerings to the 'public'. In contrast, private offerings are made to sophisticated and financially significant investors (so called 'accredited investors'<sup>4</sup>) who do not seek or need the SEC's protection. Moreover, because the offerings are private, and the investors are either limited in number or highly sophisticated (so called 'qualified institutional buyers'<sup>5</sup>), the fund need not submit itself to SEC supervision under the Investment Company Act of 1940, as amended (the '1940 Act'). In the main, funds organised outside of the US that are distributed in the US distribute their shares in the US via private placement and do so to either a limited number of US resident beneficial owners (i.e., 100 in reliance on Section 3(c)(1) of the 1940 Act) or to an unlimited number of qualified institutional buyers.

#### **The principals of private placement of securities**

Private placements need to be made without a 'general

solicitation'. Typically this means that a proposal to invest in the collective investment scheme or private fund is made to someone who has a 'pre-existing business relationship' with the fund's sponsor or a distributor acting for the fund sponsor. Face-to-face proposals to high net worth clients that are financially sophisticated would be one way to conduct a private offering that exemplifies the conceptual framework. There are other permissible alternative ways to conduct a private placement. For example, the SEC has authorised private offerings over password protected websites to clients prequalified for the type of offering made accessible over the website.

#### **The need for a registered broker dealer to pitch to clients in the US**

Typically, the distribution of privately offered interests in funds in the US requires authorisation, or as it is referred to in the US 'registration' as a broker-dealer. This is because the participations in the fund are viewed as securities under US securities laws, and the offering of those securities should be made by a registered person or firm.

#### **Avoidance of 1940 Act registration**

Private funds seek to qualify for exclusions from the 1940 Act, and non-US collective investment schemes

<sup>4</sup> The term 'accredited investor' comes from Rule 501 under Regulation D of the Securities Act of 1933. Offering limited to accredited investors that do not involve any 'general solicitation' of investors are the typical form of so called 'Regulation D' private placements. Private funds and non-US collective investment schemes typically rely on Regulation D offerings to distribute in the US and yet avoid filing their offering material and registering fund shares with the SEC.

<sup>5</sup> The term qualified institutional buyer is defined in Section 2(a)(51) of the 1940 Act. It can be thought of as a definition of very highly accredited investors, such as banks, retirement plans and insurance companies, and very wealthy individuals.





must do so, because they, with very few exceptions, cannot register with the SEC under the 1940 Act without reincorporating in the US. These exclusions are perfected by conducting only a private offering in the US, and only by means of limiting US resident beneficial owners to 100 accredited investors or, alternatively, to qualified institutional buyers without numerical limit. The 1940 Act imposes on funds that breach their duty to register (i.e. a non-US fund that unlawfully conducts a US public offering) a highly punitive regime allowing parties that transact with the fund to potentially void their contracts and subject the fund and its controlling persons to legal liability, which can include civil fines and imprisonment after conviction. Accordingly, any private fund or non-US collective investment scheme needs to ensure that it complies with at least one of the exclusions from the 1940 Act summarised above.

#### **On tax efficiency for US investors**

Distribution in the US is further complicated by tax considerations. The US market is bifurcated between those US resident investors that are subject to tax which may include institutional investors as well as wealthy individuals, and institutions and retirement plans that do not pay income taxes as such but which are potentially subject to tax penalties if they invest in funds whose portfolios are not constructed properly - as will likely be the case for leveraged funds, for example. Unfortunately, that which tends to be beneficial to non-US investors, such as accumulating funds, are likely to be problematic to taxable US investors who typically are deemed to receive income from the fund for tax purposes, whether they do so or not, and require fairly detailed tax reports from their non-US funds to minimise tax inefficiencies. While these tax reports are not returns filed with the Internal Revenue Service, they can be burdensome to prepare.

#### **Some practical considerations**

Accordingly, before starting on distribution of a non-US collective investment scheme in the US, it is typically advisable to determine whether a non-US fund will be tax efficient for the target market place in the US and if that market place is made up of qualified institutional buyers of sufficient number, or whether limiting the offering to 100 US residents with sufficient assets to invest in the fund makes for an economically viable business opportunity after giving consideration to

distribution costs. It also makes sense to sort out how much it will cost to hire a registered broker-dealer to act as the authorised intermediary in the US. In addition, it may be necessary to negotiate an agreement to 'dual hat' employees of the sponsor of the non-US, fund to the US registered broker dealer if the sponsor's employees will participate in distribution of the fund's shares. It will also be important to determine whether or not the collective investment scheme invests in a manner that does not generate tax penalties for investors that comprise the fund's target marketplace.

#### **Funds for employer sponsored retirement plans**

It has become common place for US employers to offer private pension schemes to their employees. These are quite popular in as much as income tax recognition is deferred until retirement. So called '401(k) defined contribution' retirement plans typically offer employees the opportunity to direct a portion of their wages into investment options that are collective investment schemes organised in either one of two ways. The investment 'options' are often either collective investment funds sponsored by a US bank or trust company, or they are registered mutual funds as discussed below. Bank collective investment funds are relatively difficult for most offshore fund managers to sponsor and are effectively precluded from being offered on a cross border basis from outside the US, in as much as any bank collective investment fund must be maintained by a 'bank', although the US branch of a non-US bank may qualify as a bank for this purpose. Even if a non-US fund sponsor is part of a bank with a US branch which seeks to sponsor a collective investment fund, care must be taken to meet the definition of 'maintained by a bank', which may preclude the use of sister companies of the bank located outside of the U.S to manage the collective investment fund. In addition, bank collective investment schemes must qualify for an exclusion for the 1940 Act, as policed and interpreted by the SEC, must operate in accordance with requirements of bank regulators often relying on guidance from the Office of the Comptroller of the Currency, and must meet the disclosure obligations, fee restrictions, prohibited transactions restrictions and fiduciary duties imposed by the Department of Labor. Suffice it to say that a non-US collective investment scheme will not be eligible

to be offered to employees as an investment option in a defined contribution retirement plan for numerous reasons. But the sponsor of a non-US collective investment scheme may distribute to another segment of the US retirement plan market. Many employers still provide their employees with fixed (i.e. defined benefit) pensions upon retirement that are funded by the employer. Employers must set aside assets to back their future pension liabilities under defined benefit plans, and these assets can be invested in private funds and/or non-US collective investment schemes. Accordingly, it is not uncommon for sponsors of non-US collective investment schemes to distribute them to US corporations investing pension assets on a private placement basis.



#### **Distribution of US mutual funds**

US distribution of mutual funds is affected by three principles. Firstly, mutual funds are sold in public offerings and accordingly their shares must be registered under the 1933 Act and they must use prospectuses including market material and provide shareholders with financial statements that comply with SEC disclosure regulations and the Sarbanes-Oxley Act. This Act imposes requirements relating to financial statement disclosure and holds the Chief Executive Officer and Chief Financial Officer personally liable for financial statement misstatements or omissions under certain circumstances. The second principle affecting US fund distribution is that the distributors must be registered with the SEC as broker-dealers who need to comply with the rules of the Financial Industry Regulatory Authority ('FINRA') relating to fund distribution, including review by the FINRA of sales materials. Thirdly, the 1940 Act limits flexibility of pricing arrangements. Uniquely, US mutual funds are subject to a retail price maintenance statutory provision



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The 1940 Act imposes on funds that breach their duty to register a highly punitive regime allowing parties that transact with the fund to potentially void their contracts and subject the fund and its controlling persons to legal liability, which can include civil fines and imprisonment after conviction



which prohibits the negotiation of commissions, but permits the use of sales load breakpoint schedules and exemptions from sales loads that are disclosed in the fund's prospectus. Additionally, the 1940 Act and SEC regulations govern the use of fund assets to pay distribution costs under Rule 12b-1. Rule 12b-1 is subject of widespread criticism and ongoing SEC reconsideration but remains in force. Typically Rule 12b-1 allows for asset based distribution fees that are used to compensate distributors based on a percentage of fund assets. Whilst these fees are prominently disclosed in fund prospectuses, they have been criticised as 'hidden fees', in part because of a peculiar and widely used provision of US law that permits delivery of prospectuses after sale. The hidden fee controversy has also included concerns related to shelf space payments and other incentives paid to brokers by fund sponsors that seemingly might affect the objectivity of a broker's recommendation of those funds and might give rise to conflicts of interest. Additionally, deferred sale charge arrangements, so called B Shares, have come in for criticism that they have been favored by brokers because brokers may have been paid higher commissions to sell B Shares than they would have received had they recommended that their clients invest in lower cost share structures. In response, some fund sponsors have discontinued their sale of B Shares and B Shares have receded from the prominence they once held. In addition to enforcement actions, the SEC proposed to remedy the perceived fee and commission disclosure gap in 2005 by means of a 'point of sale' disclosure document to be delivered by broker dealers to mutual fund investors before an initial purchase. The proposal remains pending. In April 2009, the FINRA proposed that if a mutual fund prospectus does not disclose compensation paid to the broker in the fund's 'fee table', the broker would be obliged to make its own disclosure to its clients, and to repeat the disclosure on a semi-annual basis. This proposal's comment period ended in August 2009.

### Reform legislation

Numerous financial services reform initiatives are currently underway. The SEC formed an Investor Advisory Committee which established an 'Investor Purchaser Subcommittee' on 15 September 2009 to, amongst other things, consider the needs of investors when they purchase mutual funds and the fiduciary duties

owed to those investors by persons who recommend mutual fund investments. Legislation is pending before Congress entitled 'The Investor Protection Act of 2009' that would make such a committee a permanent fixture of the SEC's structure and would authorise the SEC to mandate delivery of a mutual fund disclosure document prior to sale. Additionally, the SEC would be granted broad powers to adopt rules imposing duties on brokers and designed to address and eliminate compensation arrangements and conflicts of interest that the SEC deems do not serve the public interest. If adopted, the new legislation seems likely to lead to significant changes in the distribution of mutual funds to the public in the US. The SEC's rule making may also affect private placements. Distributors of non-US funds considering engaging in private placements of their funds in the US will want to monitor closely the progress of the Private Fund Investment Advisers Act of 2009 in as much as the legislation would require foreign investment advisers with 15 or more clients in the US and \$25 million under management from US clients to register as investment advisers. The SEC would also be granted the discretion to define 'client'. Read together, the provisions of the draft legislation would grant to the SEC the discretion to count US investors in a privately placed non-US collective investment scheme toward the 15 client limit and the \$25 million registration tests.

### Some practical considerations

Non-US based advisers that are not already registered with the SEC as investment advisers will want to watch this proposed legislation closely and weigh its implications before conducting a private offering in the US. A private offering of a collective investment scheme in the US may give rise to the need for the adviser to register under the Investment Advisers Act, meaning that US law will apply to the adviser's US clients, including disclosure requirements, fee related regulations, prohibitions on certain transactions, and recordkeeping requirements.



# The introduction of an extended Qualified Intermediary programme: what is the impact for the fund industry?

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“It appears that the United States, on the heels of its recent success in Court and in furthering President Obama’s tax proposals, is intent on extending its global reach in the fight against offshore tax evasion through the introduction of a new specific legislation. But just how far will this intent go?”

On 7 December 2009, Congressman Charles Rangel presented the Tax Extenders Bill of 2009, which incorporates the provisions of the Foreign Account Tax Compliance Act of 2009 that was previously introduced on 27 October 2009. The Foreign Account Tax Compliance provisions of the Tax Extenders Bill of 2009 are commonly referred to as 'QI 2.0'.

Unlike the qualified intermediary regime (hereafter 'QI') currently in force, QI 2.0 casts a much wider net in an attempt to cover all foreign financial institutions, not just the traditional custodian banking industry. Thus, QI 2.0 will effectively create a parallel system to the QI regime, not replace it.

Though it is impossible to predict the practical application details of the new Bill at this stage, we will take this opportunity to detail how the US intends to impose this expansive new information reporting and withholding tax regime and its anticipated effects on the fund industry. Indeed, the proposal already describes the type of economical operators who will participate in the program, their obligations in terms of documentation, withholding and reporting. However, after a first review, its implementation appears unworkable, costly and disproportionate.

## QI 2.0: headlines

After attempting to extend the QI regime in 2008 (cf Announcement 2008-28), QI 2.0 personifies the US' desire to expand its reach in its endeavour to combat offshore tax evasion by US persons.

This new program, as currently written, will affect practically every type of foreign financial institution, not just banks and custodians. Entities such as private equity, hedge funds, securitisation vehicles and any other investment vehicle, whether privately held or widely distributed, will be impacted. Collectively, these 'in scope' entities are referred to as 'Foreign Financial Institutions' ('FFI').

Whilst QI 2.0 merely sets the framework for the anticipated system, it is the Internal Revenue Service (hereafter 'IRS') that will be responsible for drafting the regulations by which FFIs will need to comply. Even though these rules will not be written until sometime in 2010, we can already speculate on the possible implications for the non-US fund industry. It is foreseen that QI 2.0 will result in a new definition of 'business as usual' in the industry, one that carries with it an additional compliance load including but not limited to due diligence, reporting, withholding and audit, that

will require costly investments in both resources and systems upgrades and lead to possible limitations on investor base and/or investment choices.

### A double-edged sword – US account or US investment

So what if a fund still wishes to invest in the US market after the entry into force of this new regime? Under QI 2.0, the US will require withholding agents to apply negative assumptions on all accounts, meaning all accounts should be treated as US accounts unless proven otherwise. So much for the 'Innocent until proven guilty' axiom the US courts tout. This will result in the need to have all account holders, grantors and owners, not just US persons, certify that they are either US persons or not US persons. This will need to be done not only at the level of the FFI but also at the level of any affiliate.

As QI 2.0 specifically addresses US accounts and US source income, a single US account or single security producing US source income will affect the activity of the investment fund. Under QI 2.0, a US account is defined as any financial account held at an FFI by one or more specified US persons or US owned foreign entities. In addition, for the fund industry, there is no *de minimis* threshold for substantial ownership.

More specifically, who are the new US persons targeted? The Bill introduces two new types of US persons: firstly the 'specified US person' which generally relates to any US individual, corporation, partnership, trust or other US entity. Entities excluded from the scope of this definition are generally those representing a low risk of tax evasion, such as US banks and US government entities. The second category introduces a totally new concept of a 'substantial US owner'. Indeed, FFIs will have to apply a look-through approach to identify any such substantial US owner hidden behind any US owned foreign entity, i.e. any foreign entity held by one or more substantial US owners.

In practice, this means that any foreign entity invested in a fund will have to provide either a certificate of non-US status or the individual details of any substantial US owner. There are, at this stage, many open questions including whose responsibility it will be to obtain documentation when the holding is made through a nominee account?

It is vitally important to stress that even if the fund has no US accounts, the fact that the fund has US source income will result in the fund needing to enter into an agreement with the IRS or suffer from a 30% withholding. In the case of a fund of funds, even an indirect ownership of an asset that produces US source income through another fund might create the need to negotiate an agreement with the IRS.

### Annual reporting

Under QI 2.0, for each documented US account, the FFI will have to produce annual reporting disclosing the name, address and TIN of each underlying US person, either specified or substantial, as well as the account number, balance and other details related to the activity carried out on the account in a specific year.

The possibility to produce the reporting on a free format basis clearly represents a concession granted by the US in reference to the complex standard reporting format (Form 1099), although this option is still available under certain conditions.





Strictly speaking, it means that should any share/unit of a fund be held by one US person, either specified or substantial owner, the fund will be bound to produce annual and individual reporting for the IRS in the name of such investor. The amended Bill does contain a specific provision that should avoid duplicative reporting though who will assume the reporting responsibilities towards a specific US account may sometimes appear unclear.

#### **Punitive withholding tax for recalcitrant account holders**

The Tax Extenders Bill of 2009, as opposed to the Foreign Account Tax Compliance Act of 2009, is less restrictive. Indeed, it will be possible to consider an FFI as compliant, and therefore not taxable, even if not all of its account holders, grantors or owners are themselves compliant. Therefore a single 'recalcitrant account holder' will not taint the whole fund, as would have been the case under the Foreign Account Tax Compliance Act of 2009.

Under QI 2.0, withholding agents will also be required to levy 30% on all 'withholdable payments' made to any 'recalcitrant account holder', 'non-participating FFI', or on behalf of any other FFI not assuming withholding responsibility. These payments include not only US source dividends, interest or other FDAP ('fixed or determinable, annual or periodic') income but also any gross proceeds from the sale of assets that can produce US source dividends or interest. This also includes payments made under dividend equivalent arrangements using equity swaps, arrangements previously not subject to withholding tax.

Whilst the Bill offers the possibility to delegate the withholding responsibility to the upstream withholding agent, an FFI not assuming the primary withholding tax responsibility, will however still be liable in the case where the responsible party fails to withhold for any reason. This delegation, however, does not eliminate the FFI's need to enter into an agreement with the IRS. In addition, this will deprive the FFI from any tax reclaim possibility.

Last but not least, it is important to stress that many investment funds (i.e. FFIs) that suffer the withholding tax will not be eligible to claim a tax refund or credit as they do not have access to treaty benefits.

#### **An expansive reach**

QI 2.0 means that there will be very little choice of whether to comply or not at the level of the FFI. The choice now will be whether to comply with QI 2.0 or to suffer the 30% withholding, with no in-between and without reference to who takes primary withholding responsibility.

To avoid any unpleasant situations, investment funds will need to complete an in-depth review of all prospective and existing share (unit)-holders. In the fund of funds universe, this could lead to a significant shift of assets between funds, though it is still unclear at which level the agreement will apply, whether on fund or sub-fund. Not only will investment prospectus' need to be clear in the fact that the fund will or will not invest in US securities, and who it will or will not accept as a share(unit)-holder, the fund will also need to declare if it is FFI compliant.

Even for funds that decide to exclude investments that produce US source income from their portfolios, and exclude US accounts from holding shares, the chance that an investment may be re-characterised into a US investment is ever present. For this reason, many funds that make the choice to distance themselves from investments producing US source income and having US accounts will still need to document accounts under the stringent requirements of QI 2.0 as even an inadvertent connection to US source income will have negative consequences for the fund.

#### **Practical issues**

Whilst QI 2.0 is currently scheduled to become effective for payments made after 31 December 2012, funds must begin undertaking efforts now to develop measures to document and track all investors to ensure reporting requirements are met. Those that delay action until the IRS issues rules for QI 2.0 will be left with an even more limited time to identify accounts and action steps to remedy gaps in documentation.

Even if a fund enters into an agreement with the IRS and documents each of its accounts appropriately, and closes those which are deemed recalcitrant, it could still suffer the effects of 30% withholding if any intermediary along the payment chain is non-compliant.

Therefore, funds will need to review all chains of payment where it is present to ensure that each member of the chain is compliant. If any intermediaries are found to be non-compliant, the fund must immediately act to remove the non-compliant link. This situation may also lead to a renegotiation of agreements between a fund and its financial intermediaries so that the fund is reimbursed for any loss suffered (i.e. 30% withholding) that takes place due to the intermediary's non-compliance.

#### Those that do versus those that don't?

Will this legislation result in a segregated fund industry? Will some funds make the decision that the increased costs are too great and decide to divest themselves of US assets and no longer allow US? Could QI 2.0 derail the consolidation attempts of the European fund industry? Will this lead to a massive divestiture of US securities by FFIs that could end up derailing the US economic recovery? Whilst some widely held, publically traded funds will be outside the scope of QI 2.0, this will be more the exception than the rule.

FFIs may choose to analyse the costs resulting from QI 2.0, such as annual reporting costs, and allocate these costs to the share (unit)-holders (i.e. those with US accounts) that require such reporting. This may result in the loss of US investors in these funds as the costs may be prohibitive to small, non-institutional investors. If funds chose to move in this direction, the European fund market would essentially be cut off to all but the largest US investors. However, whilst the potential loss of these investors would eliminate the annual reporting requirement, the need for full documentation of account holders would not be eliminated.

It can be foreseen that funds not ready for QI 2.0 implementation will be forced to sell US assets prior to the enactment date in order to avoid 30% withholding. This de facto forced sale would result in those funds eliminating US assets from their portfolios and, until an agreement is reached with the IRS, eliminating US assets as investment possibilities. However, this act alone will not remove a fund from the scope of QI 2.0. Even though a fund may not be subject to QI 2.0, the shadow of QI 2.0 will require the fund to continue documenting all shareholders to ensure there are no US accounts.

#### Conclusion

At the time of writing, whilst QI 2.0 has not yet been passed by Congress, the far reaching effects of the Bill are evident. The fund industry, along with other financial institutions, will need to remain diligent in their protests to the IRS and Congress to avoid unduly onerous reporting and documentation requirements.

The US appears open to discussion and this current time, before and during the writing of regulations by the IRS, presents a significant opportunity for the fund industry to influence the outcome before the guidelines become final.

QI 2.0 presents the FFI world with the opportunity to act either reactively or proactively. Some will chose to passively approach the date of enactment, whilst others will proactively fight abuse measures to be introduced in the final regulations.

To ensure the final regulations are workable, the message from the fund industry, and from other industries that share this common goal, should be clear and consistent. If QI was a wave through the traditional banking industry, QI 2.0 may prove to be a tsunami through the entire financial services industry.

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**QI 2.0 means that there will be very little choice of whether to comply or not at the level of the FFI. The choice now will be whether to comply with QI 2.0 or to suffer the 30% withholding, with no in-between and without reference to who takes primary withholding responsibility.**



# ETF - A trillion dollar baby

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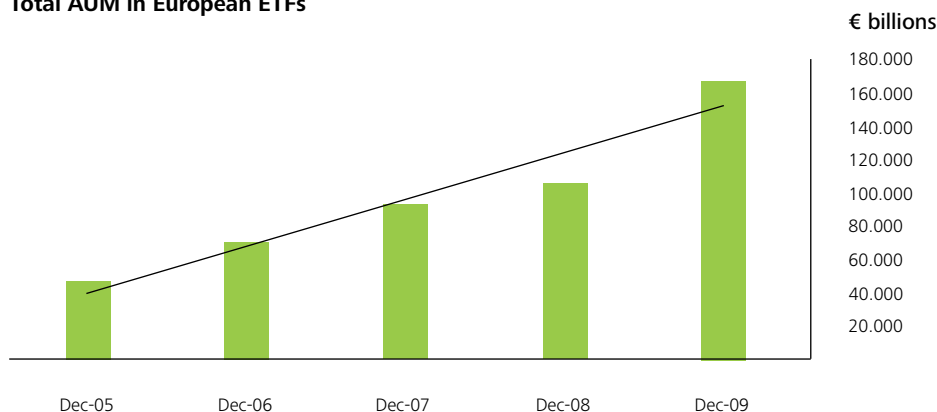
Since Exchange Traded Funds (“ETFs”) first appeared on the US marketplace in 1993 and in the European market place in 1999 the assets under management of such funds have consistently risen in each calendar year.

The resulting global assets under management ('AUM') in ETFs as at the end of 2009 reached \$1 trillion with the European based products representing a quarter of the market share at €168 billion (\$240.76 billion). For comparison, the total AUM in all European domiciled investment funds is approximated at €7 trillion (€6,840 billion at end September 2009). Therefore in Europe the ETF share of the wallet is only around 2.4% of assets however, this share is growing and the indicators are that it will continue to do so.

A more recent development has been the emergence of Exchange Traded Products ('ETPs'), which are different to ETFs in that they are legally structured as notes, certificates or other forms of securities rather than as a fund. While we recognise that there are fundamental differences between ETFs and ETPs, in this article we refer to ETF, ETP and ETF&P when referring to both types.



## Total AUM in European ETFs



Source: Bloomberg

### Uses and users

Given the risk of selecting an active asset manager which adds value on a risk adjusted basis, many investors are turning to pure beta providers at an index or sub-index level and the possibility to invest in a wider range of asset classes include less-correlated segments such as commodities. ETF&Ps are, at present, the vehicles of choice to do this. The implementation of dynamic core and satellite strategies by some asset managers is an additional impetus to increasing asset allocations in ETF&Ps. Where the core portfolio holdings can be low risk perhaps cash type returning assets, or further up the yield curve to include short duration government bond indices, and the satellite component including risky asset classes where alpha is hoped to be generated. ETF&Ps can play a part in both core and satellite segments, providing low cost market exposure and liquidity should a sudden re-allocation be required. The alpha, and or portfolio protection, can be generated from the asset allocation between the two asset classes.

Retail investors are currently less aware of the uses of ETF&P. This could be attributed to a lack of understanding and that investment funds are sometimes sold (pushed) to investors rather than bought (pulled) by investors and one could imagine that intermediaries may be inclined to present the product which could generate additional performance whilst providing an additional revenue stream to the advisers via a retrocession of management fees. Additionally, the brokerage and custody fees charged on ETF&Ps become more significant for investors with a small investment amounts. Notwithstanding the fact that ETF&Ps can offer a complete basket of exposures that would be difficult to trade individually, due to market access and cost.

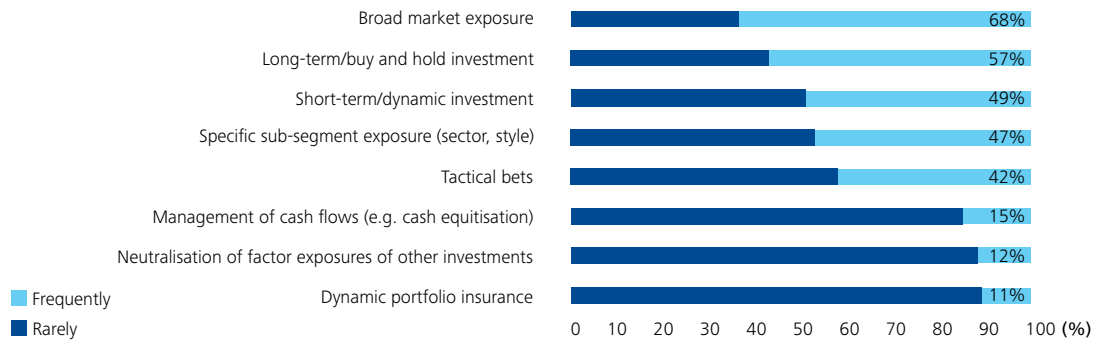
For package providers, ETF&Ps are being used increasingly within the portfolios of investment package providers such as unit linked life assurance and UCITS as a cost effective asset allocation.

Institutional investors have been at the centre of the ETF&Ps developments and consumption. It is estimated by EdHec in 2009 that 36% of equity exposure by pension funds is gained via ETF&Ps; this figure is estimated at 22% for commodity exposure. This is the natural heartland of ETF&Ps. 95% of European pension funds use ETF&Ps and the market is keen to see additional indexes covered, including short ETFs where the returns are the inverse of the index return. Liquidity in the ETF&P is a key consideration for institutional investors once other factors like tracking error and fees are assumed to be competitive. Most institutional assets are invested in segregated mandates which explains why, as mentioned earlier, ETF&P penetration in investment funds is only 2.4% of investment fund assets.

Within the ETF&P product set there is an increasing array of underlying asset classes from equity, bond indices to commodities and in 2008 the first actively management ETF was approved by the US SEC. Leveraged and Short ETF&P are also being launched as other asset managers aim to exploit a wider range of portfolio construction methodologies. The trading mechanisms such as limit orders and real time transactions coupled with daily liquidity are encouraging investors to manage macro asset allocations.

An EdHec-Risk survey of 360 institutional investors and private wealth managers conducted during January and February 2009 revealed that most ETFs are used as buy and hold or as a vehicle to gain broad market exposure.

**How often do you use ETFs for the following purposes?**



Source: Edhec-Risk February 2009

**The threat of fragmentation in the ETF&P marketplace**

Many institutional investors are now using ETF&P to gain exposure to markets. The main determinates of a quality product in the eyes of investors are: fund size, which is an indicator of liquidity and liquidity itself, tracking error which is an indicator of a rigorous process and efficiency, and fees. The result of this is a flight to the best of class ETF&Ps with the knock on effect of leaving some ETF&Ps without sufficient demand and likely closure.

Europe has around 34,000 funds compared to the US's 8,000 funds with nearly double the assets.

**New trends, and successful core segments**

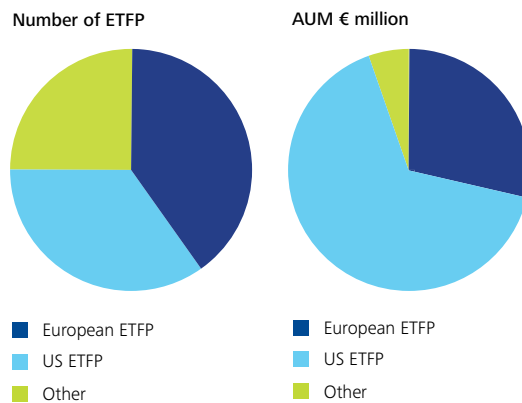
There are now 17 actively managed ETFs in the US and currently none in Europe. For smaller active asset managers, such as First Trust and Grail Advisors, the ETF distribution route is attractive as an alternative to competing with the large active asset managers and may be a last chance to have first mover advantage. However, the active asset managers issuing these active ETFs aren't all small; amongst their number are PIMCO, Goldman Sachs and Vanguard. Blackrock have gone on the record in January 2010 to say that they are not currently looking into putting its active management capability into the newly acquired iShares ETF structure, but that they are investigating options to improve the distribution of ETFs to retail investors, perhaps by packaging them with active funds.

	Products	Listings	AUM € billion	AUM \$ billion
Global ETF&P	2673	4839	817,07	1132,70
European ETF	896	2468	217,90	302,07
European ETP	176		15,20	21,07
US ETF	791	*	479,98	665,40
US ETP	144	*	61,10	84,70

\*US ETFs are only listed on two Stock Exchanges, therefore typically only one listing is sought

To make the transition from a traditionally administered actively managed fund to a fully functioning EFT takes a different administrative platform. In particular the Transfer Agent, Depository Bank and Fund Administrator need to be able to process a contribution/redemption in kind at short notice and ensure prompt and accurate settlement of the underlying positions. Not many administrators have this capability at present.

**US ETF and EU ETF comparison as at 31 January 2010**



Source: www.exchangetradedfunds.com

US ETF&P are, on average, nearly three times larger in terms of assets under management than their European counterparts. Yet Europe has 15% more funds with many more listings being maintained to meet local market preferences. This is a familiar picture which is mirrored in the wider investment fund market where

In Europe there has not been much success in the Non Delta 1 products, typically represented by leveraged and inverse ETF&Ps, according to data compiled by Blackrock; assets under management in this sector have been growing but at a slower rate than other products during 2009. This could be due to the positive market conditions during the calendar year 2009. Perhaps Non Delta 1 products will be more popular in 2010 if capital market returns are flatter or negative market returns are foreseen.

iShares' head of Sales Strategy, Nizam Hamid, considers that ETFs built on the UCITS structure have clear advantages over certificates and notes due to greater transparency and as they negate counterparty risk. As well as the economic exposure to underlying assets of the ETP, an investment in an ETP also infers an exposure to the product's (often a zero coupon note or a certificate) issuer, which may need to be aggregated with other exposures to the same issuer.

Lyxor, who manage 178 ETFs, also view the UCITS structure as the most appropriate vehicle due to the comparative better transparency, less counterparty risk and ease of distribution of UCITS in Europe, Latin America and certain Asian countries. Lyxor foresees continuing growth from institutional investors and anticipates that a non-commission based distribution model will boost ETFs' attractiveness to retail investors.

### Are ETF&Ps eligible investments for UCITS?

A common question at the present time is if ETFs are eligible investments for EU UCITS funds to invest into?

The first step is to determine if the target ETF is incorporated and regulated as a fund, or if the ETF is actually a securitised instrument such as a note or certificate, therefore to be considered as an ETP. If the ETF is constructed as a fund structure then Article 50 (1) e of the recast Directive which governs investments into UCITS and other UCIs is applicable (this has been the case since the UCITS III Directive). However, if the ETP is constructed as a note, bond or certificate, then it is to be considered as a Transferable Security or Financial Derivative as described in the recast UCITS Directive (2009/65 EC) under Article 50 (1) a to d, or as a Financial Derivative Article 50 (1) g. Each ETF&P needs to be looked at on its own merits to determine if it can be deemed eligible.

To comply with Article 50 (1) e, the ETF must be regulated to a standard equivalent to UCITS, have safeguards for the protection of investors, provide annual and semi-annual reports describing the assets and liabilities, and themselves limit investments into other UCITS or UCIs to 10%. No such rules apply to ETPs which are eligible under the Transferable Securities or Financial Derivative categories.

Not all ETF&Ps can be automatically considered as being eligible investments for a UCITS fund. The development of the ETP market has seen the introduction of more complex fund structures which invest into assets that were not originally considered by the UCITS directive. The combination of increasing investor demand for non-traditional investments, due to their correlation benefits, such as commodities, physical property and hedge fund-like vehicles, have seen the introduction of structures that invest into such assets on both a long and short basis. Such ETFs cannot themselves be structured

in accordance with the UCITS directive. To be considered as eligible investments, such ETFs have structured their activities as corporate entities which issue transferable securities to the public. These transferable securities give non-leveraged exposure to the underlying assets. One of the first structures to organise their activities is the popular Gold Bullion Securities product offering which is a Jersey based corporate entity limited by shares. This company then issues undated zero coupon notes to investors which give a one-for-one exposure to movements in the gold price.

In 2006, the European Commission issued Explanatory Memorandum ESC/14/2006 which stated that transferable securities that give exposure to commodities should not be considered as having an embedded derivative contract - provided that this linkage is on a one-for-one basis. This is commonly known as the 'Delta-1' approach as the transferable security is based on an unleveraged index. Using this methodology, it would be possible for a promoter to issue transferable securities that could give exposure to metals or commodity prices. This development has been publicly endorsed by the German financial sector regulator, the BaFin. However, this view does not appear to be universally shared by all other EU financial sector regulators. Naturally ETPs are not only targeting UCITS as investors, ETPs can be acquired for segregated institutional accounts or for private banking portfolios.

Most commentators consider that since the Lehman collapse it has been less popular to establish securitised ETPs as this presents greater counterparty risk. This is echoed by the Lyxor and iShares who see the mainstream of products to continue to be established as ETFs.



# Securities lending: new priorities

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Managing Director  
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## Changes in the securities lending market

After surviving the financial crisis of 2008 and the subsequent malaise that lingered into early 2009, many beneficial owners were left asking themselves: what now, where do I go with my lending program from here?

Within eighteen months, the industry weathered a number of significant events: the bankruptcy of a major global investment bank, impaired liquidity in cash collateral vehicles, a number of regulatory changes, significant redemptions and de-leveraging of hedge funds and the subsequent uncertainty created by these events. As a result, both the industry and beneficial owners are surveying the new landscape, and charting a course for the future.

In reviewing and assessing what happened, it is important to highlight the distinction between securities lending activities and collateral management. To the best of our knowledge, losses incurred in securities lending programs relate to the investment of cash collateral rather than as a result of counterparty exposure. However, it has become clear that strong indemnification from borrower default, coupled with a well controlled lending environment are critical elements in effectively managing risk.

## Initial responses to the crisis

Beneficial owners reacted to the crisis with a range of different responses. The most common questions and areas of focus included the following:

- Do we fully understand the risks of our lending program?
- Do we have the tools and reporting to adequately monitor and manage those risks?
- If we accept cash collateral, how much liquidity should we have, and are the investment guidelines consistent with our objectives?
- What new parameters, if any, should we consider for the lending program?
- Who else in the organisation should be apprised of our securities lending program and its activities?

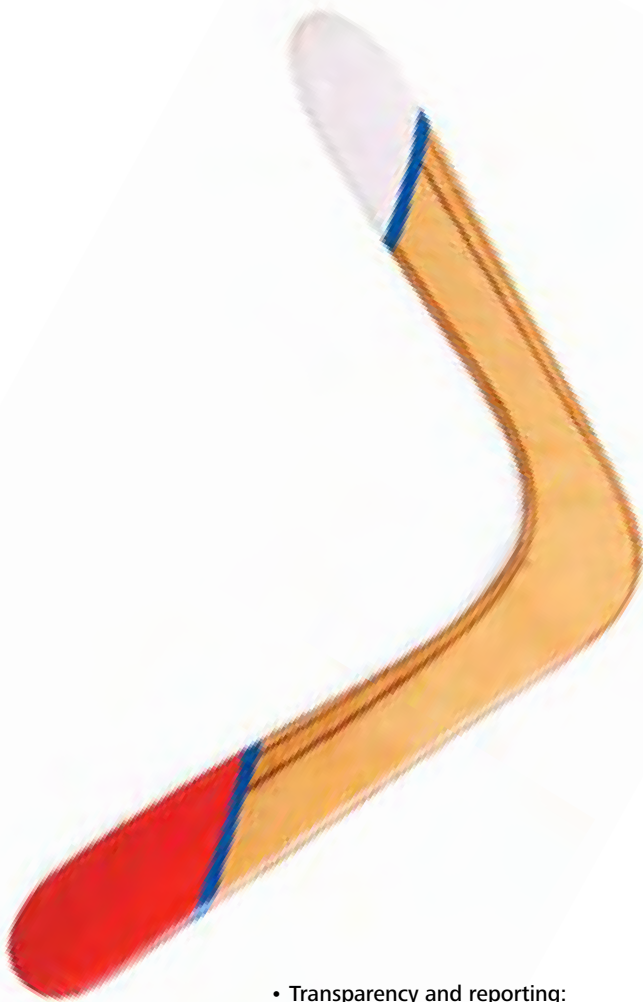
Ultimately, a few lenders suspended their programs or withdrew entirely from the market. However, the majority continued to lend, with some introducing additional restrictions and controls.

## Current state of the market

Based on the experience of the last eighteen months, lenders have focused on certain key themes which include the following:

- **Broader and deeper beneficial owner engagement:** due to losses in cash collateral pools as well as an increased focus on risk, there has been a significant level of engagement from senior management, portfolio managers and board level personnel. Lenders are asking questions, and re-evaluating or confirming their program objectives. For example, is lending viewed as a source of Alpha for the underlying portfolios, or is it simply regarded as a means to help defray management costs?
- **Risk management:** the management of risk has risen to the top of the priority list for many beneficial owners. There is a heightened awareness of counterparty risk, the need for credit diversification, and the value of indemnification against borrower default. Lenders are also looking closely at the amount of capital that supports an agent's indemnification and the strength of the organisation providing it.
- **Intrinsic value vs. General Collateral ('GC'):** after experiencing losses on collateral pools or 'near misses', some lenders have decided to move towards an intrinsic value lending orientation. These beneficial owners have questioned the risk/reward trade-off of GC lending. This is a thin spread/high volume product which is dependent on collateral reinvestment returns. By limiting activity to those loans with adequate intrinsic value, the importance of the reinvestment return is reduced.  
  
This view is reinforced by the current lack of attractive money market reinvestment opportunities and has manifested itself in the following two ways: firstly through more conservative reinvestment guidelines; and secondly by the implementation of minimum spread parameters for certain programs.





- **Transparency and reporting:**  
in some cases, lenders have asked for enhanced reporting to monitor additional risk metrics in their lending programs. In addition, reports are being disseminated more broadly, including to investment professionals in the lender's organisation. For some lenders, the oversight and management of lending was previously the sole responsibility of the Operations or Treasury group. More recently, there has also been a clear movement to involve investment professionals in the oversight process.
- **Continued 'unbundling' of services:**  
consistent with the trend of the past several years, lenders continue to select service providers for discrete aspects of the lending, custody and collateral management bundle of services. The intent has been to obtain the 'best of breed' provider in each of these disciplines.

In the last eighteen months, there has been a noticeable trend towards investment managers taking the management of cash collateral in-house, if they have a money market capability. This reflects a more conservative stance towards investment guidelines and the desire of certain fund boards to have more direct control over cash collateral.

## What is the outlook for lending?

### Regulatory

Although there continues to be some uncertainty surrounding pending regulatory changes, certain positive developments have emerged in the last eighteen months. Across many jurisdictions there has been a significant increase in the level of dialog between regulators and securities lending market participants. The improved flow of information and engagement should serve to reduce the opportunity for 'unintended consequences' of new regulation.

Another example of a positive development stemming from US regulators is the impact of the SEC's Rule 204, which mandates the closeout of failed sale transactions. This rule led to a significant drop-off in the number of failed deliveries since its introduction. Failed delivery transactions in DTC dropped from 1.08% of all trades in July 2008 to 0.16% in July 2009.

### Cash collateral

This year continues to present challenges for cash managers as historically low money market yields do not offer attractive investment opportunities for cash collateralised lenders. In addition, for those using cash collateral there has been a clear trend toward more conservative investment guidelines.

### Reasons for optimism

In terms of demand, there is reason for optimism due to the potential for growth. In the first months of 2010, hedge funds have begun to attract net in-flows, however, the market has not yet returned to the activity levels experienced prior to September 2008. The ratio of 'hard' to 'easy' loan balances continues to lag behind historical levels by a significant degree.

As confidence and a sense of stability have returned to the market, lenders who withdrew or restricted their lending activities have largely returned. A number of cash collateral pools which previously held illiquid or otherwise distressed positions have experienced liquidity events, or are no longer constrained. In general, many lenders are re-evaluating the risk profiles of their lending programs, and making adjustments to improve the risk adjusted returns generated from lending for their investors.

# Applying multi-boutique strategies in the quest for alpha

**Christophe Girondel**

Managing Director of Nordea Investment Funds S.A.  
and Global Head of External Fund Distribution at Nordea

Whilst ETFs and passive investments have taken centre stage in the asset management industry, some believe that fundamental alpha management is still the place to be, even if the road to success is not without obstacles.

At Nordea, a multi-boutique solution is the response to the quest for alpha.

Throughout the latest financial crisis, the importance of Exchange Traded Funds ('ETFs') has become increasingly transparent to the financial industry; multi-billion sales figures cannot be ignored and have beaten all expectations. Moreover, ETFs are no longer solely employed by institutional investors; private bankers have increasingly used them as part of their asset allocation strategy. One may believe that the trend is new but in reality the shift towards more passive investment started years ago; it is just that it has become more apparent during the extraordinary market situation experienced of late. In 2009, asset allocation and timing mattered much more than the provision of alpha in a single asset class. In addition, volatility in 2008 remains fixed in investors' memories through a fast exit strategy made possible by liquidity, a very important decision-making factor. Does this latest surge in ETFs signify a paradigm shift marking the end of fundamental alpha management? Is a combination of overlay and beta the key factor to success?





### Product polarisation

At Nordea we do not believe that fundamental alpha management has lost its space on the investors' shelf. The return to more normalised markets will show that overlay/beta have to be complemented by strong alpha production for the benefit of the end investor. We are however convinced that the business will polarise more strongly towards low-cost beta via ETFs on the one side, and high conviction alpha solutions on the other. This development is not new, however its development has been accelerated by the recent turn of events in the markets and the industry.

The consequence of this polarisation for asset management is becoming more apparent. Clients are seeking clarity in the offering of their investment managers whilst making their investment selection. Asset managers will in future face a matter of critical importance, to choose in terms of positioning between low cost beta solutions such as ETFs and more profitable, but also challenging, alpha generation. Taking the middle of the road is no longer an option for cross-border groups. At best, products in this category could be viewed as a marginal solution for captive distribution networks in Europe privileging home-made products versus third party solutions. Indeed, third party clients will privilege either a pure alpha solution or a pure beta strategy with the associated fee levels.

The upshot leaves many players in a fundamental dilemma when selecting the alpha production path. Providing alpha consistently is extremely rare. Low tracking error (beta) investment management can be easily performed and replicated at any financial organisation. Providing alpha requires higher conviction but also stronger focus on money management and is much less prevalent. Satellite products using alpha strategies are all about giving the fund manager freedom

to invest with minimum constraints to maximise alpha production, albeit under strong risk management supervision. The risk in a bigger organisation is that individual managers are overruled by strategy committees or simply intimidated into going along with their colleagues. All too often we see strong managers driven away from large corporations due to bureaucracy or lack of freedom. It is important to mention that risk management is not about bureaucracy or removing freedom to manage money, it is about setting clear rules and guidelines that frame and monitor money management but leaving responsibility and freedom to portfolio managers.

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**Asset managers focusing on outperformance need to manage the challenge of providing alpha for all asset classes and all regions. The burning question then is how to achieve success when alpha is so elusive?**



### Adapting to change

As the Nordic regions' largest financial institution, this predicament was clearly something we too were presented with at Nordea. Nordea has a global business model servicing mainly Nordic clients and internally manages the majority of the Group's retail investment funds and insurance assets. The Group encompasses around 150 investment specialists within four investment centres in Stockholm, Copenhagen, Helsinki and Bergen. As the leading investment manager in the Nordic region, we manage a large sum of core (beta driven) investment solutions, but at the same time we chose to implement a specific strategy to focus on producing alpha: our multi-boutique strategy.

The first pillar of our multi-boutique strategy was to establish dedicated internal teams whose sole objective is to provide alpha. These teams are independent in their daily money management but supported by our solid investment management platform when it comes to front-office systems, middle-office team, compliance and even more importantly risk management. Such a set-up provides them with the ability to focus on the key matter at hand: managing money. These teams constitute our internal boutiques, our response to the polarisation. As an illustration, internal boutiques include our Nordic equity team, thematic investment specialists and multi-asset professionals, all of whom have demonstrated their ability to produce above average returns in their respective areas.

If one compares alpha creation to the artistic world, we do not believe that one artist can compete in all categories and appeal to all tastes. On the other hand it is certainly possible to develop exclusive relationships with a wider range of artists and propose their talents in a dedicated gallery focused on high quality and distinctive approaches.

Therefore, being Nordic, we are pragmatic in regarding our capabilities; facing reality and recognising that we can not provide alpha in all asset classes or all regions using purely internal resources. To meet the challenge, we decided to team-up with external boutiques, on an exclusive basis, to complement our alpha offering. We selected relatively unknown investment managers who have demonstrated strong performance in their respective asset classes in order to provide better solutions to our clients. The result is exclusive agreements with three US managers, two important European boutiques plus emerging market players in Brazil and Asia.

Nordea is certainly not a pioneer with regards to the multi-boutique strategy, despite our first partnership with an external manager happening over 10 years ago. In truth this strategy has been implemented over the last four years. Certainly, there are many different ways in creating a collection of boutiques. Sometimes competitors try to create boutiques wholly on an internal basis; more often they purchase them which allows the founders of smaller fund-management groups to cash in on some of the value they have created and to take advantage of the larger group's marketing influence. Yet when boutiques become part of a larger business, they risk losing the spark that made them successful in the first place. What is innovative in our approach is the fact that we give our sub-advisors every freedom to continue to manage money successfully, without imposing a corporate culture or *modus operandi*.

By employing a multi-boutique approach, know-how and quality in investment management becomes possible across a broad product range, in part through exclusive agreements with some of the leading investment management companies.

This multi-boutique approach expands Nordea's investment capability. It positions us to work with the best investment advisors in the industry and provide them with an optimum environment to continue delivering outstanding results. We also have the flexibility to add boutiques when new investment opportunities arise.

Paramount for us is the ability to offer the talents of proven managers to our private banking clients seeking alpha, but also to our distributors and in turn their clients. From an investor perspective this model enables us to offer the best possible investment solution in the given asset class. This will sometimes also mean giving them access to lesser known asset managers that they might otherwise be unable to invest in. For the portfolio manager, our set-up allows them to focus on the job in-hand – managing assets. For Nordea, here in Luxembourg, the result is that we can focus on the distribution side and providing a quality service to our clients. The model is beneficial along the value chain.

Today our platform consists of a pan-European sales presence in local markets, support infrastructure and marketing authorisation in 18 countries. The kind of boutiques we are looking for either do not have the size, ability, or interest in concerning themselves with registering their funds across Europe, building large sales and client support teams, setting up distribution agreements and so on. Through our distribution agreements this network gives access to prominent distributors that the boutiques could never normally gain access to. This is a compelling offer and certainly helps us to secure some of the best, if hereto lesser known, asset managers in the business whilst avoiding the traps outlined above that may lead them away from doing what they do best – managing money.

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## The warning bells have already begun to toll for many traditional firms not willing to depart from their business-as-usual approach.

### The best of times and worst of times for asset managers

Demand for a host of traditional products is now in sharp decline as flows quickly polarise between 'true' alpha and 'cheap' beta. Unless players move quickly to revamp their business models, to provide such 'higher alpha' and/or 'cheap beta', their products will suffer pricing pressures. The implications for the asset management industry are profound, but for the survivors there are plenty of opportunities to continuing growing their businesses in the years ahead.







# UCITS: the battle for Asia

Accounting for merely 10% of total Asian mutual fund assets, UCITS funds' growth potential in Asia remains immense but competition from local funds is rapidly increasing. Why do UCITS funds only appeal to investors in certain Asian countries and what are the challenges they face to increase their popularity?

**Geoffrey Cook**  
Partner  
Brown Brothers Harriman

Today there are a few global fund management firms operating successfully in Asia, with many others actively looking to capture a share of expanding Asian wealth, hoping to offset the relative asset stagnation they are facing in their respective, more mature, domestic markets.

The popularity of the UCITS structure in Asia is definitely encouraging for global fund management companies that already have an established European cross-border fund range, allowing them to leverage an existing operating platform and distribute funds which have already reached critical mass and to benefit from an existing track record. The potential economies of scale that can be extracted from using a single global vehicle are significant for asset managers and ultimately also benefit investors.

The European Fund and Asset Management Association ('EFAMA') reported that in 2007 Asian investors accounted for 90% of net sales of Luxembourg and Dublin-based cross-border UCITS funds. Today, EFAMA estimates that close to 17% of UCITS assets under management originates from Asia, making this region, the largest non-European contributor. The Association of the Luxembourg Fund Industry ('ALFI') believes Asia is of strategic long term importance to the Luxembourg fund industry and is opening an office in Hong Kong in 2010 to ensure that goal becomes reality.

Developments in Asia today can be likened to those in Europe in the late 1980s, as fund management companies looked to distribute funds into each European country through a single UCITS fund range. The temptation to adopt a similar operating model to break into the Asian market is, of course, very high; however, there are considerable challenges in Asia that mean simply applying the European model to this region may not be the right answer.

#### **Cross-border versus local product**

In Europe, a single UCITS structure can be, to a large extent, distributed in all European countries. Not so in Asia. Some Asian markets are fully open to foreign investment products while others are still not directly accessible.

General trends can be distinguished depending on the relative market maturity and size of the local market. For example, the larger markets such as Japan, Australia, China, South Korea and India are also the most difficult to penetrate via an offshore product strategy. Conversely, the more mature countries with highly developed capital markets and wealth density such as Hong Kong, Singapore and Taiwan tend to offer the best opportunities for UCITS fund promoters. As an example, 91% of all funds registered in Hong Kong are offshore and the vast majority of them are Luxembourg and Dublin based UCITS. Similarly, in Taiwan, almost half of all fund assets under management are held in foreign funds.



The varying approach towards accepting foreign funds distribution in Asia can, to some extent, be attributed to the challenges faced by local governments and financial regulators. On the one hand, their responsibility is to protect retail investors by keeping full oversight of the products being publicly offered to them. They are therefore more inclined to only allow public distribution of onshore investment products which they can fully control and regulate. However, on the other hand, in an environment of aging populations and the urgent need to develop self-invested private retirement plans, they also have the responsibility to allow retail investors to build sound global asset allocation portfolios by accessing the best performing global and foreign invested products.

Local governments in the largest countries, such as China, India and South Korea, may try to protect their less-mature local asset management industries by helping them to build their foreign investment expertise without the direct threat from foreign products. Restricting access to foreign funds is a way for local authorities to require foreign players to set-up local fund management capabilities which, in turn, help to develop local asset management expertise.

Currently cross-border funds represent less than 10% of total fund assets in Asia. This means that a strategy based simply on the distribution of a global UCITS

structure would seriously limit the addressable target market. A combination of foreign and local funds is therefore a pre-requisite for long-term success. This however does not come without additional challenges. Global asset managers developing local products will find 'on-the-ground' operational and fund management capabilities, the use of local service providers with inconsistent technology platforms and service levels, and local staff recruitment and retention to be the major hurdles. To avoid this, it is imperative for cross-border fund promoters to organise themselves to make UCITS the best investment proposition to Asian Investors. In order to achieve this they will need to overcome a number of important challenges.

#### **Automation is critical**

The European fund market has seen some slow but continuous development in automation and straight through processing ('STP') of fund orders and fund settlement over the course of the last 10 years. The creation by SWIFT of ISO fund messaging standards, the development by Euroclear and Clearstream of fund processing facilities to trade and settle mutual funds, and the development of commercial fund distribution platforms such as Co-funds in the UK, Allfunds in Spain and Fund WorldView® have helped fund investors and fund promoters in Europe build a more robust, cost-efficient and scalable environment for investing in cross-border mutual funds.

These initiatives and commercial offerings have still not travelled to the East. According to EFAMA, in Q4 2008, only 8% of orders originating from Asia made use of an ISO standard, as compared to 47% of orders in Europe and the Americas; up to 65% of fund orders were still processed via fax or phone in Asia in 2008. Progress here is challenged by the lower cost of processing transactions manually in the region. Developing automation for trading systems involves substantial investments which Asian investors are not willing to make.

We believe that standardisation automation of fund processing in Asia is still a long way ahead. The only fund market that has achieved an acceptable level of automation is the US which experienced a major 'paper crisis' in the mid 1980s; concerted efforts by the asset management community ultimately forced the changes. Despite the enormous efforts made in the last 10 years, Europe is still far from having reached a reasonable level of automation.

The problem in Asia is that the servicing and risk issues created by manual processing are exacerbated by the time-zone difference and could be far more damaging for UCITS fund promoters. It is not uncommon for Asian investors to only receive trade confirmation two days after the trade was placed. One can easily imagine how unimpressed Asian investors can be when dealing in European based products, based on the cultural expectation of zero-defect.

As trade volumes in Asia rise – accounting, according to EFAMA, to about 30% of all orders received by Luxembourg transfer agents in Q4 2008 – so does the cost, as well as the reputational and operational risks of managing thousands of daily investors' orders manually. In this context, it is not difficult to see why the opportunities to succeed in the region can be severely hampered by the costs and risks of manual processing.

In the absence of a pan-Asian hub or communication standard, fund companies will imperatively need to find ways to increase their connectivity with their main investors and distributors. This can only be achieved by investing in middle-ware tools to accommodate the widest range of communication options or by leveraging third parties that have already built these connections.

#### Global/local client service

For fund management companies implementing a European distribution strategy, the challenge is limited to supporting investors who are resident in different countries but in broadly similar time zones. The success of the two main European cross-border fund centres, Luxembourg and Dublin, relied on their ability to attract a multicultural, multilingual and highly educated workforce to service a mostly European investor base.

When fund management companies broaden the distribution of their products to Asia, an even more sophisticated approach is required to service investors. Local time-zone client servicing in the investors' language has become a pre-requisite for many Asian-based clients. Client servicing teams need to be educated on a different client mentality and culture, and different market requirements. Operational procedures and controls must be adapted to reduce the increased risk. Significant technology enhancements are required to accommodate Asian investors' needs and necessary regulatory reporting.

Service provision to investors is becoming an increasingly important differentiator for fund promoters worldwide; the significance is magnified in Asia. While the top tier global asset managers have the resources to build on-the-ground client servicing teams and fund dealing desks, the cost for many others may be prohibitively expensive.

### Asia as part of a global distribution strategy

Brown Brothers Harriman's ('BBH') experience, in working with some of the largest asset managers who have successfully developed in Asia, has shown that there are several key elements necessary in the development of a flexible and scalable operating model.

Firstly, the Asian distribution strategy must be fully integrated within their global distribution strategy. In practice, this means a global operating model coupled with local support and expertise. Taken individually, most markets will not justify the infrastructure investment required to meet local clients' needs and market requirements. To leverage sufficient economies of scale, fund management companies must be able to operate from a single global technology platform fully integrated with each local client servicing team.

Secondly, we contend that a global operating model must be open to allow the seamless integration and aggregation of disparate sources of data across different providers. As the number of investors in different countries grows, the need to receive timely and accurate management reporting across the organisation has become vital to managing investments and cash flows, client monitoring and reporting, compliance and for risk management purposes.

In Asia, banks control about 60% of fund distribution. The largest players are either global or regional banks that will often have a centralised fund selection unit but will still require extensive local servicing in each country where they are active. The ability to effectively





manage these client relationships globally while servicing them locally can only be achieved with the support of efficient Management Information Systems ('MIS') that can be accessed in real time at different levels of the organisation in different locations.

A few global fund firms have already built substantial IT and client service teams in Asia. Going forward, it will be interesting to see how many additional promoters will want to develop the infrastructure required to support distribution across Asian markets. It is more likely that these fund companies will focus on developing local asset management capabilities and local sales teams in the region, and will look to outsource most of the administrative tasks to service providers able to offer more than the usual fund servicing capabilities.

In the last few years, BBH has experienced an increased appetite from global fund managers to outsource non-core activities to specialised fund service providers. In Asia, the traditional fund outsourcing model has taken a very different form from what we have seen elsewhere.

Today global fund companies acknowledge that the largest share of their resources should be focused on their core competencies of asset management and asset gathering, rather than building operational processes, implementing heavy IT infrastructures and processing transactions.

Fund management companies are no longer exclusively looking at outsourcing fund accounting and shareholder servicing activities but are now seeking more from their outsourcing partner(s). These value-added services include local time-zone dealing desks and multilingual client servicing teams, compliance support, automated fund messaging and ordering solutions, trailer fee administration and negotiation, aggregated management reporting across fund ranges, tax support, drafting of fact sheets and prospectuses as well as operational consulting.





These services, which are often referred to as distribution support services, have become key to fund managers wishing to leverage third parties that can deliver established technology infrastructure, local presence, expert advice and scale to reduce fixed capital commitments required to develop a successful Asian distribution business.

In response, fund service providers like BBH have substantially increased their investments in distribution support services focused on adding real value to their asset management clients. These service providers can benefit from the mutualisation of technology investments and resources to deliver significant economies of scale. Ultimately, we believe that this is pure example of a win-win strategy, as supporting and enabling our clients' distribution efforts' will, in turn, help us grow our own book of business.

#### **Getting it right is worth it**

The relative success of UCITS funds in the region offers opportunities for global fund management companies to expand their distribution into Asia in a cost-effective way, without the need to create local fund structures. Unfortunately, unless cross-border fund management companies find an effective operating model to meet Asian investors' needs, UCITS alone will not be the panacea hence the need to punctually complement a global flagship fund with locally domiciled products.

Past experience has shown that superior investment performance, and strong marketing and sales campaigns are not sufficient to be successful in global fund distribution. Providing local investors with the most suitable investment solutions and the right client servicing model is equally important.

There is no denying the excitement surrounding the development of the Asian markets. The question facing fund companies is how to build a flexible and efficient operating model to construct a profitable business in Asia. Those that understand that they are not in the business of building systems and managing transactions should look to partner with service providers for whom these activities are core and with whom they can work together to tap into the enormous opportunities that the Asian region holds.

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**The growth of the Asian fund industry which, according to Lipper's 2009 forecasts will expand by 2014 from \$1.2 trillion to \$1.9 trillion, creates tremendous opportunities for global asset managers.**

# Sunshine on the distressed debt market

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The current climate of economic and financial distress raises numerous liquidity and solvency concerns. With assets falling dramatically to a fraction of their face value, financial institutions are faced with the need to write-down their assets due to mark-to-market accounting rules or simply from a prudence perspective resulting in recognition of large losses. However, as every cloud has a silver lining, windows of opportunity exist for investors: the niche market of distressed assets and, in particular, distressed debt.

## Overview

Distressed assets are financial instruments which have suffered a substantial write-down in value due to the financial and economic situation of the company which issued those assets. In many cases, the company faces serious difficulties, is in bankruptcy or is about to collapse. Distressed assets consist of common and preferred shares, bank debts, trade claims, corporate bonds and derivatives.

Acquiring distressed assets allows investors to purchase assets at a discounted price with the underlying aim of making a profit upon repayment whilst ensuring recurring earnings; the investor's philosophy being that the company's situation is not in fact as distressed as the market believes and that an improvement in the issuer's business will result in the debt being traded at par or fully reimbursed at maturity.

Broadly, investors' strategies can be divided into two main camps. Firstly, investors could be 'non-control' driven, meaning that they will only influence the reorganisation of the company and will then sell the distressed assets at a higher value or wait for repayment of the par value. Secondly, willing investors can be 'control-orientated', which means that they will become a major creditor of the company and even a major shareholder by converting their debt into equity<sup>1</sup>.

The distressed debt market in particular, is a win-win situation, where investors with available cash flow have an opportunity to buy loans from financial institutions at a trade price below par value with the expectation of recovering par value on an improvement in market conditions. For financial institutions, it is an opportunity to rid their balance sheets of impaired assets and to raise fresh cash to cover their liquidity shortfall and improve their solvency margin.

<sup>1</sup> *Distressed debt opportunities appear on investment horizon* by David Hoffman, *Investment News*, 14 July 2008.



### The distressed debt market

Historically, distressed debt opportunities arise cyclically. A period of lenient lending policy followed by challenging global economic conditions and poor corporate credit worthiness will lead to an extensive supply of distressed debt opportunity<sup>2</sup>.

The distressed debt market blossomed in the US in the 1980s and early 1990s when the savings and loan crisis was in full swing. Financial institutions faced a difficult patch by writing off loans granted to individuals. Created by the Federal Deposit Insurance Corp., the Resolution Trust Corp. was in charge of auctioning off those distressed debts<sup>3</sup>. A new market had come to life. The 1990s were characterised in the US by times of strong economic growth and low default rates resulting in a decline in the number of distressed transactions. These glorious years in the US coupled with the currency crisis in Asia were the catalyst for distressed debt investors to focus on the Asian market, thereby gradually globalising the distressed debt market which originated in the US<sup>4</sup>.

Fast forward to 2000 and 2001 and the telecommunications industry downturn, largely as a result of the American WorldCom Inc scandal, offered new opportunities for the distressed debt market as the companies affected were not in a position to repay funds they had borrowed to build their infrastructures and networks<sup>5</sup>. Distressed debt investors established their headquarters in London and the distressed debt market then spread to Europe taking advantage of the increase in defaults in payment<sup>6</sup>.

Potential ultra-high rates of return generated by distressed debt investments seduced investors who succumbed to a new generation of funds specialised in those opportunities<sup>7</sup>.

Finally, more recently traditional private equity houses and financial services firms such as Goldman Sachs, Blackstone, Carlyle and Apollo also turned to the distressed debt market<sup>8</sup>.

<sup>2</sup> *The guide to distressed debt & turnaround investing*, Howard S. Marks, March 2007 (page 13 and 14).

<sup>3</sup> 'Debt industry overview' provided by Faulkner & Gray, *Debt Sales Directory*, 2000.

<sup>4</sup> E.g. *Shinsei Bank case. 'An overview of the private equity distressed debt and restructuring markets'*, in *The guide to distressed debt & turnaround investing* by Kelly DePonte, March 2007.

<sup>5</sup> 'Distressed debt investors force needed discipline on telecoms' Mairin Burns, 2003.

<sup>6</sup> 'The distressed debt market-a major force that's here to stay' by Marykay Fuller, *Recovery*, HYPERLINK '<http://www.r3.org.uk/recovery>', Spring 2006.

<sup>7</sup> In particular, Drexel Burnham Lambert, Cerberus, Lone Star and Oaktree Capital Management. 'An overview of the private equity distressed debt and restructuring markets', *The guide to distressed debt & turnaround investing* by Kelly DePonte, March 2007.

<sup>8</sup> 'Private equity firms rush to distressed debt assets' by Helia Ebrahimi, *Telegraph.co.uk*, 3 December 2008.

### Opportunities in the distressed debt market

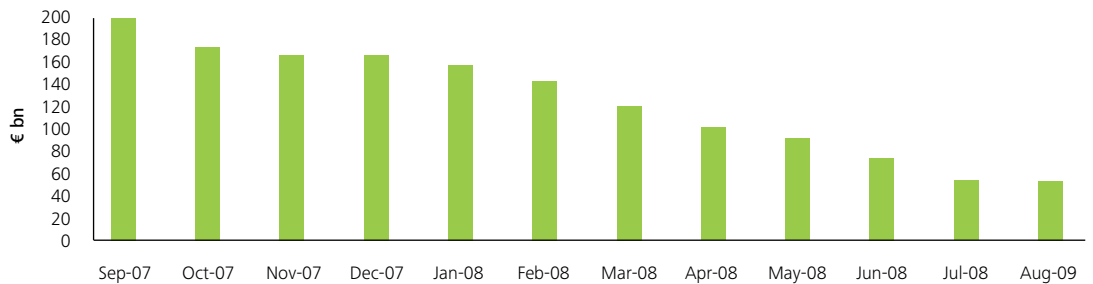
During the years 2006 and 2007, Leverage Buy-Outs ('LBO') activity entered its glory years. Banks lent huge amounts to private equity and hedge funds which, in turn, used that debt to highly leverage their investments to generate greater returns.

Today the LBO market is facing severe difficulties. Analysts consider that the crisis had its roots in the US credit market crisis<sup>9</sup>. Indeed, since the crisis began in 2007, many banks engaged in LBO transactions have been struggling to recover payment on receivables<sup>10</sup>. As a consequence, money is more expensive and interest rates are increasing, de facto decreasing the appealing mechanism of leverage.

In 2008, about 53 LBO deals were cancelled. The best example is the failure of one of the biggest ever planned LBO's of 48.5 billion dollars to take over Bell Canada Enterprises<sup>11</sup>. The following charts illustrate the decline in LBO transactions and the trend by banks to divest themselves of LBO transactions.

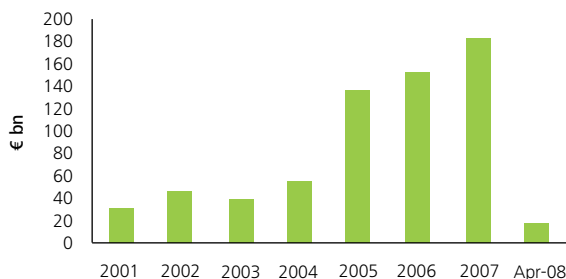
Banks are now facing urgent liquidity needs and have to clean up their balance sheets, notably to comply with their indebtedness ratio requirements. Consequently, distressed debts could be discounted up to 40%<sup>12</sup> of their face value thus creating attractive investment opportunities<sup>13</sup>.

### Leveraged loans remaining on banks' balance sheets



Source: Standard & Poors LCD

### New issue volume of European LBO loans



Source: Standard & Poors LCD

<sup>9</sup> *Opportunities in distressed assets and debt'* by Nick Skrekas, Reuters study, 2009 (Chapter 2, page 28).

<sup>10</sup> 'Quel est l'avenir des LBO face à la crise' by Jean-Charles Simon and Tiphaine Hue, M&A Magazine, 5 March 2009.

<sup>11</sup> 'Quel est l'avenir des LBO face à la crise' by Jean-Charles Simon and Tiphaine Hue, M&A Magazine, 5 March 2009.

<sup>12</sup> 'Investors find opportunities in distressed private equity deals' by David Bain, Private Equity News, 30 March 2009.

<sup>13</sup> 'Restructuration, les acteurs misent sur le LBO' by Antoine Landrot, L'AGEFI, 5 April 2007.

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## At a time where people see the crisis with a glass half empty perspective, one can also take the view it is half full, with great opportunities for investors with liquidity in a market exponentially growing.

In addition, following the LBO demise, investors now want to de-leverage<sup>14</sup> their investments by selling their receivables at the estimated value of repayment which is lower than the par value. In this context, a new cycle has started and an up-and-coming market is arising for distressed debt acquisitions.

Specialists are inclined to think that the volume of payment default will inflate in 2009 and it is forecasted that one fifth of European speculative-grade companies could default in 2010<sup>15</sup>, thus facilitating the purchase of distressed debts at rock bottom prices with potentially strong returns to investors. According to Moody's, the default rate will reach 16.4% in the fourth quarter of 2009 exceeding the peak of 11.9% in 1991 and 10.4% in 2001<sup>16</sup>.

The financial crisis did not settle things; indeed companies are unable to refinance their debts as credit providers are more than cautious<sup>17</sup>. Therefore, companies are now facing a deadlock, inability to repay and inability to borrow. In this context, investors must strongly consider taking advantage of the snowball effect of the liquidity crisis by contributing to the restructuring of companies in bad shape. Well-informed investors with taking the view that a strong recovery is on the cards may well find the goose that laid the golden egg. Indeed, investors who become major creditors of a defaulting company and then convert their debt into equity can make significant profits from putting the company back on its feet.

In addition, the European legal framework<sup>18</sup> regarding insolvency rules and procedures enhances the distressed debt market<sup>19</sup>. Both at the European level and at individual country level, the trend is to encourage a company's recovery rather than favor liquidation procedures. In this context, the investor's risk is lowered.

Distressed opportunities are not geographically limited and are spread across various sectors. The emerging markets of Asia, Eastern Europe and Latin America have supplied numerous distressed assets while the main European distressed opportunities according to Debtwire<sup>20</sup> are expected in the UK, especially in the financial sector, swiftly followed by the German automotive industry and the Spanish construction industry. The consumer retail sector and chemical and media businesses will also offer great opportunities as indicated in a 2009 Debtwire survey<sup>21</sup>.

All stakeholders in the distressed debt process are satisfied; the lender to the company can exit a particular situation and get back liquidity whilst allowing investors to expect a greater return on their investment.



<sup>14</sup> 'Investors find opportunities in distressed private equity deals' by David Bain, *Private Equity News*, 30 March 2009.

<sup>15</sup> 'Distressed debt funds leap too soon' by Stephanie Baum, *Private Equity News*, 16 February 2009.

<sup>16</sup> 'Opportunities in distressed assets and debt' by Nick Skrekas, *Reuters study, 2009 (chapter 1, page 21 -22)*.

<sup>17</sup> 'Opportunities in distressed assets and debt' by Nick Skrekas, *Reuters study, 2009 (chapter 1, page 21)*.

<sup>18</sup> 'EU regulation on insolvency procedures, 2002.

<sup>19</sup> 'The distressed debt market- a major force that's here to stay' by Marykay Fuller, *Recovery*, [www.r3.org.uk/recovery](http://www.r3.org.uk/recovery), Spring 2006.

<sup>20</sup> Debtwire is a division of the Financial Times Group specialized in worldwide market analysis.

<sup>21</sup> 'Opportunities in distressed assets and debt' by Nick Skrekas, *Reuters study, 2009 (chapter 1, page 23)*.





### The pillars of solid investments in a distressed market

When entering the distressed debt market, one should keep in mind a number of issues to be monitored to optimise profits and the effective tax rate during the holding period and upon disposal.

#### 1. Beneficial ownership requirements

Although the international fiscal meaning of beneficial ownership still needs to be specified and harmonised, the concept is a clear line of defense used by countries against treaty shopping. Source countries are becoming more and more reluctant to grant relief or exemption merely on account of the status of the intermediate recipient of the income.

Therefore, when structuring the acquisition of debts at a trade price below par value, one should ensure that the investor in the recipient country will be viewed as the beneficial owner of the income by the tax authorities of the borrower's source country. Otherwise, withholding tax or tax cost (i.e. on interest and possibly gains) imposed by the source country may negatively impact the expected returns on the investment.

An example of a recent challenge to beneficial ownership can be found in the 2006 UK Court of Appeal decision in the 'Indofood' case<sup>22</sup> according to which the 'International fiscal meaning' of beneficial ownership prevails against the 'narrow technical' domestic law meaning and the recipient must enjoy the full privilege to directly benefit from the income. Against this background, on 26 February 2009, the

Canadian Federal Court of Appeal gave its decision in the case of *Prévost Car Inc. v. Her Majesty the Queen* (2009 FCA 57). It upheld the decision of the Tax Court of Canada and dismissed the tax authorities' appeal on the interpretation of the term 'beneficial ownership'.

The absence of harmonisation of the meaning of beneficial ownership obliges investors to adopt a sensible and pragmatic approach when considering distressed debt acquisitions.

#### 2. Tax charge on interest and gains

Monitoring the tax cost on interest income and gains in the event of recovery at a higher value whilst complying with the arm's length principle is another key aspect of the structuring. Similarly, Controlled Foreign Company rules need to be considered. Indeed, these aspects can dramatically impact the expected return on investments.

A crucial point is the interest differential that may arise from the financing of a distressed debt acquisition. The cost of financing a distressed debt should be significantly lower than the yield arising on the distressed debt itself since the yield on the debt payable will accrue on the basis of the discounted price, i.e. the amount required to fund the acquisition, whereas the yield on the distressed debt will accrue on the basis of its face value.

In addition, in respect of distressed real estate backed debt opportunities, it is important to implement a structure which delivers the expected commercial outcome whilst minimising tax leakages that could arise notably upon exercise of the guarantee such as transfer tax or taxation in the country where the real estate is located, especially in the absence of a double tax treaty.

#### 3. Accounting and auditing implications

The key aspect, from an accounting perspective, is to identify the features of the debt acquired as to determine whether the investment will be viewed as a distressed debt or a discounted debt.

The accounting implications for both asset types differ significantly in relation but not limited to profit recognition and recoverability. In a nutshell, distressed debts refer mainly to an instrument incorporating a counterparty risk whereas discounted debts relate chiefly

<sup>22</sup> *International Finance Ltd. v. JP Morgan Chase Bank, London Branch*, (2006) EWCA Civ 158.

to liquidity issues. Defining whether we are dealing with distressed versus deep discounted debts should be analysed on a case-by-case basis depending on the overview and characteristics of the transaction and instrument.

From an audit perspective, the main issue that may arise relates to valuation criteria with a distressed debt being more difficult to value due to the high risk of default by the entity that holds the debt.

#### **4. Liquidity & credit risk**

Investing in distressed debt necessitates, more than in any other financial field, the implementation of an accurate and comprehensive risk management process. A broad variety of risk drivers are known to rule the dynamics of a structured vehicle investing in distressed debt, ultimately affecting its financial condition and viability.

#### **5. VAT impact**

Depending on the manner and conditions of acquisition, buying distressed debts may result in performing financing activities. This may categorise the company as a VAT taxpayer and may thus have different VAT consequences, e.g. VAT registration or reporting obligations.

Depending on the situation, it may result in either a higher VAT cost or an opportunity to reduce VAT cost. Every situation should be carefully analysed to ensure all VAT obligations are met and that the VAT situation is optimised.

#### **6. Cash flows and flexibility**

Access to liquidity is a key element in current market conditions: investors are eager for cash. Investment structures allowing efficient and regular cash management and/or repatriation must be considered when distressed debt is not paid in kind.

Finally, when designing investment structures one should remember that it must remain adaptable to change and divestment in a changing market.

Structuring investments in distressed debts requires a thorough understanding of the current market and expert knowledge of the appropriate acquisition vehicles.

Customised structures exist in some countries to ensure the optimal global tax charge for each specific situation whilst ensuring comfort for the investors that the way in which the investment is executed will not be challenged by tax authorities.

The choice of the appropriate location and structure will depend on a number of features such as the size and location of the target portfolio, the need for a regulated vehicle or the number of investors. It is essential to implement structures which deliver the desired commercial outcome and at the same time tax efficient returns.

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**When entering the distressed debt market, one should keep in mind a number of issues to be monitored to optimise profits and the effective tax rate during the holding period and upon disposal.**

# Emerging countries tax constraints... or why you should pay attention to our tax news alerts

**Pascal Noël**

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## Introduction

Amongst all the challenges that Luxembourg investment funds have had to face during the recent economic crisis, there was also another one – the constant amendments to the tax laws implemented in many countries, predominately affecting the taxation of non-residents. In times of crises, many countries decide to increase the taxation of income obtained by non-residents in order to secure a higher collection of taxes.

In relation to the taxation of investment funds, it is our opinion that a positive trend is sweeping through the EU Member States, mainly due to the case law of the Court of Justice of the European Union (hereafter 'ECJ'), and the efforts of the European Commission.

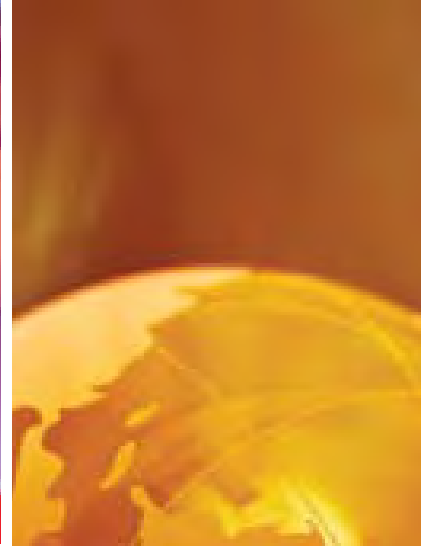
During 2009 and already in 2010 some EU Members States have amended their tax laws to tackle differential tax treatment measures between resident investment funds and other EU investment funds. However, whilst within the EU, Members States cannot apply prejudicial tax laws to EU investment funds, this type of EU Treaty protection ceases to exist when EU investment funds distribute and invest in third countries. In these situations, EU investment funds qualify, for tax purposes, as non-resident entities that in most cases are subject to final withholding taxes in the source country.

It needs to be stated that amendments to the tax laws of source countries have a direct impact on investment funds on several levels: on the determination of the net asset value of the fund; on tax compliance obligations; on potential problems in relation to tax declaration obligations in these local countries. More specifically, the expected revenue from investments is inevitably affected when amendments to tax laws represent increases in withholding tax rates i.e. gross income from interest, dividends and capital gains being subject to a higher level of taxation.

The situations mentioned above constitute a continuous challenge for all the parties involved in managing the life of investment funds including but not limited to fund managers, auditors, tax advisors, legal advisors, paying agents and custodians.

The non-compliance of tax obligations can be due either to the lack of appropriate sources of information, but, in many cases due to the lack of appropriate accounting methods and systems. Examples include failure to assess the amount of capital gains to be booked (FIFO/LIFO/average cost); failure to compute the tax charge (tax provisions) due; issues regarding the determination of the taxable base (investment test vs. trading test).

In the following paragraphs we illustrate some of the most recent amendments in specific jurisdictions which we understand may have an impact on Luxembourg investment funds.



## Impacted jurisdictions



In **Peru**, until 31 December 2009, gains derived from the transfer of securities on the Peruvian stock exchange were exempt from income tax. Since 1 January 2010, capital gains tax is levied, on both listed bonds and equities, on the sales realised by non-residents at the rate of 5% or 30% depending on whether the transaction takes place respectively in or outside of Peru. This new tax will be levied on the net capital gains consisting of the market value of the security less its tax cost. Non-residents will need to request a certification for this tax cost from the Peruvian tax authorities otherwise the full proceeds will be taxed. For transactions realised on the stock exchange, non-residents will be subject to filing requirements with the Peruvian tax authorities. Both the certification and filing requirements constitute an increase of the tax compliance obligations on investment funds in Peru.

On the other hand, there is currently no Double Tax Treaty signed between Luxembourg and Peru that may potentially minimise this new tax charge. This means that the various types of Luxembourg investment vehicles including but not limited to FCPs, SICAVs and SICARs, will be impacted and these funds should consider the potential impact of this capital gains tax on their net asset value.



**Indonesia** has recently approved amendments to its tax laws, effectively creating bureaucratic obstacles that prevent Luxembourg investment funds, more specifically, Luxembourg SICAVs, from benefiting from the beneficial treatment from the Luxembourg-Indonesia Double Tax Treaty. The Indonesian Directorate General of Taxation recently issued two regulations and a circular

letter establishing new procedures for claiming tax treaty relief for Indonesian withholding tax. The new regulations which took effect as from 1 January 2010 have significant implications for Luxembourg SICAVs, whereby the reduced withholding tax on interest is now on 10% instead of 20%; the reduced withholding tax on dividends is now on 15% instead of 20% and no capital gains taxation in Indonesia. Luxembourg FCPs should not be impacted as they do not benefit from Luxembourg Double Tax Treaties, in any case.

Under the new regulations, Luxembourg SICAVs will need to obtain the new Certificate of Domicile (hereafter 'COD') in a prescribed format: Form DGT1 for interest and dividends and Form DGT2 for (i) non-residents who receive capital gains from transfer of bonds or stocks listed on the Indonesian stock exchange and held through a custodian in Indonesia and (ii) for foreign banks. The COD must be stamped by the Luxembourg tax authorities and should, under certain conditions, remain valid for 12 months as of the date of certification by the Luxembourg tax authorities.

The COD Form DGT1 contains a number of specific questions which must be answered by the Luxembourg SICAV, based on which the paying agent can determine whether or not the income recipient satisfies the new beneficial ownership requirements and is not deemed to be abusing the tax treaty. As the COD Form DGT1 contains questions such as 'is the earned income subject to tax in the country of residence of the recipient of the income' or 'is the company engaged in active conduct of a trade or business' that a Luxembourg SICAV is unable to confirm, the upfront claim for tax treaty benefits by the Luxembourg SICAV is likely to be denied by a paying agent in Indonesia.

However, it seems treaty benefits could still be available if the Luxembourg SICAV's shares are regularly traded and listed on a stock exchange, which unfortunately is not the case for the majority. In this context, Luxembourg SICAVs will need to consider the potential increase in the tax charge on Indonesian source income until they obtain confirmation of their tax treaty eligibility further to the filing of the required COD.



In **Brazil**, on 20 October 2009, a 2% financial transaction tax was introduced on all fixed income and equity investments made by foreign investors on the Brazilian stock and capital market to reduce speculation and to help contain the appreciation of the Brazilian currency. In an attempt to avoid this tax, foreign investors have been purchasing Depository Receipts such as American Depository Receipts on Brazilian securities on foreign stock exchanges rather than purchasing Brazilian stocks on the Brazilian markets.

As a consequence, the Brazilian government introduced a 1.5% financial transaction tax on depository receipts of Brazilian companies listed on foreign stock exchanges. This tax is applicable as from 19 November 2009 on the assignment of shares that are admitted to be traded on the Brazilian stock exchange 'with the specific intention to secure the issuance of depository receipts traced abroad'. It is our understanding that custodians in Brazil are already applying these rules and deducting the tax amounts from fixed income and equity investments.



As of 1 January 2010 **Taiwan** introduced the basic income tax ('AMT') system with the purpose of taxing foreign sources of income obtained by its resident individuals. This had previously been exempt. Some examples of such foreign sources of income are capital gains from the sales of foreign securities, both listed and unlisted, as well as foreign funds; income derived from foreign securities and funds; and sales of foreign real estate whereby 12% of the sale price is included in FSI with 88% deductible as costs and expenses.

Although this measure is strictly intended at Taiwanese individual residents, it might have an impact at the level of Luxembourg funds as their offerings will become less attractive for individual residents. Additionally, those residents who are not familiar with the rules surrounding the calculation of AMT may rush to redeem their foreign holdings unnecessarily.





In relation to **India**, the majority of the Luxembourg SICAVs invest therein through their Mauritian subsidiary company, as these are not subject to capital gains taxation in India due to the application of the Double Tax Treaty India-Mauritius. There is uncertainty about the future of this route in the context of a tax reform that should take place in India in 2011. It is also worth noting that Luxembourg SICAVs investing directly in India are subject to tax on short term gains of less than 12 months as they do not benefit from the double taxation treaty.

Interest, dividends and short term capital gains which are held for less than 12 months are subject to tax in India through withholding taxation (interest at rate of 20%) and tax return/ advance payments (short term capital gains at rates of 15.45%). The potential tax charge can be significant on such volatile emerging markets.

Currently there are discussions on the potential approval of a new taxation regime for capital gains. The new framework proposes to eliminate the distinction between short- and long-term (capital) investment assets. Accordingly, capital gains on the sale of such assets would be taxable at the normal rates. In the case of non-residents, capital gains would be taxable at a flat rate of 30%. These uncertainties including potential tax charge from the sale of shares, delays in the repayment of the tax advances, and possible modifications of the tax rules in 2011, are not always reflected at the level of the NAV of Luxembourg funds.



**Greece**, although not considered an emerging country, is also introducing a new regime of taxation of capital gains applicable to both residents and non-residents. In fact, originally scheduled for 1 January 2009, the entry into force of a flat rate of 10% withholding tax on gains derived from sale of shares listed on the Athens

stock exchange for both resident and non-resident enterprises and individuals has been postponed for the third time. According to the relevant provisions of the new law, capital gains tax of 10% shall apply on gains arising from sales of shares listed on the Athens stock exchange as long as such shares have been acquired on or after 1 July 2010. By failing to be entitled to treaty benefits, Luxembourg SICAVs and FCPs may suffer this 10% withholding tax on gains arising from sales of listed shares acquired on or after 1 July 2010.

#### Conclusion

The increase of tax charges on non-resident investors, and as a consequence on foreign investment funds, will probably continue to increase in the context of the current financial crisis. The USA may indeed become the winner in this tax contest, as they recently announced a significant tax reform. As from 2013, foreign investment funds will be required to sign an agreement and to report information to US tax authorities. Non-compliance will lead to a 30% withholding tax on the proceeds derived from the sale of US securities!

Our frequent tax alerts will inform you who may follow the example of the US. However, we hope that the negative impact of such measures on local stock markets will discourage many countries in trying to compete with the US in this area.

# Investment funds: liquidity risk and the supply-&-demand paradigm

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Liquidity risk is rapidly moving up the agenda of professionals and is suddenly receiving an increasing deal of attention from both practitioners and regulators. The recent credit turmoil has stressed the risk management landscape. The financial industry has come to realise that it inevitably must develop stronger liquidity risk management structures. This holds particularly true in the context of the coming UCITS IV framework.

The notion of liquidity is, in many ways, similar to the concept of fluidity in physics. Both refer to the possibility of exchanging, acquiring or consuming a given quantity in smooth, regular conditions. This is in effect a process of transportation: liquid conditions contrary to high fluctuations can be controlled more easily thus ensuring continuous exchange.

Science abounds with examples of more or less liquid states. In fluid mechanics, the example of honey is illustrative. Everyone has experienced its so-called viscosity by simply turning a honey jar upside down. Children are often astonished when contemplating for the first time how the honey defies the laws of gravity and resists the temptation to reach the ground! Traffic jams have also been the object of increasing scientific attention over the last few decades: in particular, the transition from liquid to jammed traffic has been excessively documented. Finally, aeronautic engineers have concentrated heavily on the feared blowholes which are encountered by planes when the density of the air suddenly changes, resulting in the plane dropping - sometimes quite abruptly and heavily.



Despite their different areas, these examples share one specific feature in common: they are the manifestation of a state of non-equilibrium which is created under the action of two kinds of forces that do not entirely compensate. These driving and resisting forces have a specific terminology in economy, and their conjugated actions have been enshrined as economics' holy principle: the law of supply and demand.

#### **Liquidity risk in the investment funds industry**

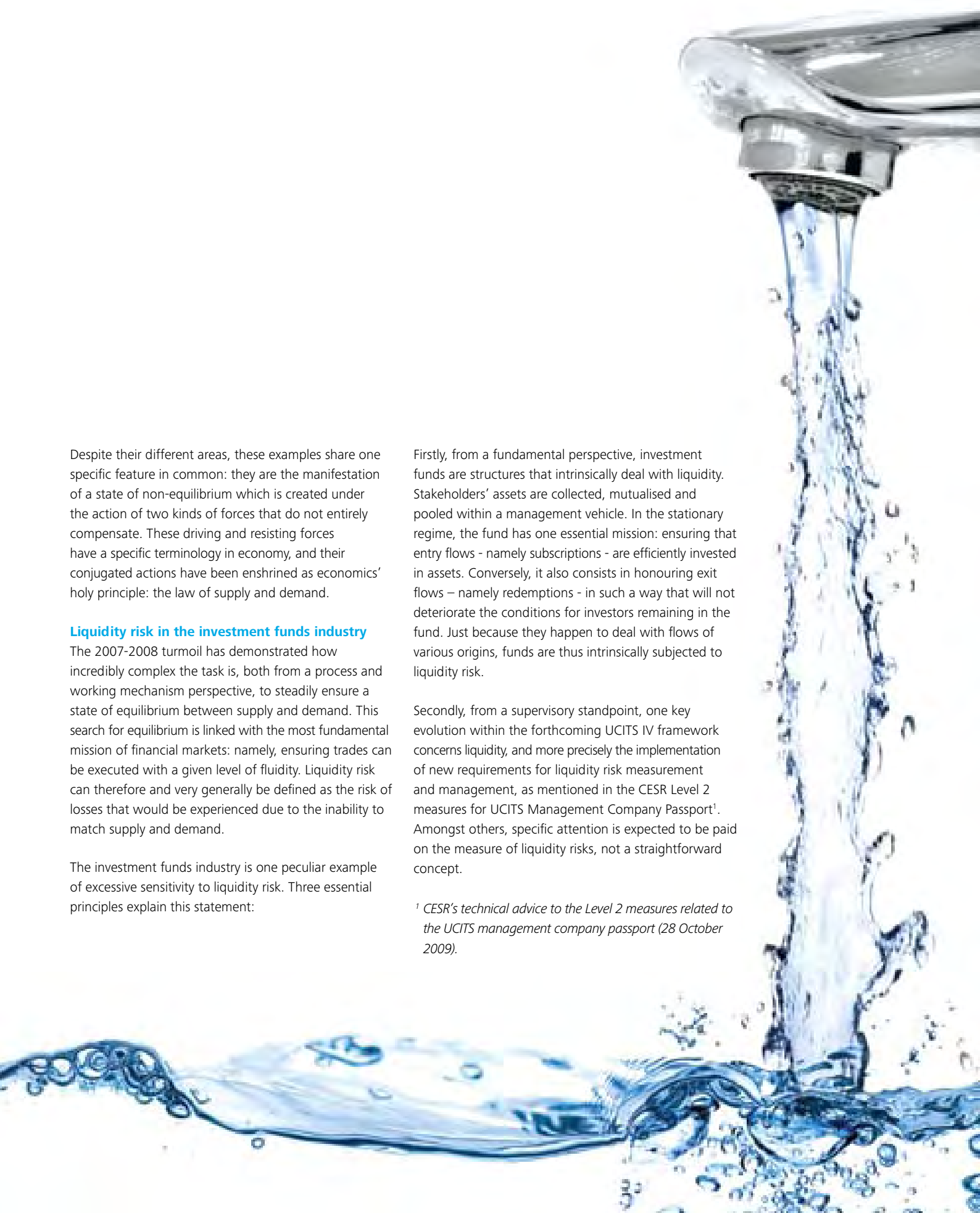
The 2007-2008 turmoil has demonstrated how incredibly complex the task is, both from a process and working mechanism perspective, to steadily ensure a state of equilibrium between supply and demand. This search for equilibrium is linked with the most fundamental mission of financial markets: namely, ensuring trades can be executed with a given level of fluidity. Liquidity risk can therefore and very generally be defined as the risk of losses that would be experienced due to the inability to match supply and demand.

The investment funds industry is one peculiar example of excessive sensitivity to liquidity risk. Three essential principles explain this statement:

Firstly, from a fundamental perspective, investment funds are structures that intrinsically deal with liquidity. Stakeholders' assets are collected, mutualised and pooled within a management vehicle. In the stationary regime, the fund has one essential mission: ensuring that entry flows - namely subscriptions - are efficiently invested in assets. Conversely, it also consists in honouring exit flows - namely redemptions - in such a way that will not deteriorate the conditions for investors remaining in the fund. Just because they happen to deal with flows of various origins, funds are thus intrinsically subjected to liquidity risk.

Secondly, from a supervisory standpoint, one key evolution within the forthcoming UCITS IV framework concerns liquidity, and more precisely the implementation of new requirements for liquidity risk measurement and management, as mentioned in the CESR Level 2 measures for UCITS Management Company Passport<sup>1</sup>. Amongst others, specific attention is expected to be paid on the measure of liquidity risks, not a straightforward concept.

<sup>1</sup> CESR's technical advice to the Level 2 measures related to the UCITS management company passport (28 October 2009).





Thirdly, liquidity risk is considered as critical factor for the survival of the fund, and potentially the management company. When confronted with liquidity risk, a fund will have no other choice than to remedy this by means of specific actions, e.g. sell substantial assets in the case of honouring an important redemption. Unfortunately, there is no such thing as a safeguard guarantee in terms of their ultimate effect. Such drastic measures could result in further deteriorating the liquidity risk profile of the fund, which we will discuss below. In other words, if the liquidity risk has reached a given threshold of magnitude, it is practically impossible to restore financial sustainability at fund level. Any measures taken to improve this state are more likely to jeopardise rather than resolve. This is very much like striving to extinguish a fire by dropping oil on it.

It is thus a safe bet to assume that the interest of investment funds in liquidity risk will significantly increase, especially from a measurement side. Yet precise measurement of liquidity risk is not possible without a comprehensive, profound prior analysis of liquidity risk drivers. To pave the way for quantitative measurement, a qualitative understanding of the nature of the factors influencing liquidity risk is an indispensable prerequisite from an investment fund perspective.

#### **Analysis of the supplying force in investment funds**

Liquidity suppliers in investment funds are essentially two-fold: on the one hand, investors are likely to inject money, on a discretionary basis, into the structure. On the other hand, selling assets held by the fund also supplies liquidity. Albeit different, both of these liquidity providing mechanisms ultimately result in the same actions of converting cash to assets or assets into cash. It is this very conversion that defines the essence of liquidity risk for investment funds.

When shares are sold in the market and transformed into cash, liquidity risk stems from the limited ability to trade shares at best execution prices. This limited capacity can be seen as the result of three different contributions:

- Product-related liquidity risk: assets are more or less liquid, depending on the typical volumes that are exchanged between transacting agents for this product. As a rule of thumb, corporate bonds are generally significantly less liquid than publicly traded blue chips. This can also be qualified idiosyncratic, in analogy with traditional terminology of market risk.
- Exogenous liquidity risk: the barometer of liquidity activity in the overall market where the transaction is supposed to take place is also influential. This would generally be called systematic liquidity risk, again exploiting the analogy with market risk.
- Endogenous liquidity risk: when time is a constraint in the selling process, for example in a forced liquidation, there may be no other alternative than selling shares en bloc. This is likely to put large volumes in the order book, and the likelihood of trading them within the bid/ask spread is actually very low. On the other hand, bidders will be ready to quote a price for the acceptance of this bloc, but they would need to be remunerated in such a way so that their own liquidity risk is reflected, in the case they would intend to sell the assets at a later stage. This might ultimately result in important discounts that should be conceded.



### Analysis of the demanding force in investment funds

Liquidity takers in investment funds are mainly found on the investors' side. Without prior notice, the investment structure can be notified of an unexpected, important redemption order which will need to be honoured according to certain conditions as stipulated in the prospectus. There is a broad range of factors resulting in redemptions, and the exhaustive categorisation of such drivers is not realistic. We can, nonetheless, group redemptions drivers into different groups, including but not limited to:

- Disappointment in the fund's performance
- Risk appetite conversion & arbitrage to other funds
- Maturity of placements
- Systemic risk in markets (not specific to the fund, but affecting the fund as an aftershock)
- Herding and contagion effects

Liquidity risk on the redemption side on fund level should thus be caught by the modelling of investor behaviour. More specifically, it should consist in inferring the potential fluctuations of the demand function based on the nature of the stakeholders. Since these are human beings, for whom reactions and decisions are incredibly complex to gauge and predict, one could legitimately think at first sight that this exercise is pointless.

There has been, however, over the last decade a developing interest in the modelling of human reaction<sup>2</sup>. This is field of behavioural finance tries to define and

formalise the psychology of financial markets. Its main hypothesis relies in acknowledging that any decision, taken in a strongly interacting medium (e.g. finance, where many players are involved in the price construction process) is derived from human biases in individual and collective behaviour. This approach somehow supersedes the well-known 'investors' rationality', a concept that both pioneered micro-economical advances and yet which has been the object of increasing criticism over the years. Arguably, it constitutes a more realistic alternative to the investors' rationality assumption and utility optimisation, which apart from in the textbooks, does not seem to work so efficiently in practice and fails to replicate the empirical reality<sup>3</sup>.

More prominently, there are various practical ways of accounting for this so-called behavioural risk. Despite the apparent complexity of modelling human reaction, some universal factors are derived which can be used in the redemption risk parameters. When combining qualitative specifications from the investors' side (e.g. risk appetite, geographic origin, risk concentration, emotional profiling, historical redemptions, attitude towards crisis) with general human biases (e.g. hindsight effect, underreaction-adjustment-overreaction chain), one can build surprisingly relevant programs in the ambitious attempt to assess redemption risk more accurately.

<sup>2</sup> *Andrei Shleifer, Inefficient Markets: An Introduction to Behavioral Finance (1999).*

<sup>3</sup> *The Nobel Memorial Prize in Economics, attributed to Daniel Kahneman in 2002, for its pioneering contribution to Behavioural Finance, clearly recognises the foundations of this approach in economics.*





NAV	Position	Market price	Liquidation time
100	A	15	34
	B	15	30
	C	15	20
	D	15	19
	E	10	17
	F	10	15
	G	5	6
	H	4	5
	I	6	3
	J	5	2

### Liquidity risk in a nutshell: case study investment funds

Here we will consider the simplified example of a fund consisting of ten positions, each with a given market value and typical market volumes. Based on a strategy of not selling more than 15% of usually traded volumes a day, estimations for the required liquidation time of each position can be derived.

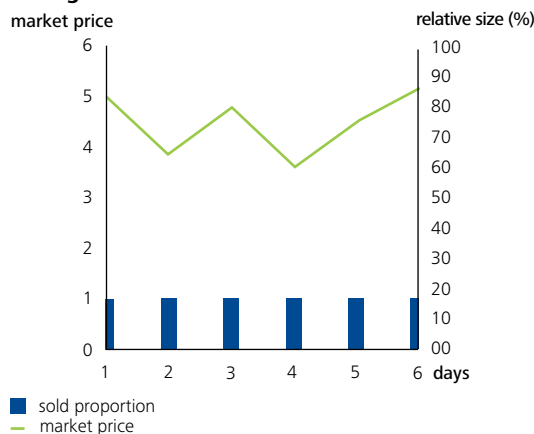
Let us further consider an unexpected redemption request, representing 20% of the NAV. Without putting too much pressure on market prices, the fund manager can, within six days, sell enough liquid assets (Positions G, H, I and J) to honour the redemption request.

However the fund manager faces two important consequential questions:

- What discount must be expected due to market risk?
- What is the new liquidity risk profile of the fund after selling its most liquid assets?

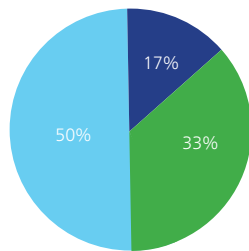
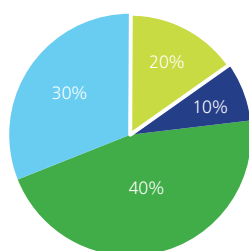
In our examples, liquid assets G,H,I and J are in the same time supposed to exhibit quite a high volatility. Consequently, the execution price is likely to vary significantly from one day to the other during the selling process. In the above example for Position G, the average price during the 6-day selling period is 4.5 instead of the initial market price of 5. This corresponds to a 10% discount, which albeit large is totally realistic in light of some typical risk profiles of investment funds (long-equity strategies for instance).

#### Selling of Position G



**Liquidity profile before selling**

**Liquidity profile after selling**



**Sellable**

- within 5 days
- within 10 days
- within 20 days
- within 40 days

***Ceteris paribus* the liquidity profile of the fund has considerably deteriorated. Future redemption requests cannot be honoured for 10 days without significantly impacting the NAV.**

**Deloitte's philosophy in terms of liquidity risk**

At Deloitte, we firmly believe in the power of quantitative risk modelling as well as recognising portfolio managers' need for pragmatic tools. This statement equally applies to liquidity risk: paradoxically, it is a straightforward concept for any finance professional, yet it is still in its infancy from a modelling perspective.

It is our conviction that liquidity risk measurement is only as accurate and efficient, from a quantitative perspective, as the modelling is realistic and relevant. State-of-the-art developments in liquidity risk, such as time-to-cash distribution functions, bid/ask spread dynamics or the optimisation of liquidation strategies, to just to name a few, can – if modelled accurately – and do indeed help investment funds manage expected normal liquid conditions better than some of their competitors. Scientific and consistent stress test modelling, rather than applying purely arbitrary assumptions, provides valuable projections and guidance especially in times of turbulent liquidity. Finally, liquidity risk, being proteiform and rapidly expanding, means that correlation and contagion effects also have to be captured to reflect these types of dynamics.

In conclusion, we support one key perspective of liquidity risk. Qualitative understanding should be completed with intuitive and more sophisticated approaches. The treatment of liquidity risk has simply to be commensurate with the stakes: namely the issue of survival for investment funds.



# Some food for growing appetites: new rules, new opportunities with Master-Feeder UCITS

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In March 2007, the European Commission announced a series of targeted enhancements to the UCITS Directive 85/611/EC. Following further work and consultation, the Commission adopted a proposal for the revised UCITS Directive in July 2008, an amended version of which was approved by the European Parliament in January 2009 and adopted by the European Council in June 2009. The final text of the revised Directive 2009/65/EC was published in the Official Journal on 17 November 2009 and became known as “UCITS IV”.

This UCITS IV Directive introduces several areas:

- A full passport for the UCITS Management Company
- A framework for cross-border UCITS mergers and Master-Feeder UCITS structures
- Simplification of the notification process
- Replacement of the current simplified prospectus by the key investor document ('KID')
- Enhancement of regulator cooperation



### Advantages of the Master-Feeder UCITS structure

The Master-Feeder UCITS structure allows asset managers to capture the efficiencies of larger pools of assets, and the promoter to create dedicated investment funds complying with the requirements of domestic markets.

The structure allows efficiencies in the manner in which investments are made since only a single trading entity, i.e. the Master fund, is used. This avoids the need for the investment manager to split orders or to engage in 're-balancing' trades between parallel or 'side-by-side' structures. It also eliminates the need to enter into duplicated agreements with counterparties, thus reducing costs in the longer term. Moreover, the set up of another feeder of an existing Master-Feeder UCITS structure is fairly straight-forward and allows entry into new target markets including the full range of EU markets, or to easily meet the needs of specific types of institutional investors.

### Master-Feeder under UCITS IV

The fragmentation of the European investment management industry has been noted for many years, impacting the competitiveness of UCITS products and raising key issues such as costs to investors. The current trend to rationalise is expected to continue with the restructuring of fund ranges to keep demanded products and to achieve critical mass.

The decision of the European Union to define a framework for cross-border UCITS mergers and Master-Feeder UCITS structures has been positively received by the industry as a means to help ease the process of rationalisation.

The feeder UCITS and the master UCITS must enter into a legally binding agreement in which the feeder fund will be required to have at least 85% of its assets in a single master fund. Additionally, the feeder fund will have to act in the best interests of its investors and to monitor effectively the master UCITS. This may allow a promoter to transform two UCITS products domiciled into two different countries (countries A and B) into feeders UCITS investing in only one master UCITS in either country A or B or even in a third country. This set up should no longer require a management company and the substance of the fund in either country A or B thus allowing a promoter to penetrate new markets at lower cost.



## Challenges

The UCITS IV Directive creates challenges on the tax side in relation to Master-Feeder UCITS structures. The tax consequences in relation to structure changes, such as a UCITS wishing to convert into a feeder UCITS of a master located in another country of residence, are not clearly defined yet. The tax consequences of the Master-Feeder UCITS structures should be neutral but this needs to be thoroughly analysed at the level of the fund, the Management Company and the investors.

Master-Feeder UCITS structures also challenge the cross-border model and give rise to concerns of transparency and difficulties in monitoring day-to-day activities. These difficulties may lead to more expense due to duplication. CESR has reviewed these elements and already defined eight areas of improvement:

- Agreement between feeder and master UCITS
- Measures to avoid market timing
- Liquidation, merger or division of a master UCITS
- Agreement between depositaries
- Reporting by the master UCITS depositary
- Agreements between auditors
- Change of feeder UCITS objective and transfer of assets in kind

In this article we will summarise CESR's technical advice to the European Commission issued on 22 December 2009 on these topics as most of them will form part of the Commission level 2 measures.

### Agreements between parties

Management companies of feeder and master funds will have to enter into an information-sharing agreement. In the case of only one management company for both the feeder and master, this agreement between parties could be replaced by 'internal conduct of business rules' applicable for all feeders with no need for one agreement per entity. These 'internal conduct of business rules' should include an adequate level of detail including but not limited to charges and expenses, frequency and timing of NAV calculation, investment policy, measures to avoid conflict of interests or market timing and dealing arrangements. This level of detail is similar to that required for agreements between feeder and master UCITS with the difference that if a promoter wishes to launch a new feeder, they can refer directly to these internal conduct of business rules.

If there is an agreement between feeder and master UCITS, this agreement should be of a sufficient level of detail to deal with standing situations and anticipated changes such as liquidations, mergers or divisions. The choice of applicable law regarding the agreement between feeder and master UCITS is linked to the laws of the feeder or master fund's home state as far as this agreement can ensure fair and equal treatment of unit/shareholders.

We draw particular attention to the fact that the choice of applicable law regarding the agreement between feeder and master UCITS should also apply to the agreements between the depositaries of master and feeder funds and the external auditors of master and feeder funds. When the agreement between feeder and master UCITS has been replaced by the management company's internal conduct of business rules, the law applying to the agreements between depositaries of master and feeder funds and the external auditors of master and feeder funds shall either be the one of the master or of the feeder UCITS.

In relation to the duties of a depositary which may differ between Member States, one can say that improved harmonisation could be expected on this subject but on the other hand these differences can be covered in the agreement between depositaries. This means that the coordination between both depositaries should include appropriate clauses in relation to their respective duties under national law.

One other key area of this agreement is the level of reporting by the master UCITS, and/or the master UCITS depositary. It has been retained as a general principle that the master UCITS should inform the master UCITS home Member State, the feeder UCITS (or where applicable the management company) and the depositary of the feeder UCITS of any irregularities which may have an impact on the feeder UCITS. As a result, we strongly recommend that the agreement between masters and feeders should also include clauses as to when the master depositary should report the same types of issues that the feeder depositary would be required to report. It is worth considering that errors and feeder's materiality levels may be more restrictive than the master's in different jurisdictions.





The coordination agreement between the external auditors of masters and feeders is described as having similarities to agreements between feeder and master UCITS and depositaries. Moreover, it is highly recommended to minimise potential problems by choosing external auditors in the same group and to align the accounting year-end dates between feeder and master.

#### **Change of feeder UCITS objective, liquidation, merger or division of a master UCITS**

Previously we mentioned that the management company's internal conduct of business rules or the agreement between feeder and master UCITS should be sufficiently detailed to cover anticipated changes including liquidation, merger or division of a master UCITS.

For a liquidation, merger or division of a master UCITS, provisions already exist at the level of the feeder in the case of a restructuring, including notification to unit/shareholders and the possibility to redeem units/shares without charges within 30 days before the decision takes effect. Nevertheless, this short-term period could lead the feeder (i) to be unable to react to any consultations or requirements of the competent authority if required, (ii) to be unable to re-invest and (iii) to be left with no other solution than for example to liquidate because the master has already started its own process of liquidation. In the case of the master's liquidation, the feeder should submit, within 60 days, its own plan to its competent authority outlining its intentions i.e. whether it will feed into another master, convert itself into a non-feeder UCITS or liquidate. When there is only a merger or a division of the master UCITS, a period of 30 days applies to the feeder to communicate to its competent authority its own choice between (i) staying the feeder of the same master, (ii) feeding into another master or (iii) converting itself into a non-feeder UCITS.

The current level of requirement of a UCITS, regardless of whether it is a master or feeder, to notify unit/shareholders in the case of changes including amendments to its investment policy, will also be required should the UCITS wish to (i) convert itself to a feeder UCITS, or (ii) if it is already a feeder, to feed into another master, or, (iii) if it is already a feeder, to cease feeding into one master. If such changes lead to a transfer of assets in kind from the feeder to the master, no harmonised procedure is planned and national procedures will continue to apply also for feeder UCITS.

#### **Next steps**

The elements described above are still subject to formal approval by the European Commission but Master-Feeder UCITS structures under UCITS IV are clearly a welcome development for promoters wishing to enter new target markets or who wish to satisfy the needs of specific types of institutional investors more easily. It is also worth noting that the aim of the European Commission is to enhance the process of harmonisation within the EU and to avoid Member States from creating additional requirements. In the meantime it is recognised that agreements between parties should also cover other issues than those defined by CESR's recommendations.

Given the current environment, we strongly encourage promoters to already start re-defining their pan-European fund distribution strategies to include Master-Feeder UCITS, to draft arrangements between the concerned parties and review their management company's internal conduct of business rules in preparation. We recognise that such documentation will not be easy to draft but in the long term, it will become standard for all feeders within the EU, and could enhance pan-European fund distribution.

# The evolving regulatory landscape and the long term goal for UCITS funds in the European Union

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Partner - Regulatory Consulting  
Deloitte Luxembourg

In this article we will look at the continuing attempts to realise the elusive goal of a single European market in financial services that protects investor's interests.

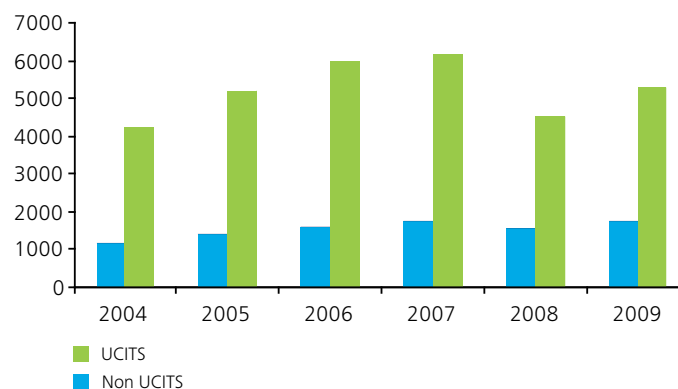
## Evolution of the EU funds industry

The evolution of the European fund industry has been driven principally by the continued success and development of the UCITS directive which represents 74.5% of Assets under management in the EU. Whilst UCITS I focussed on investments into a limited range of assets, UCITS III introduced a veritable change in the potential investment universe – notably through the introduction of derivatives and other more complex instruments. This change was primarily demanded by fund managers and their clients who wished to access the more exotic instruments developed through new financial innovation.

The flexibility of the eligible investments allowed within UCITS III funds enables some hedge fund like portfolio structures to be created within a UCITS structure. These 'alternative' style UCITS have recently been dubbed Newcits to differentiate from the 'traditional' 100% long UCITS which make limited use of derivatives. UCITS' investor appeal goes beyond the EU with UCITS funds now being sold in nearly 60 countries and territories throughout the world.

It is noteworthy that the new UCITS IV directive contains little change to the potential investment universe of these funds. Instead, it is designed to make the UCITS market more efficient, in particular by introducing simplified notification procedures for the cross-border marketing of funds and management companies. Additionally, comparability between UCITS should be aided via the implementation of the two page key investor information.

**Net Assets of European Investment Funds (€BN)**



Source: EFAMA Quarterly Statistical Release March 2010

## Regulatory arbitrage between EU directives

The UCITS Directive was introduced in 1985 and subsequently revised in 2001. It provides a common EU framework for the structure, authorisation, supervision and management of UCITS funds. Investor protection was and remains integral to its success.

In recent years the EU has introduced a number of other financial sector directives – including, but not limited to, the Prospectus Directive, the Market Abuse Directive, MiFID and the Transparency Directive. Across all these directives there is one main issue that affected open-ended funds: the exemptions – not only in the directives themselves but also in the differing interpretations applied by individual Member States.

Since the implementation of MiFID, UCITS as a product-related directive found itself with one foot in and one foot out of MiFID's scope. However, UCITS IV introduces MiFID obligations at the point of sale but retains the



burden of needing to be registered with host authorities prior to public marketing. In contrast, competing products such as certificates or structured notes ('structured products') and unit-linked life assurance policies can be created as a 'wrapper' with underlying exposure to UCITS or non-UCITS funds and in many cases they can be distributed to retail clients on a cross-border basis.

For structured products, their ability to fit under MiFID's 'Transferable Securities' definition and their frequent inclusion of a capital guarantee are attractive to the retail client market. Nevertheless, there is much discussion regarding the cost transparency of these investments as the fees are bundled inside the price of the product, and are rarely visible to the end investor. Similarly, the distribution of life assurance products is regulated under another 'silo' Directive, the Insurance Mediation Directive, and therefore MiFID's fee transparency requirements to which UCITS and non-UCITS products are subject does not impact these products at all.

This uneven playing field has led to some cases of assets switching out of funds and into structured products, especially in the German and Italian markets. In terms of new sales, these products gained momentum as intermediaries moved to distribute an opaque product that 'guarantees' a commission rather than a fund for which a commission received or a trailer fee paid requires justification under MiFID's inducements obligations.

Such developments led CESR to issue a consultation paper in October 2009 on observed market practices in respect of inducements. The main objective of this consultation was to assist regulated firms in gathering a better understanding of some of the main industry practices on inducements and to allow them to understand what types of behaviour securities regulators encourage (good practices) and discourage (poor practices). This would allow such firms to benchmark themselves against industry compliance practices under the MiFID inducements rules, with the additional comfort of knowing whether securities regulators encourage or discourage particular instances of behaviour by firms.

### **Introducing the packaged retail investment products initiative**

This fragmented and uneven approach to the regulation of financial products in the EU caused the European Commission ('EC') to refocus its efforts to bring about a single harmonised European market for financial services. The EC recognises that there is a substantial body of Community law to protect investors of all types. However, the legal requirements on product transparency, sale and advice differ according to the legal form of the product and its distribution channel. This does not provide a consistent basis for the protection of the retail investor or the development of investment products within the EU. It also allows regulatory gaps. At the very least, the level of protection afforded to retail investors should not vary according to the legal form of the product.

To rectify these problems, the ECOFIN Council in May 2007 started work on what we now know as the Packaged Retail Investment Products ('PRIIP') initiative. The objective of this initiative is to introduce a consolidated approach that will provide a coherent basis for the regulation of mandatory disclosures and selling practices throughout the EU irrespective of how the product is sold or packaged, thereby levelling the playing field. It is hoped that it will provide a market in which regulatory arbitrage does not drive savings towards particular products.

In an efficient market, competition between investment products should lead to benefits for both investors and the economy. Competition should lead to the creation of enhanced investment products that meet investor's needs. However, depending upon the packaging used for the investment product, its investment characteristics and eventual cost to the investor may become less transparent.

The existing EU MiFID regulation on selling practices sets out two main requirements. The first is that distributors should act professionally and fairly and focus on the needs of investors when selling or advising on fund products. The second requires that conflicts of interest are avoided, effectively managed and/or disclosed.

The EC is now working on the legislative process required to bring the PRIIP initiative to fruition. The proposed PRIIP Directive will not be a quick or easy



solution to today's problems. The EC will be required to deliver a consistent and cross-sectoral approach which takes into account differences in regulation whilst delivering a level playing field for investor protection that does not stifle financial innovation.

Independently, the UK intends to implement rules following their Retail Distribution Review to improve the clarity of the advice provided to investor. This will split client advisors into two groups, those paid for by fund managers and those paid for by the client. This approach echoes the US fee based and advisor based model which some people argue will benefit fund supermarkets that can provide research tools and market commentary on a impartial basis and at low cost.

#### Current regulatory concerns

The ongoing financial crisis and the misdemeanours of some market participants will also focus the attention of the EC and the various European regulators on the activities of financial service providers. One such area is the corporate governance standards applied to funds and fund promoters. This is highlighted in a comment made by Eddy Wymeersch, Chairman of CESR who on 1 October 2009 said:

"Currently, boards are representatives of the asset managers but there are no checks and measures in place to look over the shoulder of the asset manager."

"Direct Fiduciary duty should be in place so that asset managers are held responsible to investors."

"My goal would be to start thinking about adapting legal frameworks for investment funds in terms of boards for funds and the information that is provided to investors."

In recent years a number of jurisdictions have introduced mandatory requirements and voluntary codes of corporate governance. These resulted from cases of fraud or financial reporting scandals such as Enron, Worldcom and more recently Madoff. Whilst some countries have simply enacted the most recent requirements of the Transparency Directive, which require disclosure of governance practices and the implementation of an audit committee, others have gone considerably further, often based on or exceeding the requirements of the OECD Principles of Corporate Governance.

Whilst directed at the corporate world, these initiatives have also impacted the fund industry as listed funds are required to enact the same governance standards as companies. These rules not only apply to the more exotic alternative asset classes such as private equity and venture capital but also listed UCITS vehicles.

As a separate issue, some countries outside of the EU, which allow UCITS to be registered for public distribution, are looking for mutual recognition. An example of this is Switzerland which allows close to 4,000 UCITS to market their funds in its territory. The Swiss authorities are now questioning why Swiss domiciled funds cannot have reciprocal marketing arrangements in the EU. An additional issue vexing non-EU domiciles is the prospect of being placed on the other side of the Alternative Investment Funds Managers Directive ('AIFMD') boundary, implying that they could not manage EU domiciled alternative investment funds. The actions taken to harmonise the financial markets within the EU can also generate unintended consequences for relations outside the EU.

### **Building long term savings in Europe**

Whilst the aforementioned problems indicate that the EC is still some way from its stated objective of a harmonised single market for investment products, we must not lose sight of the potential benefits for investors, fund promoters and the EU of a single European market for financial services.

The EU's population is ageing whilst its public finances are deteriorating. The need for individuals to save more for their retirement is pressing. But such saving is also beneficial to the EU as a whole as it can fund long-term, large scale development of the European economy. The UCITS brand can play an important part in this process by being the vehicle of choice for investors' needs.

It could be argued that the UCITS framework has withstood the financial crisis relatively well. It is true that some money market funds failed to manage their liquidity whilst others were affected more directly by the Lehman collapse. Fund promoters must continually earn this trust through good governance, improved communication and by delivering good value products that meet investors' needs which have become notably risk-averse since the start of the crisis. Investors need to raise their level of financial understanding to make informed choices thereby rewarding only the best product propositions. The fund industry welcome the planned PRIIP Directive as this should help investors in selecting good value savings products.

Reducing costs would further help improve the value proposition of investment funds. One way of reducing costs is for the fund industry to realise cost savings through the delivery of operational efficiencies. UCITS IV aims at delivering such efficiencies in particular by introducing simplified notification procedures for the cross-border marketing of funds and management companies. It is up to the fund industry to use these measures to realise efficiencies through the generation of economies of scale. Distributors must also play their part to deliver further cost savings to investors given that frequently over 50% of the costs borne by the end investor relate to distribution activities.

But it is not just the fund industry and investors that need to do more. The EC also needs to take action to foster a long term savings culture in the EU. One possibility would be to introduce a pan-EU pension framework requiring employees to undertake regular investments in savings products. Such schemes could operate through monthly deductions which would dilute the effect of price movements in the underlying products. Governments should encourage such contributions by offering the employee tax incentives on such investments. Such incentives could be based upon the employee's age, investment horizon and the length of contributions. Given the free movement of goods and services within the EU, such pension schemes should be allowed to move throughout the EU as its contributor changes domicile.

Whilst some in the EU see the creation of a single European market in financial services as a long-term goal, such a measure is becoming more immediate as the pressure on government finances and pension provision increases.

PRIPS is an important development to level the savings products playing field and AIFMD cannot be rushed otherwise it may do more harm than good. Given the size of the task ahead and the benefits to investors which can be achieved, it is hoped that all stakeholders will put aside their various self interests to realise this important evolution.

# Deloitte, Sword FircoSoft and Dow Jones launch a new service to ease Know Your Customer procedures



Sword **FircoSoft**  
Filtering Since 1994

**Caroline Chochoy**  
Sword FircoSoft  
Marketing & Communication Specialist

**Kim Gagliardi**  
Dow Jones  
Public Relations Manager

To help investment management businesses throughout the world comply with the ever growing demands of Know Your Customer (KYC) procedures within the anti-money laundering and anti-terrorist financing legislation, Deloitte, the leading professional services firm, Sword FircoSoft, the premier supplier of watchlist filtering solutions and Dow Jones, the premier anti-money laundering content provider (with Dow Jones Factiva), have launched a new service called uComply™.

Designed to address the needs of small and medium-sized players, uComply™ is a new all-in-one automated investor information filtering service, available as a download on an annual subscription basis. In six simple steps, organisations are given access to the service which filters investors against sanctions lists published, among others, by the Office of Foreign Assets Control (OFAC), United Nations (UN), and European Union (EU), as well as a database of Politically Exposed Persons (PEPs). The uComply™ service also allows organisations to review and decide on alerts with appropriate audit trail and generate statistical summary reports.

uComply™ assists Asset Managers, Transfer Agents, among others, to remain compliant without the financial burden of a long-term commitment. This enables organisations not only to protect themselves from potential expensive legal consequences, but also helps them preserve their commercial reputation.

“Through uComply™, small and medium-sized players now have access to a state of the art ‘all-in-one’ name matching service adapted to their specific needs and constraints. With Dow Jones and Sword FircoSoft we are collectively demonstrating that conventional business and technological barriers to KYC compliance management are now removed”, said Pascal Eber, Partner, Advisory & Consulting at Deloitte Luxembourg.

John Nash, Global Alliances Director at Sword FircoSoft, is convinced of the application’s success: “We are excited by the opportunities the uComply™ service brings to the investment management community across the world and proud to be associated with it alongside to other great firms like Deloitte and Dow Jones”.

“Smaller Institutions have often found it difficult to access the tools needed for effective and efficient automated sanctions and anti-money laundering screening. uComply™ addresses their needs by providing market leading screening technology, workflow design and compliance content without requiring large investments in compliance infrastructure” said Rupert de Ruig, Managing Director of Risk & Compliance at Dow Jones.

More information is available on the Deloitte website ([www.deloitte.com/lu/brochures/ucomply](http://www.deloitte.com/lu/brochures/ucomply)) or upon request to Pascal Eber ([peber@deloitte.lu](mailto:peber@deloitte.lu)).

**About Sword FircoSoft:** *over 335 financial institutions in more than 55 countries (representing over 650 sites) are already benefiting from the #1 watch list filtering solution\* provided by Sword FircoSoft. Sword FircoSoft, provider of multi-alphabet ready filtering solutions, also offers best-in-class straight through processing and business intelligence solutions.*

*For more information about the advantages that Sword FircoSoft can offer your organisation, please visit [www.sword-fircoSoft.com](http://www.sword-fircoSoft.com).*

*\* ranking by Celent since 2003*

**About Sword Group:** *Sword Group (NYSE Euronext: FR0004180578 SWP) delivers high value business applications to organizations across regulated industries. A global leader in the delivery of Governance, Risk and Compliance Management solutions, Sword’s skills, infrastructure and experience help our customers improve performance, increase efficiencies and maximize return on investment.*

*Our flexible delivery options, including On Demand, Software as a Service (SaaS) and ASP, combined with our extensive industry expertise enables Sword to support our customers across insurance, healthcare, energy, banking & finance, telecoms, utilities, engineering & construction and government.*

*With operations in 37 countries, Sword today employs over 2000 people and in 2007 generated €179m in consolidated revenue.*

*For more information, please visit [www.sword-group.com](http://www.sword-group.com)*

**About Dow Jones:** *Dow Jones & Company ([www.dowjones.com](http://www.dowjones.com)) is a News Corporation company (Nasdaq: NWS) (Nasdaq: NWSA) (ASX: NWS) (ASX: NWSLV; [www.newscorp.com](http://www.newscorp.com)) and a leading provider of global news and business information. Its principal products include The Wall Street Journal, Dow Jones Newswires, Dow Jones Factiva, Barron’s, MarketWatch and Dow Jones Indexes. Its Local Media Group operates community-based newspapers and Web sites. Dow Jones also provides news content to television and radio stations.*



## Hot off the press

### **Alternative Investment Fund Managers Directive – the project is postponed**

On 11 March 2010, the Council of the European Union (the "Council"), under the presidency of Spain, issued a new compromise proposal (the fourth) on the draft Alternative Investment Fund Managers Directive which will amend Directives 2003/41/EC and 2009/65/EC (hereafter the "Draft Directive").

The discussions on the draft Directive were supposed to be finalized during the last ECOFIN meeting in Brussels on March 16 to achieve a global compromise. The Spanish Finance Minister has unexpectedly taken the topic off the ECOFIN Council agenda.

This reflects concerns expressed by the United Kingdom and, to lesser extent giving echoes to US criticism, over the third country issue.

Indeed the Draft Directive allows Member States to accept the marketing of non-EU AIF on their territory if they comply with certain minimum rules (such as reporting obligation or risk management obligations). The current approach is considered by UK as protectionist and goes against the subsidiary principle. They would prefer to leave the possible regulation related to the marketing of non-EU AIF to Member States alone.

The official envisaged time-table leading to implementation is as follows:

1. The European Parliament's Committee on Economic and Monetary Affairs is expected to adopt its report on April 12
2. In May 2010, the trialogues with European Parliament, European Council and European Commission will take place
3. In July 2010, the final text should be adopted by the plenary meeting of the European Parliament at first reading
4. According to Mr Gauzes, European Parliament rapporteur, Member States should implement the directive in their national law in early 2011

However, following the last events, the time-table has to be reshuffled as the text could not be adopted by the parliament before September 2010.

The coming months are crucial for the different delegation and the whole lobbying process. The Draft Directive is definitively an opportunity for European Fund Industry to modernise and harmonised the universe of Alternative Investment which includes Hedge Funds, Private Equity and Real Estate Funds.

## To be covered in our next edition

- Art as a new asset class
- Hedge fund products: design and distribution
- Alpha or Beta: challenges and opportunities for traditional active Asset Managers
- Analytics as a new source of revenues for fund service providers
- SAS70 norm change: an opportunity for service providers?



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