

# Performance

A triannual topical digest for asset management professionals, issue 3, September 2010



## Market buzz

Alpha or beta?  
Challenges and opportunities  
for traditional active investment  
managers in a polarising market

Mergers and acquisitions in  
the Spanish asset management  
industry

## Tax perspective

UCITS IV  
The tax agenda  
  
The Aberdeen case  
Taking it to the next level

## Regulatory angle

Risk & Governance  
The future of SAS 70  
  
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# Preface



We are happy to welcome you to the third edition of Performance, Deloitte's topical digest on developments, trends and outlooks in the Investment Management industry. The positive responses to our two first editions have strengthened our motivation to continue producing an informative and interactive magazine. One such outcome is that in the future, Performance will be published at four month intervals to optimise our coverage of the most pertinent market themes.

In this third edition, 'Market buzz' outlines the main trends in the Spanish mergers and acquisitions market and alpha/beta challenges for traditional asset managers. Under 'Tax perspective', this edition details a concrete case study on tax reclaim opportunities and offers an insight into the fiscal impacts behind UCITS IV. The 'Regulatory angle' tackles an impact analysis on the change of SAS70 norm, describes the implications behind the UCITS IV related 'Key Investor Information' document, provides a view on the opportunities of the Dutch Premium Pensions Institution and gives interesting views on the US Custody Rule, which is a first contribution of our US practice, and a first step in the further geographical expansion of our Performance magazine.

We would like to warmly thank all the industry professionals who, through their prized contributions, consistently help us deliver this exceptional magazine including those persons external to Deloitte. Performance would not be possible without you.

As usual, our editorial aim has been to make this edition original and innovative. Your comments and suggestions for future topics or article contributions will be, as ever, gratefully received.

Enjoy this edition and we look forward to reaching out to you soon.

Sincerely,

A handwritten signature in blue ink, appearing to read 'Vincent Gouverneur'. The signature is fluid and cursive, with a long horizontal stroke at the top.

Vincent Gouverneur  
Partner - EMEA Investment Management Leader

*Performance is a triannual 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.*

# Alpha or beta?

## Challenges and opportunities for traditional active investment managers in a polarising market

**Eliza Dungworth**  
Partner – Tax  
Deloitte UK

**Justin Nuccio**  
Director – Consulting – Financial Services  
Deloitte UK

**Sebastian Cohen**  
Senior Manager – Deloitte & Research  
Deloitte UK

**Michael Dunn**  
Consultant – Financial Services  
Deloitte UK

Traditional active investment managers are in danger of becoming caught in the middle as their market polarises between alpha and beta providers. Investment managers specialising in providing low cost index-tracking products are increasingly able to generate similar returns to those of traditional active managers. For traditional firms, providing 'beta' returns at 'alpha' cost is no longer an option.

Investment managers face a choice between becoming more efficient beta providers or differentiating through higher alpha returns. Some may choose a third way: moving towards a 'total solutions' model to specialise in providing both types of return under one roof. There are, however, operational challenges in doing so. Traditional active managers need to achieve more cost-efficient, standardised and scaled-up processes that are required for the provision of beta returns, without stifling the autonomy and agility required to outperform the market for alpha returns.

Winning investment managers are likely to be those who are able to align their business strategy and organisational structure to deliver against their chosen investment approach.

### Caught in the middle

Thanks to new technologies and innovations, specialised passive investment firms have been able to offer index-tracking products that give similar beta returns to many traditional active managers – but at a lower cost. Figure 1 shows the gross average annual returns for a selection of global mutual funds (which are typically actively managed). Since the end of 2008, these have been only marginally higher than those of more passive products such as exchange traded funds (ETFs). Indeed, due to higher fees, net post-fee returns of active investment managers can be lower than some passive indexing/beta products.

Investors have become increasingly aware that the fees of traditional active managers can eat into their net returns, causing them to migrate away from actively managed funds and products towards more passive products, like ETFs. For instance, the value of global mutual fund inflows (excluding ETFs, which tend to be passively managed) fell from \$1,400 billion in 2007 to -\$121.1 billion in 2008, subsequently recovering to just \$13.3 billion up to the third quarter of 2009. At the same time, Figure 2 shows that investors seeking beta returns have swung towards lower risk, lower cost and passive index-tracking products. Total ETF asset values rose to a peak of \$1,035.7 billion at the end of 2009, rising from \$796.7 billion in 2007, a CAGR of 14.0%.

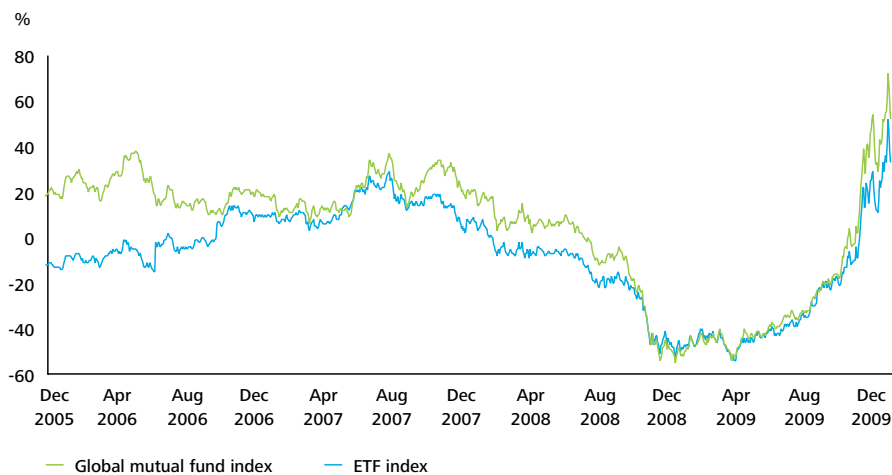
The fall-out for traditional active managers from these changes has been significant. They have suffered from declining margins and pressure on fees as investors have paid less and less for beta returns, and as low-margin index-tracking products have continued to make a significant contribution to traditional active managers' overall returns.

Even at the alpha end of the market, investors have demanded sustained high returns at lower cost. This has stretched alternative investment managers and caused a shake-out among underperforming alpha providers. The number and value of private-equity funds fell sharply, from 1,624 funds of funds and assets of \$888.4 billion (January 2009), to 1,561 funds with assets of \$698.5 billion in January 2010. Figures show a similar trend within the hedge funds sector.

How should traditional active managers respond to these changes in investor preferences and the subsequent shifts in the competitive landscape?

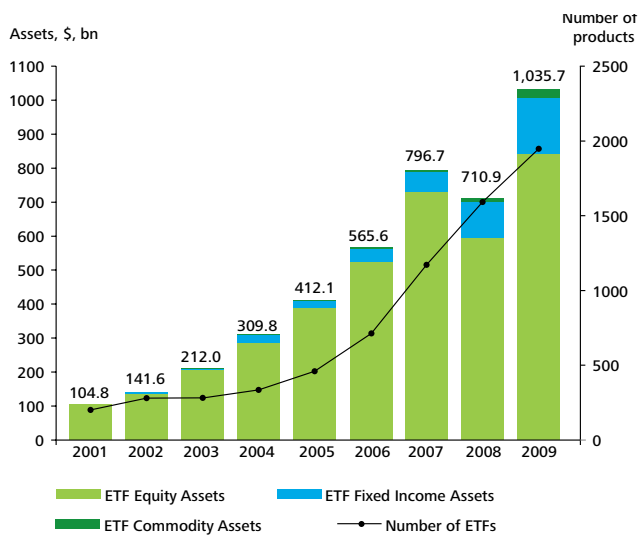


Figure 1. Global mutual fund and ETF annual returns, December 2005 – December 2009



Source: Bloomberg, 2009  
 Note: Deloitte analysis based on a global basket of ETFs and mutual funds.

Figure 2. Global ETF Assets, 2001 – 2009



Source: Blackrock (Blackrock ETF Landscape Industry Review, December 2009)



#### Different capabilities for alpha and beta

The decision to compete on alpha, beta or both is complex as the infrastructure required to deliver passive (beta) and active (alpha) returns is very different.

- **Passive managers** seek to provide high-volume, low-cost, more liquid index-tracking products. They aim to minimise operational errors and inefficiencies and to gain economies of scale in order to avoid any erosion of profits in a lower margin market. Processes are typically simplified and standardised to improve operational efficiency within a centrally controlled, scalable infrastructure that is based on a data platform spanning multiple markets and products.

- Requirements for success include an autonomous, coded, front-end IT trading platform that is capable of sending automated trade messages to brokers and other counterparties. Functions/processes need to be scalable in order to facilitate the automation required for enhanced operational efficiency which is crucial given the volume of trades on highly liquid indices.
- **Active managers** require differentiated strategies to outperform the market. Their products and instruments may be more complex, requiring specialised high-end research capabilities. They require sophisticated data systems and trading platforms. Functions are often more integrated, enabling people and processes to come together for a faster, more tailored response to client and market changes.
  - Requirements for success include having more sophisticated functions and data platforms in place to enable multiple, more complex investment techniques. Processes are more tailored, consisting of sophisticated primary research and analysis to generate an appropriate investment strategy.

The infrastructure required to deliver investment management propositions has become increasingly specialist. Firms face difficulties in specialising at either end of the market as the capabilities required increasingly diverge. Those attempting to compete in both the alpha and beta markets are struggling to find an optimum business operating model that straddles them.

## Rethinking operating models

### Three models

Shifting to either alpha or beta specialisation entails a choice about what should be defined as their core business, and what capabilities should be built, acquired or divested.

We identify three different types of business operating models that bring together strategy, proposition and operational considerations:

- **Universal:** The largest investment management firms, those that are 'universal', benefit from both economies of scale and scope. They diversify fully across product ranges, from passive through to traditional and alternative actively-managed funds. Their organisation aims for integrated functions and processes. Customers/clients can potentially benefit from this one-stop-shop approach, offering a single point of contact along with diverse product-ranges and sophisticated global research capabilities. When executed well, an integrated approach can contribute to building a high-quality brand, which is increasingly important in today's market where investors have embarked on a flight to quality.
- **Multi-strategy:** The multi-strategy model is distinguished from the integrated one-firm universal model by the idea that investment professionals operate best under differentiated, semi-autonomous umbrellas. The benefits of scale and scope are exploited within the parent company. This may be through shared financing and fund-administration functions, or through asset-servicing capabilities. The organisation is characterised by autonomous funds and fund groups which have independence in portfolio management and trading. At the same time they are able to leverage the existing infrastructure of the parent group, most notably its asset-servicing, legal and regulatory capabilities.

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Shifting to either alpha or beta, managers find it hard to achieve the more cost-efficient, standardised and scaled-up processes that are required for the provision of beta returns, without at the same time stifling the autonomy and agility that are essential to outperform the market for alpha returns.

- **Boutique:** The boutique firm is distinguished by the extent to which its divisions, people and processes enjoy organisational and cultural autonomy. Such firms typically rely on partners and service providers to achieve scale and scope, usually at a higher per-unit operational cost than is incurred at universal and multi-strategy firms. This, however, can often be outweighed by higher investor returns and market outperformance.

Bringing together the infrastructure required for alpha and beta into one model requires investment managers to simplify, standardise and scale-up in order to achieve lower costs and a competitive edge for their beta products and services. At the same time, functions and divisions concerned with the provision of alpha services often require a degree of autonomy and flexibility. Therefore a selective approach has to be taken.

### Selective approach to integration

Figure 3 illustrates a framework that may be useful in guiding decisions on which funds, functions or processes can be integrated for gains in efficiency (and control), and which ones should be operated discretely. The latter are most likely to include operations that deliver tailored services or a differentiated, market-beating performance.

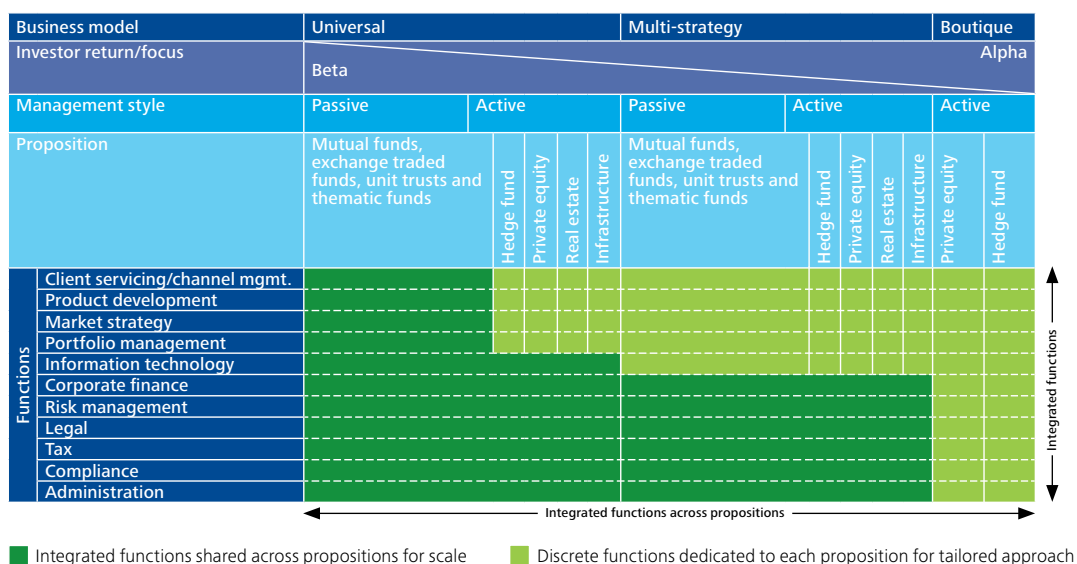
Within the **universal model** (serving several funds/divisions at the same time), functions are typically consolidated, with processes simplified and standardised to enable them to be scaled-up. This enables such firms to differentiate through efficiency. A mature universal model is characterised by highly scaled processes, a wide distribution network, and an integrated, one-firm approach.

By contrast, within the **multi-strategy model** at least two types of business operating models coincide.

Beta-generating business units are engineered to compete on the efficiency operations, while the alpha-based divisions must outperform the market, operating with a degree of flexibility and freedom. To accommodate this dual approach, only certain functions are selected for firm-wide integration. Those deemed core to supporting alpha-based business remain un-integrated, tailored to the funds or product-sets they support.

Which functions and processes should be integrated and which ones should remain separate? Client servicing/channel management, product development, market strategy and portfolio management are kept largely separate (operated discretely) at the divisional level. However, functions such as corporate finance, risk management, legal, tax, compliance and administration, can be integrated across several divisions. Information technology should be integrated within the universal model, while remaining divisionally separate

Figure 3. Selective integration - A framework for aligning the investment strategy with the organisational structure





within the multi-strategy model. The boutique model, by contrast, is characterised by highly integrated functions spanning front, middle and back office operations.

Active management firms with a more limited capacity for specialisation should place greater focus on defining their core proposition. This may entail selling or spinning off unrelated products and teams. Only those actively managed firms with a capacity for managing change (and a sufficiently strong balance sheet) should consider growing inorganically.

### Practical steps for change

There are five practical steps that traditional active managers can take as they respond to the challenges and opportunities of a market which is polarising. Each investment-management firm will have its own starting point, and no one size will fit all.

#### 1. Determine the strategic agenda and assess core competencies

Firms are required to reappraise both their role and their propositions within the value chain and assess how and where to compete in the market.

Investment managers should:

- Determine their future strategy and business model by means of a review that will help them to better understand competitors, client segments, product and service strengths (and weaknesses), along with brand perceptions and other differentiators
  - For a total-solutions provider, this may require a better understanding of the firm's ability to allocate assets through highly diversified but integrated and scaled processes. For alpha providers integrated functions, an effective risk culture and tailored technology and research capabilities may be vital in determining the structure of any future business model. A good understanding of the current client base and the strategy for accessing other potential clients is required and firms need to examine client perceptions of their brand relative to competitors. Plugging gaps in capabilities and/or market segments may well involve organic growth or a strategic acquisition.

- Assess strategy in light of the firm's current operational capabilities
  - Are there any operational limitations which will impact the future business strategy? A plan to plug any gaps in operational capabilities may involve organic change or strategic acquisition. The potential success or failure of post-merger integration (PMI) should be considered in any decision to build capabilities other than organically.
- Simplify operating models through a renewed focus on core competencies
  - For beta-related propositions, core competencies may be largely concerned with scalable processes to achieve higher volumes. For alpha, however, competencies will include the use of sophisticated investment techniques, along with access to real-time data to help outperform the market. A decision on whether to compete on operational efficiency or on market outperformance will be required. Geographic scope should also be determined, along with a decision to focus on emerging markets or on mature markets.
- Be aware that, in more volatile markets, the brand plays a key role in attracting and retaining investors
- Simplify propositions (products and services) to reduce complexity
  - Determining whether to focus on providing either alpha or beta returns (or both) will be critical. Consider an appropriate investor segmentation strategy and an assessment of all product and service offerings to identify less profitable or most capital-intensive activities.

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There are five practical steps that traditional active managers can take as they respond to the challenges and opportunities of a market which is polarising



## 2. Map out the current operating model

Investment managers may not have the people, the processes and/or the technology to deliver on their current strategy, or to meet the requirements of any shift towards offering more specialised alpha/beta products. Managers should:

- Understand the impact of any changes on the current operating model – for instance, the effect of moving to a new asset class, strategy or product suite. Can the current operating model facilitate the delivery of the current proposition? Can it accommodate the potential impact of any strategic re-positioning? Building new capabilities may require a decision on whether to expand organically or otherwise. Related to this, investment managers will need to determine the extent to which they should integrate new acquisitions or keep them separate. Their decision will be influenced by each business unit's need for autonomous or scaled operations.
- Determine which functions should be kept in-house, by assessing the potential use of shared service providers/centres of excellence or of outsourcing.

## 3. Move to a more variable cost base

Revenues are variable and can decline, while costs remain fixed, largely due to investment managers' traditional inclination to keep product-manufacturing and distribution capabilities in-house.

- As a general principle, non-core functions should be outsourced, while core functions should be kept in-house
  - To achieve greater flexibility, suppliers should be moved to variable-cost agreements
  - There should also be a renewed focus on renegotiating with vendors

- Evaluate the use of shared service providers and/or centres of excellence, determining which functions to optimise or release from the core operating model
- Review the role of performance-related pay (PRP)
- Mitigate against a fixed-cost base by increasing the contribution to revenues of fee-based areas – such as advisory

## 4. Integrate common processes for efficiency

Current operating models can be inefficient, with each business unit typically operating its own infrastructure. This has led to sub-optimal operations and the duplication of processes. Where the key differentiator is process efficiency and the sophistication of technology – as opposed to human capital, investment managers should:

- Determine which functions to integrate
  - Assess the extent to which functions that typically do not require as much flexibility and/or autonomy can be integrated, usually those that are not individually tailored to specific products, investor segments or geographies. Examples may include finance, risk management and compliance.
  - Consider where acquisitions have been made without any significant post-merger integration (PMI) activity.
- Integrate risk-based processes and functions to achieve standardised, measurable and transparent risk governance and control across the enterprise

## 5. Allow autonomy where appropriate

Alternative investment firms seeking alpha returns are primarily people-based businesses where, investment professionals require autonomy in order to make unique judgements regarding their markets. Some struggle to operate within the boundaries of their firm's operating model (which seeks a standardised approach to many processes) with the lack of flexibility, causing a slower, less tailored response.

It is important that functions for more tailored propositions are kept separate from more standardised platform-based processes in order to allow autonomy and specialisation where needed. At the same time, firms need to seek out operational efficiencies that may be inherent in processes that are not highly scaled.

Investment managers should:

- Selectively integrate those units that require greater autonomy, while ensuring appropriate levels of support from an enterprise-wide platform
  - Keep separate those functions requiring greater levels of flexibility, such as client servicing, product development and market strategy
  - Establish at group level the policy which determines the treatment of those businesses which should be operated on a more autonomous basis
- Encourage greater integration of functions for improved speed to market – for example, foster a culture of enhanced trust and co-operation for critical functions within alpha divisions

## Conclusion

Investment managers are being called upon to respond to an industry in flux. Firms face the combined pressure of having to achieve operational efficiency at the same time as they have to distinguish themselves from their competitors through market outperformance. Success requires firms to balance such contrasting requirements.

Deloitte has identified three prevailing business models: universal; multi-strategy; and boutique. Each model has its own merits and challenges to be overcome.

Integrating functions and divisions may be crucial to achieving greater consistency in propositions and operational efficiency, along with improved risk and control procedures. Investment managers should, however, avoid the temptation to go for wholesale integration. An appropriate level of divisional autonomy may be required, so that the capabilities needed to increase their chances of outperforming the market are not stifled.

# Mergers and acquisitions in the Spanish asset management industry

**Enrique Gutiérrez**  
 Managing Partner – Corporate Finance  
 Deloitte Spain

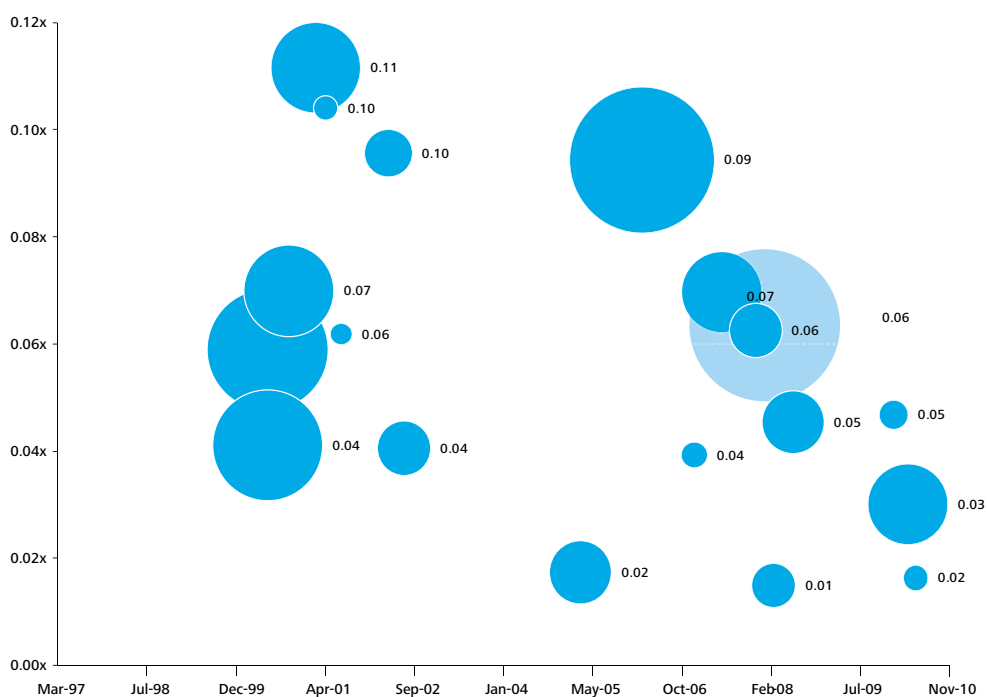
## M&A boom in the 90s

The current corporate activity in the Spanish asset management industry needs to be understood from a historical perspective. During the decades of the 1990s and early 2000s, some of the main local players who pioneered the industry were taken over by international financial groups. The key driver of this wave of M&A activity was simply the objective to quickly gain a presence in the promising Spanish market. Despite the relatively small size of the deals, such transactions were completed at significantly high price multiples that

captured the prospects of strong assets under management (or AuM) growth and private banking business.

As a consequence of this sellers' market, a price anchoring effect arose in the Spanish M&A arena for asset managers. Hence, goodwill multiples ((Price-Equity)/AuM) above and beyond 0.06 times the AuM base became the standard reference for sellers for future transactions.

Evolution of the transaction price in the Spanish asset management industry in terms of goodwill multiples (1)



(1) goodwill multiple calculated as [(price – equity) / AuM]  
 Source: Thomson One Banker, Merger market, and CNMV press releases



From 2003 to 2008, strong economic growth and convergence with European wealth standards prompted Spanish asset managers to scale up operations in a buoyant market. Established players began increasing their commercial capabilities by aggressively hiring star managers and bankers from competitors, whilst a number of new independent boutiques started up overnight. The focus on revenue growth led to intense competition for clients and hence professionals, a vicious circle that was only temporarily sustained by the bullish equity market and the additional income generated by up-front distribution fees.

In this context, only a few transactions were successfully sealed, primarily at the top of the cycle; and usually at price levels of previous deals. Transactions carried out during this cycle were consistently starred by independent boutiques with a good reputation and solid

track record of success but which had exhausted the growth potential provided by their founders. According to these founders, the logical next step was not only to realise their wealth but also to continue operations under the umbrella of a banking institution, thereby accessing the private banking and asset management division to acquire a much wider client base.

The markets plummeted in 2008, and the progressively tighter margins of the underlying asset management business became apparent as a significant share of assets shifted to low-margin products or moved to bank deposits. This sudden change in market conditions confronted the industry with the need for in depth strategic reflection and foreseeable restructuring and consolidation exercises.

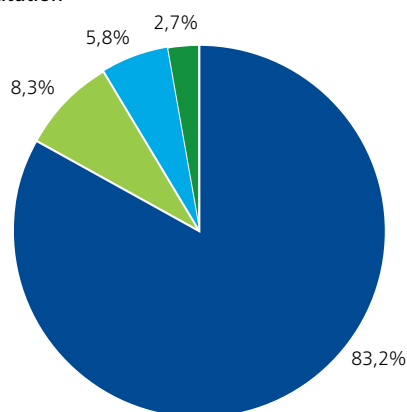
Evolution of total AuM\* in mutual funds and average management fees



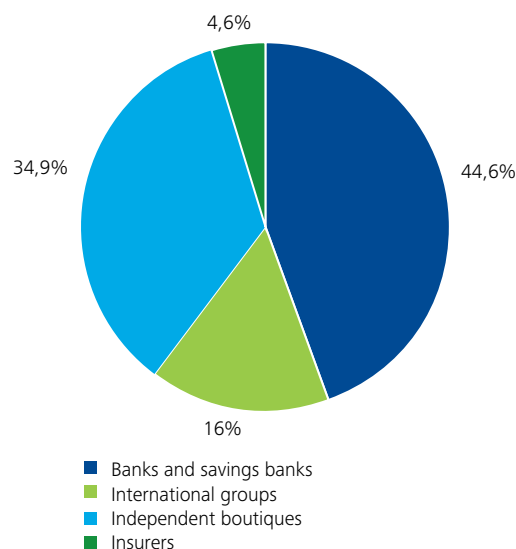
\*Total AuM in mutual funds domiciled in Spain in € billion  
Source: Inverco and CNMV

## The structure of the asset management industry in Spain

Distribution of total AuM\* by asset management institution



Distribution of the total number of asset managers by institution\*\*



\* Total AuM in mutual funds, SICAVs and foreign collective investment schemes distributed in Spain

\*\* Number of asset managers domiciled in Spain as of 3Q 2008  
Source: CNMV

During the last two years, many under-scaled asset managers have struggled to breakeven. In the highly fragmented Spanish asset management industry, a number of players are being forced to restructure their operations or to take part in corporate transactions to successfully overcome the new market environment.

M&A activity has intensified in the last few months, apparently with a new approach to pricing models as compared to the past. There appears to be convergence with the multiples regularly seen in the rest of Europe, e.g. goodwill of 0.2 to 0.4 times the AuM base. The earlier gap in value perception between buyers and sellers is closing therefore allowing consolidators to position at attractive multiples. Given the recent corporate transactions observed in Spain and Europe and the mentioned price alignment, we foresee two major types of deals in the future.

Firstly, many independent players who lack the AuM base and resources to remain profitable in the long term, have demonstrated an openness to discuss potential sale or integration with a major player. The requirement of additional AuM and global expertise makes an agreement with an international player willing to access the Spanish wealth management industry very attractive. Amongst the latter, there is a growing interest for independent private banks based in off-shore locations. It is however becoming more apparent that the primary purpose of Andorran or Swiss banks, amongst others, is to have available fully-operational on-shore platforms to continue providing services to their high net-worth clients.

Newcomers are paying closer attention to the specifics of deal structuring to retain key professionals and hence their AuM base. To secure a smooth transition of ownership and an integration that realises the full value of the company, some common elements for a successful transaction often include:

- A partial deferment of the up-front price payment, subject to the preservation of the original AuM base
- The temporary presence of the founding management as shareholders, with ample discretion in managing operations
- An incentive package for the founding management and key employees to bring in net new money via earn-out mechanisms or price adjustments

Secondly, in parallel to these M&A movements amongst the independent players, some retail banking players are considering corporate transactions involving their asset management units in the context of stronger capital requirements and increased globalisation of the asset management business. An increasing number of financial institutions are considering the sale of their asset management units with the divestment structure being linked to an exclusive distribution agreement plus a shareholders' agreement that guarantees a minimum AuM base and the coexistence of commercial efforts aimed at raising the AuM. A similar model is already widespread in the insurance sector through 'bancassurance' agreements and the benefits for both parties lead us to believe there will be an increased number of such deals. In the context of restructuring and return to the core business of the banking industry, this type of strategic alliance frees up capital and resources whilst realising much needed P&L gains. From the buyers' side, an alliance provides instant access to a target client base and sizeable assets already under management.

#### **Conclusion**

As markets rebound and international players complete their internal reorganisation, we expect increased M&A activity in the Spanish asset management market. Independent boutiques and investment management affiliates of banking groups will be positioned on the sell side with private banking groups and pure-play asset managers taking the lead on the buy side.



# UCITS IV

## The tax agenda

**Eliza Dungworth**  
Partner – Tax  
Deloitte UK



The UCITS IV Directive is set to level the playing field in the European asset management industry. But how will the Directive translate in the world of tax?

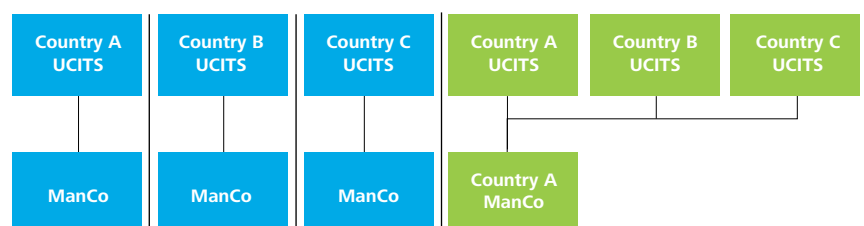
The UCITS IV Directive sets out to improve operational efficiency, reduce costs and potentially minimise levels of regulatory capital. However, the Directive does not include amendments in respect of tax. Any earlier references in drafts of the Directive were dropped. So, whilst taken in isolation, the proposals should result in a reduction of the number of management companies, a new wave of fund mergers and master feeder structures as the key avenue into new markets, any restructuring of funds or corporate groups to support this will need to be benchmarked against a back drop of disparate tax regimes each with its own agenda. For many, it is the taxation which is seen as the key obstacle to UCITS IV making any meaningful impact.

### Management Company Passport (MCP)

The MCP will allow a UCITS established in one EU member state to be managed, distributed and administered by a management company, authorised and supervised in another EU member state. The expectation is that, without the requirement to establish a management company in each home EU member state of their UCITS funds investment management groups will be able to establish operational centers of excellence and minimise duplication of operations, resulting in significant cost savings both from a capital adequacy perspective as well as ongoing overheads perspective. It also provides an opportunity to revisit the tax efficiency of the group structure.

Now ...

UCITS IV





### Tax issues for the management company

Investment management groups will need to consider the tax profile of the jurisdiction of choice of the ultimate management company. This will not always be about headline tax rates, where jurisdictions such as Ireland often score highly, but also flexibility around the taxable base. Similarly, restrictions around the deductibility of interest, withholding tax on dividends to shareholders, local CFC legislation and local substance and residence requirements will all be very relevant in any deliberations.

Questions then arise as to how any desired location is to be achieved. Would there be liquidations or mergers of management companies? Is it more like an inversion strategy? Or do the companies remain as is but transfer the management contracts between entities? The taxation consequences can be very different.

It is unlikely that a company can simply transfer tax residence without potential exit charges or future tax problems under double tax treaties. Instead some form of reconstruction may be required although as regards any corporate restructuring within Europe the EU Mergers Directive should provide protection. It will, however, still be necessary to ensure sufficient substance in the ultimate management company.

Alternatively, groups may look to achieve the same economic position by replacing the company party to the management contract. If this is the case, it will be important to establish exactly what is happening from a legal perspective. Is the contract being transferred or has the original contract been cancelled and replaced with a new contract and was that envisaged in the terms of the

original agreement? Depending on the jurisdictions concerned there may be a taxable disposal which could be classified as an intangible or at the very least subject to considerations as to whether it is revenue or capital in nature.

The impact of VAT distortions will also need to be considered. Whilst VAT, in theory, is subject to EU harmonisation, there are differences not only in tax rates, but also in the interpretation of the 'management of funds' exemption. In practice, therefore, it may be possible to obtain VAT efficiencies through establishing the management company in a particular jurisdiction.

Transfer pricing considerations bring both opportunities and potential challenges. Tax authorities are more alert to the subject of transfer pricing, with Ireland being the latest to announce their legislation introduction. The existence of an overseas management company may raise the sensitivity of this matter with local tax authorities but should not of itself cause major concerns. Currently, the vast majority of investment managers do not provide the full range of their services via the local management company, instead, delegating fund administration, asset management services, distribution activities and even some investment management activities to other entities both within and outside the group. The tax authorities should continue to approach the issue from the perspective of where the 'true value' lies and ensure that the activities are appropriately rewarded. Nevertheless, within this framework there is potential to transfer price the fee split into relevant jurisdictions to a group's best advantage.



### Tax issues for the fund

However, whilst all of the above is manageable it is the potential tax issues for the fund that cause most concern. In particular there is the concern that where a UCITS and its management company are located in different EU member states this could give rise to uncertainty as to the UCITS's tax domicile.

The tax analysis potentially differs depending on whether the fund has a corporate structure or a contractual form. For corporate funds which have their own board of directors, there is less of a problem with regards tax domicile of the UCITS, provided the board performs its role effectively; i.e. making decisions and holding board meetings in the jurisdiction of the UCITS, rather than merely ratifying decisions already taken at management company level. However, care should be taken, as, in practice, it is often the case that the UCITS's board meeting and the management company board meeting will take place on the same day, with the same individuals as members. Therefore, it will be necessary for the UCITS to make clear lines of demarcation with regards the meetings of each of the boards.

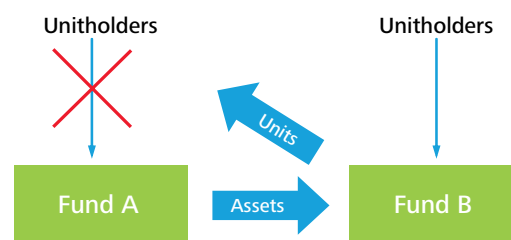
For contractual type UCITS, e.g. an FCP, the issue may be more complex. The residence of a Luxembourg FCP is determined by reference to the registered office of its management company and the existence of a foreign management company may alter that residence. This could have consequential knock on as regards the UCITS's liability to tax, VAT rates on services delivered to the fund, EU Savings Directive classification, recognition of tax transparency and the tax regime for investors, as these are all linked to the country of residence of the UCITS.

### Fund merger

Essentially, a fund merger is the transfer of assets from Fund A to Fund B in return for the issue of shares in Fund B to holders of Fund A. Whilst there are often fund mergers within particular jurisdictions, cross border mergers have been less common, often because countries do not have the regulatory framework to accommodate them or there has been legislation actively preventing them.

The UCITS Directive requires EU member states to allow mergers both on a domestic and cross border basis. Since one of the key drivers for fund mergers is the reduction of costs, it is important to ensure there are no tax costs associated either directly with the merger or the post merger structure.

### Basic structure



## Tax issues

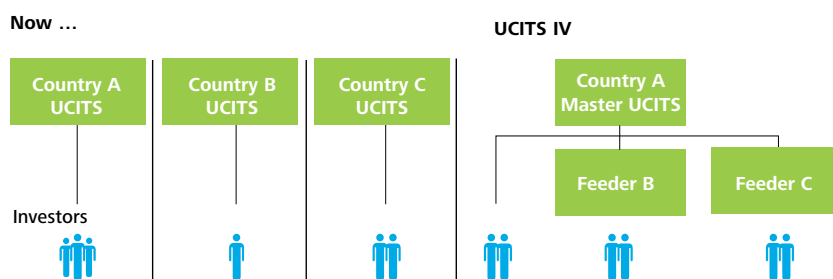
Most EU member states have legislation which enables domestic fund mergers to take place in a tax efficient manner, i.e. with no tax cost to the investor or the fund. However, some EU member states, for example Germany and Sweden do not extend that relief to cross border mergers. Indeed, the Committee of European Securities Regulators (CESR) commented in their December technical release that we may not see cross border mergers because of potential tax adverse consequences and recommends the commission keep the issue under review.

Tax issue	Key questions
<b>The merging fund</b>	<ul style="list-style-type: none"><li>• Are there any taxable gains realised on the transfer of assets to the receiving fund? Typically one would expect the fund to be exempt but it is worth checking.</li><li>• Does the merger end a tax accounting period? If so, does the fund have any tax liability? Are there actual or deemed distributions which need to be reported? Is there tax to be withheld?</li></ul>
<b>Investor issues</b>	<ul style="list-style-type: none"><li>• Are there any gains or income realised on the exchange of shares/units in one fund for another or are there reorganisation provisions that protect this?</li><li>• How has the tax profile of the investment changed? Is it now an offshore fund rather than a domestic fund and does that matter for tax? Have the nature and tax treatment of any distributions changed?</li></ul>
<b>Withholding taxes</b>	<ul style="list-style-type: none"><li>• Does the transfer generate any local taxes, such as capital gains tax, in country of investment?</li><li>• Has the domicile of the fund changed? How will that effect treaty entitlements and levels of withholding tax?</li></ul>
<b>Tax classification</b>	<ul style="list-style-type: none"><li>• How has the portfolio transfer impacted the receiving fund? How does this impact its classification for EUSD or bond funds in the UK?</li><li>• To what extent does the fund need to revisit its tax reporting in countries such as Germany, Austria, the UK and the Far East?</li></ul>
<b>VAT</b>	<ul style="list-style-type: none"><li>• Is the transfer of assets a taxable event or are there specific exemptions, e.g. transfer of going concern in the UK? Do these apply on a cross border basis?</li><li>• What are the VAT consequences of a different entity receiving the services? Have the scope and rate of VAT changed?</li></ul>
<b>Transfer taxes</b>	<ul style="list-style-type: none"><li>• Are there any capital duties on the issue of shares by the receiving funds?</li><li>• Are there any transfer taxes in relation to the transfer of portfolio investments? Are there planning opportunities?</li></ul>

Whilst it is true that with careful planning tax costs can be avoided it is seen by many as 'too difficult' and regularly quoted as a reason why the UCITS IV proposal will have limited success in this area.

### Master-feeder structures

Of more immediate attraction may be the proposal to allow master-feeder UCITS structures for the first time. Much of the fund proliferation to date has been to create mirror ranges for particular classes of investor (retail and institutional) or particular markets. The master-feeder proposals will enable fund managers to pool their assets in a single master fund and then distribute that fund strategy to different client segments and target markets, via the feeders.



### Tax issues

The application of double tax treaties to collective investment vehicles is already a difficult subject, with individual treaties taking different approaches. Some quite specifically give treaty access to funds, others will grant fund entitlement based on a proportion of the investor base and yet others will demand a full look through basis. The insertion of yet another level of ownership via the feeder fund can only seek to further complicate this difficult area. Groups will need to consider to what extent a master-feeder structure will impact the end investor in terms of withholding tax take. Investors in funds that have typically received treaty relief will be unlikely to agree to investment via a master fund that would not be eligible. At the other extreme, if funds look to structure in order to minimise withholding tax, they may find that tax authorities have become increasingly alert to possible 'treaty shopping'. Or is there something we can learn from experience in the area of pension pooling? The vehicle of choice in that arena is tax transparent with the fund applying withholding tax rates based on the ultimate investor profile. This is dependent on demonstrating that the fund knows the identity of the investor and has systems in place to monitor that. Whilst this may bring some complexity, it could minimise the tax distortion that would otherwise occur.

If an existing UCITS fund looks to convert to a feeder fund, this will typically require the fund to transfer assets

to its master fund in return for shares. In many ways, this is similar to a fund merger and the issues to be considered will be those discussed above.

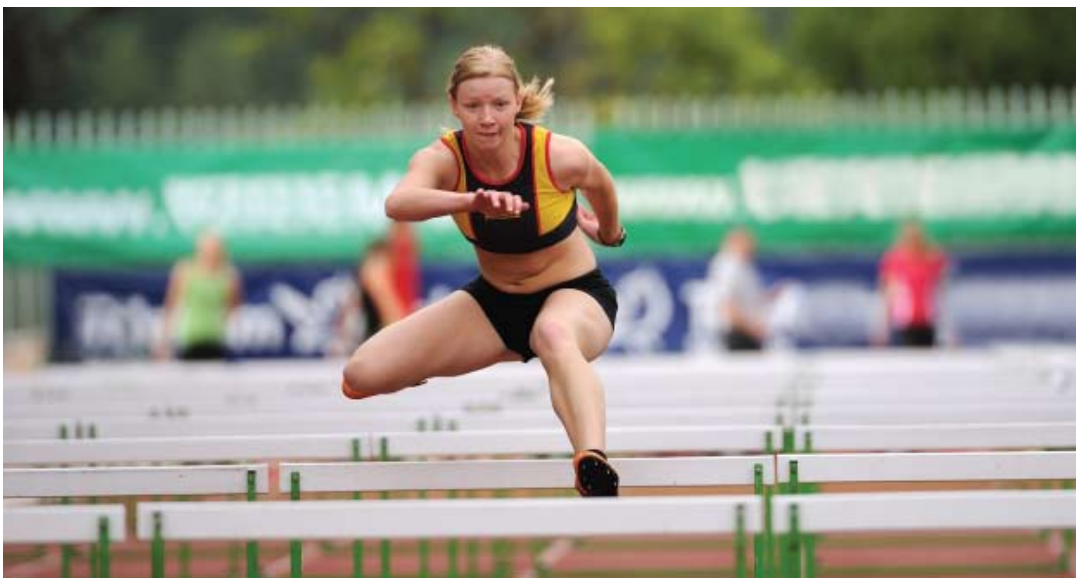
There will also be VAT issues to consider, not only on the services and fees flowing between the management company and the funds, but also between the master and feeder fund (to the extent there are any). Whilst one would hope that the VAT exemption for the management of funds would apply to services supplied by the management company to both the master and feeder funds, it will be important to confirm the position and ensure that the contractual arrangement/associated documentation is supportive. In this regard, an arbitrary allocation of a management fee across master and feeder funds could give rise to adverse VAT consequences. In addition, if a non UCITS feeder fund is used, these structures may be a greater risk. The management services supplied in connection with the feeder fund may not qualify for VAT exemption which could lead to irrecoverable VAT and additional VAT compliance obligations, e.g. the feeder fund having to register for VAT.

Finally the feeder fund will have to be clear on how the investment via a master fund impacts the various tax classification we referred to earlier, especially if the context of the various tax reporting regimes around Europe.

## Conclusion

The introduction of UCITS IV should simplify operations and clarify competition in the European asset management industry. It will speed up the time it takes to get products to market, reduce the cost of distribution, encourage the streamlining of product ranges, and help customers compare products across borders. However, one thing it will not do is simplify tax treatments within the industry. Institutions will have to stay focused on understanding the tax implications as UCITS IV settles into place, and be prepared to respond if they are to enjoy the full benefits of this new directive.

Main objectives	Detailed benefits	Benefits from UCITS IV		
		Management company passport	Master-feeder structure	Cross-border mergers
Distribution efficiency	<ul style="list-style-type: none"> <li>• Quicker time to market</li> <li>• Streamlining of the authorisation process across EU member states</li> </ul>	✗	✓	✗
Operational cost reduction	<ul style="list-style-type: none"> <li>• Maximisation of operational synergies</li> <li>• Creation of centers of competence</li> <li>• Reduced distribution documentation costs</li> <li>• Increased investment management efficiency via master-feeder structure</li> </ul>	✓	✓	✓
Fund management optimisation	<ul style="list-style-type: none"> <li>• Rationalisation of product ranges</li> <li>• Structured and harmonised legal framework for mergers</li> <li>• Reduced investment management costs</li> </ul>	✓	✓	✓
Tax optimisation	<ul style="list-style-type: none"> <li>• Review of current revenue flows</li> <li>• Enhanced opportunities for tax planning</li> </ul>	?	✓	?
Product attractiveness	<ul style="list-style-type: none"> <li>• Increased investor protection</li> <li>• Reduced operating costs and product fees</li> </ul>	✓	✓	✓



# The Aberdeen case

## Taking it to the next level

**Manuela Abreu**  
Manager – Tax GFSI  
Deloitte Luxembourg

Many players in the fund industry, and more specifically the fund managers, are aware that the European Court of Justice's Aberdeen case was ruled last year on 18 June 2009.

The European Court of Justice's (ECJ) Aberdeen case concerned a Finnish resident real estate company, Aberdeen Property Fininvest Alpha Oy (Aberdeen Property) which was held 100% by an open-ended investment company established in Luxembourg, Aberdeen Property Nordic Fund I SICAV (the SICAV). The Finnish subsidiary had asked the Finnish tax administration whether dividends distributed to the Luxembourg SICAV could be exempted from Finnish withholding tax. The reason for the requested exemption was based on the discriminatory nature of such taxation with respect to the European Union (EU) tax law.

The case was referred to the ECJ, who had to decide whether it was contrary to article 43 (freedom of establishment) and article 56 (free movement of capital) of the EC Treaty to charge Finnish withholding tax on dividends distributed by a Finnish company to a non-resident company incorporated as a Luxembourg SICAV, especially when such dividends distributed to a resident Finnish share capital company or investment fund would have been exempt.

The ECJ, having rejected the arguments from the various EU member states involved in the proceedings, held that i) investment funds with different legal forms are in a comparable situation, therefore member states cannot use this argument to justify the application of a differential treatment ii) it is of no relevance if the income receiving entity is not subject to taxes in its residence country iii) that the application of withholding taxes could not be justified by the need to avoid tax evasion. In a nutshell, the ECJ decided that a Luxembourg SICAV should be compared to a Finnish corporate resident

entity and therefore fully entitled to be granted a refund of the Finnish withholding tax applied on dividend payments.

Previous ECJ cases, such as the Fokus Bank, Denkavit and Amurta cases, had already ruled that the imposition of withholding taxes in comparable situations was contrary to EU tax law. However, the Aberdeen case reinforced once again the possibility of investment funds to initiate tax reclaim proceedings. Some argue that the Aberdeen case may not benefit all EU investment funds due to the fact that, for instance, the investment fund involved in the ECJ case – the Luxembourg SICAV – was not a UCITS fund and held just one investment and not a portfolio of investments, as is the rule in investments made by retail funds.

Although there has been much debate about this particular case, we also assume that amongst many fund managers there are still open questions for which some guidance is required. Questions such as (i) what is the right approach? (ii) where to start? (iii) what must be done? (iv) what is the right course of action? (v) how can the withholding tax amounts involved be reclaimed? are, without doubt, being asked by many. More specifically additional pertinent questions could include, (i) for how long has my investment fund been levied with excessive withholding taxes? (ii) what are the amounts of withholding tax involved? (iii) how are EU member states paying the income to the investment fund and applying the taxes? (iv) to whom will the costs of the administrative and judicial court cases be imputed to? (v) what documentation needs to be prepared to file the administrative tax reclaims?



The first and potentially most important question fund managers should be asking themselves is what their approach to EU tax reclaims will be? Fund managers will have to determine whether (a) they will initiate the administrative procedures to reclaim the withholding taxes due – i.e. the ‘offensive approach’ or (b) they will file initial claims and wait for developments taking into account maximum legal delays for the next step – i.e. the ‘defensive approach’ – or even (c) they will adopt the ‘wait and see’ approach with the risk that the advantage of the proceeding is lost entirely.

To define the most appropriate strategy, several factors need to be fully scrutinised and thoroughly analysed.

The first exercise is to distinguish investment funds of a corporate type – to which the Aberdeen case clearly applies – from the investment funds of a contractual form – where there is uncertainty as to whether these can benefit from EU tax reclaims due to their legal nature as transparent entities in most jurisdictions – and whether the funds are located in an EU member state or in a third country outside the EU. The difficulty to successfully reclaiming excessive withholding taxes in the EU increases when the investment fund is not of a corporate form, e.g. is an FCP rather than a SICAV, and is located in a third country, e.g. Singapore or the USA rather than Luxembourg or France. Comparability is a key criterion of this analysis. It is only when comparability between the legal form of the resident investment fund (benefiting from the withholding taxes exemption) and the non resident investment fund (being subject to the imposition of withholding taxes) is achieved that the tax reclaims are made possible.

Next, fund managers need to assess how many financial years are at stake, meaning how long the investment fund has been investing in a specific jurisdiction and how long has it suffered from excessive withholding taxes. These questions are directly related to the amounts of withholding taxes involved as most jurisdictions establish a maximum time period – statute of limitation – for which taxpayers can go back and reclaim taxes due. The amount of taxes involved is always affected by the number of tax years still available to reclaim in each jurisdiction. In fact, the statutes of limitation for tax laws of the 27 EU member states vary widely, e.g. between one and potentially four years in Germany, three years in France, four years in Spain and Italy, five years in Finland, Belgium and Poland, and between five to seven years in the Netherlands.

In light of ECJ case law, the 27 EU member states fall into two main categories:

- Countries where there are opportunities to pursue administrative claims as their domestic laws apply differential treatments to their own investment funds in comparison to non-resident investment funds
- Countries where there are no opportunities to pursue administrative claims as their domestic laws do not apply any differential treatment

Consequently, it only makes sense to pursue tax claims in those EU member states where tax laws were or are discriminatory in relation to non resident investment funds.



Concerning the estimation of costs, many factors must be considered including, but not limited to, costs related to the determination of the amounts involved, costs for document preparation, costs incurred for filing administrative proceedings, initiating administrative tax reclaims and judicial cases, all of which may culminate at the ECJ, as well as all legal and court assistance which is necessary in most EU member states.

One crucial element in the preparation of the tax reclaim file is the documentation phase. To initiate administrative, and potentially, judicial proceedings, the necessary documentation proof must be assembled. This phase probably constitutes the most lengthy and time consuming aspect of this entire process. Additionally it must be remembered that each tax administration applies its own rules as to what is considered as necessary documentation to be filed for the corresponding tax reclaim. In this respect the 27 EU member states can also be differentiated between more burdensome and less burdensome jurisdictions. For example, whilst some countries request a copy of every dividend voucher and corresponding tax forms, others simply accept a document produced by the fund managers, e.g. in Excel format, describing the date and amounts of dividend payments received.

For mere illustrative purposes, as each EU member state requires specific documentation, the type of documents that may be requested by certain jurisdictions include power of attorneys, name of the dividend receiving company, full address of the dividend receiving entity, name, function and telephone number of the contact person within the dividend receiving entity, tax registration number of the dividend receiving entity, amount of dividend withholding tax to be refunded, information on number of shares in the dividend distributing company, date that proceeds were made available for distribution, copy of the dividend notes concerned, bank account to which the amount is to be refunded, name of bank account holder and place of residence of the bank.



Another key consideration is the imputation of the costs of the proceedings to either the investment fund itself or to its investors. The same reasoning needs to be applied to any amounts successfully reimbursed, i.e. will they be repaid to the investment fund or to the investors? If it is the investors, then will the withholding tax only be repaid to current investors or also to those holding shares at the time the taxes were levied? Additionally, a decision needs to be taken as to whether any provisional amounts should already be booked in the accounts of the investment fund or if this should only occur upon a successful reclaim procedure. In the great majority of countries this topic is still open to discussion.

One final relevant aspect the fund manager must assess when considering whether to initiate proceedings and in which countries is the estimated time length for these same proceedings. The duration of an administrative reclaim or a judicial court case can vary dramatically between EU member states. Whilst in many northern European member states it is quite usual for an administrative reclaim to be decided within one year and a judicial case being closed within a maximum of two to three years, in most southern European member states it is not unusual for the whole process to last up to six years or more. It may also be relevant to understand if a specific EU member state allows class actions or not, as these types of legal proceedings may considerably shorten the reclaim procedure when several claimants are involved. The problem is that in many civil law European countries, class actions do not exist as such, whilst in common law countries they tend to be quite common.

Overall the decision to pursue tax reclaims under EU tax laws is not only dependant on one criterion, there several factors to consider such as statutes of limitation, withholding taxes amounts, costs, as well as access to relevant and accurate documentation.

Finally, a word on the position of the European Commission (EC) in this context. The EC, together with the ECJ, is responsible for ensuring EU law is properly applied in all EU member states. In relation to pension funds the EC has taken steps, via requests of information and reasoned opinions, against the Czech Republic, Denmark, Estonia, Finland, Germany, Italy, Lithuania, Poland, Portugal, Slovenia, Spain, Sweden and The Netherlands. More recently, the EC has started focusing its attention on the domestic tax laws of EU member states in relation to investment funds and has asked Poland, Belgium and France to amend their legislation. In both situations – pension funds and investment funds – many EU member states have already implemented modifications to their tax laws to be compliant with EU law.

It is quite clear that in the current financial environment, for most fund managers, not acting is no longer an option – this is a corporate governance issue which constitutes part of their responsibilities. It is expected, especially after this Aberdeen case, that fund investors will question the decision of fund managers not to pursue claims and will request appropriate justifications.

# Risk & Governance

## The future of SAS 70

In response to recent economic events there has been an enhanced use of third-party assurance reports. This has added a great deal of pressure and demand for clients to have their service providers retain and demonstrate even stronger internal control.

A shift in third party-assurance reporting is on the way: two new standards, an international standard and a US standard, which will replace SAS 70, have been issued recently. What are the impacts for service organisations that already have a SAS 70 report and what does it mean in terms of opportunities for the others?

**Colm A. Mc Donnell**  
Partner – Enterprise Risk Services  
Deloitte Ireland

**Laurent Berliner**  
Partner – Enterprise Risk Services  
Deloitte Luxembourg

**Pascal Koenig**  
Partner – Consulting  
Deloitte France

**Elisabeth Bordes**  
Senior Manager – Consulting  
Deloitte France

**Michael Blaise**  
Senior Manager – Enterprise Risk Services  
Deloitte Luxembourg

### SAS 70: the current reference

Service auditor engagements have become increasingly prevalent in the marketplace since the issuance of Statements on Auditing Standards No. 70, Service Organisations (SAS 70), in 1992. The objective of a SAS 70 report is to provide clients of a service organisation and their independent auditors with information on policies and procedures that may be relevant to their internal control structure. The clients use the report to understand the adequacy of their service provider's controls. The client's auditors use the report to gain a thorough understanding of their client's system of internal control and to reduce or eliminate audit procedures at the service organisation.

The pertinent audit guideline is the American Statement on Auditing Standards number 70, issued by the Auditing Standards Board of the American Institute of Certified Public Accountants (AICPA), officially titled 'Reports on the processing of transactions by service organisations'. Over the past years, the SAS 70 report has become a must-have and is often an entry-barrier to RFPs, leaving companies without a SAS 70 report at a competitive disadvantage.





### Benefits of third party-assurance reports

#### Reduced burden

Hiring an independent service auditor to perform the review allows the organisation to be subjected to just one internal control audit. Upon completion, the report is distributed to the service organisation's users so that their auditors may rely upon its opinion and findings and subsequently limit or eliminate additional substantive audit procedures. It can help to:

- Reduce the impact on your resources by minimising disruption from other outside parties
- Reduce operating costs for your clients, due to the fact they will no longer have to send auditors to audit your organisation

#### Marketing tool

Organisations use the report to generate and maintain business. With the recent heightened awareness to operational risk management, more and more prospective clients are requesting third party-assurance reports during a due diligence process to obtain comfort over the processing control. The benefits are:

- Strengthening your company's reputation and 'ticking a box' in the RFP process
- Assisting in fulfilling your potential customers' and their independent auditors audit future responsibilities
- Demonstrating that controls are designed and implemented based on an accepted internal control framework (e.g. COSO)
- Providing a control environment independent report under a standard recognised internationally

#### Risk management

Third party-assurance reports provide management with an overall risk assessment of the organisation and greater comfort over the organisation's environment and a good reliance on controls that mitigate your, and your clients', risks.

#### Training tool

Management can use the third party-assurance reports to provide employees with key information about the organisation and how transactions are processed as well as providing a rounded understanding of the global objectives of the business and supporting the fostering of control disciplines across the organisation's overall control environment soundness.

#### Assessment tool

A third party-assurance reports provides management with an independent assessment of the control procedures' adequacy and 'reasonable assurance' over the processing control environment's operating effectiveness. It illustrates the positive effects of a properly functioning and articulated control environment to an organisation's senior management and assists in reducing the likelihood of unwanted surprises by:

- Identifying and documenting your control objectives
- Analysing the effectiveness of your control activities
- Determining the consistency with which your controls are applied throughout the organisation
- Helping to identify process and technology weaknesses
- Identifying opportunities for improvement throughout audited operational areas
- Determining the consistency with which your controls are applied throughout the organisation
- Standardisation of processes among multiple services
- Assessing the strength of your management oversight



### Changes to SAS 70: the rationale

The International Auditing and Assurance Standards Board (IAASB) issued a new international standard, ISAE 3402, for engagements to report on controls at service organisations. At the same time, the AICPA has also redrafted SAS 70.

Prior to the IAASB's development of International Standard on Assurance Engagements 3402 (ISAE 3402), there was no global standard for engagements to report on controls at service organisations. SAS 70 is a US standard, and although it has been used for engagements outside the US, the IAASB saw a need to develop an internationally recognised standard. The AICPA, as part of its efforts to converge its US standards with those of the IAASB, followed suit and began drafting a new Statement on Standards for Attestation Engagements No.16 (SSAE 16) that would replace SAS 70 and mirror ISAE 3402. The revisions to SAS 70, through SSAE 16, represent the first significant modification to the standard since it was issued nearly two decades ago.

Whilst the standards drafted by the IAASB and AICPA are not significantly different from each other, nor from the present standard, they do present some changes from SAS 70 that may prove challenging for some service organisations. Since 1992, SAS 70 has proved to be a stringent standard for engagements to report on controls at a service organisation. One might reasonably ask why there is a need for newer standards when SAS 70 has been providing effective requirements and guidance to service auditors for nearly two decades. The new standards by the IAASB and AICPA are not aimed at overhauling how an engagement to report on controls at a service organisation is performed; rather, they have been drafted to meet the demands of the current market environment and to fit into the modern framework of assurance standards.

### A short history of audit requirements for service organisations

1992: Development of SAS 70 by the AICPA.

2002: Passage of the Sarbanes-Oxley Act of 2002 leads to much wider use of SAS 70.

2008-2009: IAASB begins development of international standard on service organisations.

AICPA SAS 70 task force begins redrafting SAS 70.

2010: An international standard issued by the IAASB called ISAE 3402 and an US standard issued by the AICPA called SSAE No.16 to replace SAS 70.

2011: For examination periods ending on or after June 15, 2011, service auditors are required to comply with either ISAE 3402 or SSAE No.16.

### Sign on the line

The most significant change to third party reporting is the requirement, in both ISAE 3402 and SSAE 16, that management of the service organisation provide a written assertion attesting to the fair presentation and design of controls (in a Type 1 report) or the fair presentation, design, and operating effectiveness of controls (in a Type 2 report). Under SAS 70, engagements were considered 'direct-reporting' engagements in which service auditors reported directly on controls at the service organisation and management was not required to provide a written assertion. Under the new standards, engagements will be 'assertion-based': management will be required to provide a written assertion, even though the auditor will continue to report on the subject matter (i.e. whether controls are fairly presented, suitably designed, and [in a Type 2 report] operating effectively).

To provide a written assertion, management will need to have a reasonable basis for making the assertion, which may include developing their own processes to support the assertion if such processes are not already in place. ISAE 3402 and SSAE 16 provide specific requirements that management must meet in order to provide a written assertion. For instance, management is required to:

- Select suitable criteria, which will be used to prepare its description of the system as well as to evaluate whether controls were suitably designed (Type 1 report) or suitably designed and operating effectively (Type 2 report)
- Identify the risks that threaten the achievement of the control objectives stated in the description

If the service organisation relies on controls at a subservice organisation and management elects to use the inclusive method, that is, management's description of the service organisation's system includes controls at the subservice organisation, management will also need to determine whether controls at the subservice organisation are suitably designed or suitably designed and operating effectively, depending on whether they are executing a Type 1 or Type 2 report. To make this determination and to support its own assertion, management of the service organisation would need to obtain a written assertion from management of the subservice organisation.

To meet this future obligation, service organisations should initiate discussions with their subservice organisations soon to avoid difficulties in obtaining these assertions when the new standards become effective. Once the new standards are in place, if the management of a service organisation does not provide an assertion, the service auditor will not be able to accept the engagement.

SAS 70 already requires that management provide a letter that includes written representations that controls are suitably designed, or that they are suitably designed and operating effectively. However, some service organisations may decide that the processes previously implemented so that such a representation can be made may no longer be sufficient for making a written assertion in their report on controls.

### Control ownership

Service organisations that do not already have extensive processes to monitor and evaluate their controls may face significant challenges. These service organisations will need to develop processes so that management can assert that controls are suitably designed or that controls are suitably designed and operating effectively. In addition, the service organisation will need to determine who will be responsible for overseeing the new processes and for making the assertion. This may be one or more of the CIO, COO, CFO or others in management. Service organisations should devote some time and effort to determine who in their organisation is most appropriate to accept this responsibility.

### What else is new?

There are also other changes to third party reporting that are worth noting:

- One-to-one reporting, where the service organisation did not design the controls, is not applicable under the new standard. If the service organisation did not design the controls, then there is no ability for them to provide an assertion and therefore one-to-one reporting in this scenario would not be appropriate
- In a Type 2 report, if the work of an internal audit function has been used, the service auditor is required to include in its description of tests the internal auditor's work and the service auditor's procedures with respect to that work
- Both SSAE 16 and ISAE 3402 require the service auditor to investigate the nature and cause of any deviations identified. However, SSAE 16 indicates that if the service auditor becomes aware that the deviations resulted from intentional acts by service organisation personnel, the service auditor should

assess the risk that the description of the service organisation's system is not fairly presented and that the controls are not suitably designed or operating effectively. The ISAE 3402 is silent on this requirement, but it does not mean that an intentional act could be ignored

- When assessing the design of controls in a Type 1 engagement or the design and operating effectiveness of controls in a Type 2 engagement, evidence obtained in prior engagements about the satisfactory design and/or operation of controls in prior periods does not provide a basis for a reduction in the evaluation of design or the testing of controls, even if supplemented with evidence obtained during the current period. In other words, the assessments must be wholly based on evidence obtained during the current period

### Benefits for early adopters?

The new standards drafted by the IAASB and AICPA will become effective for assurance reports covering periods ending on or after 15 June 2011. Service organisations and their auditors have the option of early-adopting the new standards. Although there may be initial challenges in meeting the new standards, early adoption may present certain benefits. Early adoption will give user organisations and their service auditors more time to assess whether management has implemented the processes necessary to comply with the new standards. This will help them avoid last-minute changes when the standards become effective. Furthermore, service organisations that early adopt may be perceived as having a stronger control environment relative to their competitors that choose not to early adopt. In addition, early adopters may also be perceived as being market leaders.



### Where do I go from here?

The new standards developed by the IAASB and the AICPA present many new challenges. Service organisations will face uncertainty and will have to make some strategic decisions. The time to start planning for these changes is now. In starting to plan, service organisations may wish to ask a number of questions, such as:

- What additional testing and/or monitoring processes will we need to implement so that we can support our assertion?
- Which member or members of management will be responsible for providing the assertion? Are they comfortable and knowledgeable to sign the assertions?
- Who in the organisation should be involved to support our assertion?
- How will the new standards affect our service organisation and our service auditor?
- Is the carve-out method or inclusive method of reporting of our subservice organisations the best method for us? Would we be able to obtain an assertion from them if we choose to use the inclusive method?
- How should we educate our user organisations and any subservice organisations about the changes and our approach to meeting them?
- Which standard, SSAE 16 or ISAE 3402, should be used by the service auditor to meet the needs of my customers?
- Should we early adopt the new standards or wait until they are required?
- Will user organisations accept early adoption of the new standard, especially in light of many contracts specifying SAS 70 as the required deliverable?
- Will we need to refine user contracts to accommodate the issuance and adoption of the new standard?

### Taking the initiative

Not every organisation will choose to adopt early – nor should they. Varying circumstances and objectives make the consideration unique for each organisation. Nonetheless, every service organisation should become conversant in the new requirements and should establish a plan for implementing them in a thoughtful, measured, and properly paced manner. Too often organisations put off considering pending requirements, only to scramble to comply at the last minute. Such an approach causes disruption, distraction, and needless expense.

A proactive stance, on the other hand, allows companies to control the process, rather than being controlled by it. Knowing well in advance which standard to follow, whether additional management processes need to be implemented, who will sign the assertion, and whether to early adopt will provide reassurance to management, employees, and customers alike.

The new standards will become effective soon. Those service organisations that act now to prepare for the changes will most likely benefit with a competitive advantage. To compete effectively in the global economy, service organisations must demonstrate transparency and efficiency. Those that take a proactive approach to the new assurance requirements will display those qualities and more: they will show that they are flexible, forward-thinking, and trustworthy.

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**To compete effectively in the global economy, service organisations must demonstrate transparency and efficiency**

# The Custody Rule and global considerations

**Tania Lynn**  
Senior Manager – Audit  
Deloitte US

## The Securities and Exchange Commission (SEC) issued on 30 December 2009 amendments to Rule 206(4)-2 (the ‘Custody Rule’) under the Investment Advisers Act of 1940.

The amendments were designed to enhance the controls on registered investment advisers who have custody or access to client funds or securities to increase protection for investors. The SEC additionally continues to publish staff responses to questions about the Custody Rule, responses from the SEC staff of the Division of Investment Management to questions received. The staff responses provide useful insights and may assist advisers in interpreting aspects of the Custody Rule. The Custody Rule impacts investment advisers registered with the SEC. Globally many pooled investment vehicles are managed by SEC registered investment advisers; therefore, the impact extends beyond the United States.

‘Custody’ is defined as “holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them.”

This may include the following situations:

- Adviser has physical possession of client funds or securities, even temporarily
- Adviser serves in a capacity that gives you or a supervised person legal ownership or access to client funds or securities (i.e. a general partner to a privately-offered pooled investment vehicle or trustee in a trust)
- Adviser enters into arrangements (including a general power of attorney) authorising you to withdraw funds or securities from the client’s account (note that if you are authorised to deduct your advisory fees or other expenses directly from clients’ accounts, you have custody)





The Custody Rule contains a number of key provisions, including the following summarised principles:

**Notice of accounts**

Requires registered investment advisers to notify their clients promptly upon opening a custodial account on their behalf.

**Delivery of account statements**

Requires registered investment advisers with custody of client assets to have a reasonable belief that the qualified custodian sends an account statement, at least quarterly, to each client for which the qualified custodian maintains funds or securities.

**Independent verification ('surprise examination')**

Requires registered investment advisers with 'custody' of client assets to have an independent accountant conduct an annual surprise examination of those assets to verify client funds and securities.

**Qualified custodian**

Under the Custody Rule, registered investment advisers, in most cases, must maintain client funds and securities with a 'qualified custodian'.

**Internal control report (e.g. SAS 70, AT 101)**

If the registered investment adviser or a related person acts as the qualified custodian of client assets, the qualified custodian (who is the adviser or the related party to the adviser) must obtain an internal control report (e.g. Type II SAS 70, AT 101) that includes an assessment of controls relating to custody of client assets.

**Additional disclosures**

The Custody Rule adds new disclosure requirements to an adviser's registration statement on Form ADV relative to the adviser's custody arrangements and compliance with the Custody Rule's requirements.

**Effective date**

The amendments to the Custody Rule were effective 12 March 2010, except in certain cases where other compliance dates are specified in the Custody Rule.

### Audit Provision

Many advisers of pooled investment vehicles look to the Audit Provision as a way of complying with many requirements included in the Custody Rule. Certain exceptions to the Custody Rule have been provided. Specifically for an adviser with custody of funds and securities of pooled investment vehicles, an exception is provided to permit the adviser to use the 'Audit Provision'. The two options an adviser has for compliance with the Custody Rule related to a pooled investment vehicle are summarised below.

#### Option 1

Use the Audit Provision, which entails having the pooled investment vehicle subjected to an annual audit by an independent public accountant registered with, and subjected to regular inspection by the Public Company Accounting Oversight Board (PCAOB) and distribute the audited financial statements to each investor in the pool within 120 days after the pool's fiscal year end (180 days for fund of funds). The audit opinion needs to be unqualified and in accordance with generally accepted auditing standards in the United States of America (US GAAS). The financial statements are to be prepared in accordance with accounting principles generally accepted in the United States of America (US GAAP). It may potentially be permitted to utilise another accounting convention where there are foreign investors only or if the financial statements are substantially similar to US GAAP. Investments which are considered privately offered securities, as defined in the Custody Rule and where the adviser is using the audit provision, these privately offered securities are not required to be held with a qualified custodian.

#### Option 2

If the Audit Provision is not used, the adviser must instead do the following:

- Notify the investors promptly of all qualified custodians being used by the pooled investment vehicle.
- Have all funds and securities, including privately offered securities held by a qualified custodian.

### Question

**Q:** To use the 'audit approach' relying on rule 206(4)-2(b)(4), must the financial statements be prepared in accordance with US GAAP?

**A:** Yes, the financial statements for pooled vehicles must be prepared in accordance with US GAAP in order to meet the requirements of the rule, with some exceptions for non-US funds and non-US advisers.

For privately offered securities recorded only on the books of their issuers, the adviser may keep the subscription agreement for the security with a qualified custodian or have the custodian act as nominee for the limited partnership.

- Have a reasonable basis, after due inquiry, for believing the qualified custodian sends quarterly account statements to each investor (or their independent representative) in the pool. The account statement is to be a statement of funds and securities held by the pool and transactions entered into by the pool and not a statement of the investor's ownership interest in the pool (e.g. investor's ending capital balance in a limited partnership).
- If the adviser sends their own account statements to investors, these account statements need to include a comment/legend notifying the investors they should reconcile between account statements received from the adviser and those received from the qualified custodian.
- Undergo an annual surprise examination by an independent accountant registered with the PCAOB and subjected to regular inspection. The surprise examination includes the independent accountant sending confirmations to both the qualified custodians and to the individual investors. The security count reports are filed with the SEC.

Pooled vehicles organised outside of the United States, or having a general partner or other manager with a principal place of business outside the United States, may have their financial statements prepared in accordance with accounting standards other than US GAAP so long as they contain information substantially similar to statements prepared in accordance with US GAAP. Any material differences with US GAAP must be reconciled. The Division would not recommend enforcement action if that reconciliation is included only in the financial statements delivered to US persons. See generally Goodwin, Proctor & Hoar, SEC Staff Letter, 28 February 1997. The required audit of those financial statements must be by an independent public accountant and meet with requirements of US generally accepted auditing standards (US GAAS).

In addition, offshore advisers registered with the SEC are not subject to the Custody Rule, with respect to offshore funds. See ABA Subcommittee on Private Investment Entities, SEC Staff Letter, 10 August 2006 ('ABA Letter'), available at <http://www.sec.gov/divisions/investment/noaction/aba081006.pdf>. The terms 'offshore adviser' and 'offshore fund' are defined in the ABA Letter (Modified 10 March 2010).





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## Whichever option the adviser elects, the adviser should document their method of compliance to monitor regularly their compliance with this and other aspects of the Custody Rule

### **Global considerations for advisers**

Aspects of the Custody Rule require particular attention for advisers with international considerations. Some of these considerations have been highlighted in the SEC publication Staff responses to questions about the Custody Rule which are responses from the SEC staff of the Division of Investment Management to questions received on the Custody Rule. The staff responses provide useful insight and may assist advisers in interpreting aspects of the Custody Rule. For international advisers there are a few key responses which should be focused on.

### **US GAAP accounting standard**

Several regulators or investors in jurisdictions outside of the United States may either require or prefer financial statements prepared in accordance with International Financial Reporting Standards (IFRS) or another local GAAP. For advisers using the Audit Provision, the Custody Rule generally requires the financial statements be prepared in accordance with US GAAP. The SEC has

accepted that an alternative accounting convention to US GAAP may be used in certain limited circumstances where the pooled investment vehicle is domiciled outside the United States, (i.e. Luxembourg, Ireland, or the Cayman Islands) or the adviser has a principal place of business outside the United States, provided the financial statements contain information substantially similar to those prepared in accordance with US GAAP or that a reconciliation to US GAAP is included. Notwithstanding this, the SEC communicated (please refer to side bar) that enforcement action would not be recommended if the reconciliation to US GAAP is included only in the financial statements delivered to US persons. Therefore in certain limited circumstances, an adviser may not need to prepare US GAAP or similar financial statements; however, the adviser will want to make sure to consider master feeder scenarios where a US based feeder fund is present and have a process in place for monitoring their distribution of the financial statements to US persons to ensure continued compliance.

#### Question

**Q:** To use the Audit Provision allowed under rule 206(4)-2(b)(4), must the audit meet the requirements of US GAAS?

**A:** Yes. If the audit does not meet US GAAS requirements, the adviser cannot rely upon the Audit Provision (Modified 10 March 2010).

#### US GAAS auditing standard

In certain jurisdictions financial statements are required to be audited under International Standards on Auditing or another local auditing standard. In these situations and where the adviser intends to use the Auditing Provision, the adviser may want to have discussions with the auditors of the funds to evaluate whether issuing two separate audit opinions or another response is appropriate. In various discussions, the SEC has communicated that provided an adviser retains a copy of the US GAAS audit opinion for documentation, no specific requirement for the financial statement with the US GAAS audit opinion be distributed to investors.

#### PCAOB registered and subjected to regular inspection auditor

If an adviser uses the Audit Provision to comply with the Custody Rule, the audit firm issuing the audit opinion must be PCAOB registered and subjected to regular inspection. An adviser should inquire with the auditor issuing the audit opinion about their PCAOB registration and inspection status and continue to monitor their status.

With these amendments, the SEC has renewed its focus on the Custody Rule. It is recommended that advisers monitor their compliance with the Custody Rule and document how they are adhering to the requirements. Advisers may need to consult with legal counsel or other experts as they navigate through the Custody Rule.



# The Premium Pension Institution or PPI

## Arjen Pasma

IM Leader – Financial Advisory Services  
Deloitte Netherlands

## Tobias Bastian

Director – Actuarial & Employee Benefits  
Deloitte Netherlands

Traditionally, the Netherlands is a country with a well-funded pension system and professional pension sector. In total, the Dutch pension funds manage approximately €600 billion worth of pension capital. For this reason, the Netherlands is an appealing country to those who wish to perform services for pension funds especially relating to asset management, pension plan administration and pension plan communication.

During the last decade, we have seen significant growth in the number of foreign parties active in the Dutch pension market. In a way, this is perceived as a threat for established (Dutch) parties. For the supervisors of the pension sector, the DNB<sup>1</sup> for prudential supervision and the AFM<sup>2</sup> for behavioral supervision, this development has resulted in a more difficult task of supervising these foreign organisations. In addition, the Dutch pension sector employs thousands of people and with a shrinking commercial asset management market, the pension sector plays an important role in financial innovation. Hence, the Dutch government and various knowledge centers, such as the Holland Financial Center and NETSPAR, are actively promoting innovation in the financial sector and particularly within the pension sector. Their ambition is for the Netherlands to become an exporter of efficient and innovative pension solutions as funding the retirement of ageing populations is a major challenge for many countries.

One of the Dutch answers could be the Premium Pension Institution (PPI). The PPI is the first stage of the 'three-stage rocket', a competitive vehicle on the international pension market on the one hand, and an answer to the identified implementation/execution problems of Dutch pension funds and insurers on the other hand.

The main characteristics of the PPI can be summarised as follows:

- The PPI carries out pension plans from multiple individuals based on Defined Contribution (DC). A PPI is allowed and effectively obliged to establish the rules and regulations; collect premiums; invest pension capital; administer entitlements; process value transfers; send annual pension statements (UPOs); purchase benefits at an insurance company; and take care of reporting and justification to stakeholders



<sup>1</sup>DNB: De Nederlandsche Bank

<sup>2</sup>AFM: Autoriteit Financiële Markten

- The PPI fits within the European pensions' Directive and therefore has a European passport through which foreign plans are allowed to be executed. The relevant social and labor legislation applies in the country where the employer offers the pension plan (i.e. in the country where the employees participate in the plan). In the Netherlands, the delayed taxation system as detailed in the Income Tax Act 1964 only applies to pension contributions and payments made by (the enlisted insurer of) the PPI
- Type of company who can act as a PPI include a foundation, a private limited company, a public limited company or a European public limited company i.e. SE
- The PPI may only make payments if they are not based on life expectancy. To be classified as a pure pension plan under Dutch fiscal rules, the payments from Dutch plans must be bought from an insurance company. For a foreign plan, the fiscal law of that foreign country applies
- There is no need for technical provisions, but there must be sufficient equity capital to cover, for example, any operational risks that are mandatory by law. This capital must be present at the time of the establishment of the PPI
- The content of the investment policy dictates if there is any need for an external asset manager. In principle, there is only a need to hire an external asset manager when non-European pension plans are executed; hence in most cases the PPI itself manages the investments
- Supervision is done by the AFM and DNB as part of the existing supervision on pension funds. The AFM looks after behavior and the DNB looks after prudence
- The PPI is exempt from corporate taxes and can reclaim Dutch dividend taxes. The same holds when dealing with foreign investments, however, depending on the fiscal treaties, dividend taxes from foreign governments may be reclaimed. In general, Dutch tax treaties are better suited for tax reclaim than, for instance, those with Luxembourg
- Both administration and asset management are considered as VAT exempt



It is anticipated that during 2010, Dutch legislation will be finalised and the first PPIs will be established. Considering the characteristics of the PPI, a number of parties can be identified as first movers. In random order these can be considered as:

1. Dutch insurers and asset managers
2. Foreign insurers and asset managers
3. Commercial pension providers
4. Multinationals headquartered in the Netherlands
5. Self employed without employees

#### **1. Dutch insurers and asset managers**

The PPI can be considered as a transparent vehicle for both Dutch insurers and asset managers. Dutch insurers can promote the PPI as an alternative to a life-long savings scheme for individuals or other saving plans. Until now, asset managers had no possibilities to carry out pension plans; in the future, they will be able to do so using a PPI. The simplicity and transparency of the PPI together with its resulting low introduction and running costs should be embraced by insurers and asset managers considering the criticism they have endured in relation to excessive overhead charges, lack of transparency, complexity and shortage in performing the so called 'duty of care'.

#### **2. Foreign insurers and asset managers**

Until the introduction of the PPI, it has been very difficult for foreign parties to start up an insurance company or pension fund in the Netherlands. The PPI offers foreign insurance companies and asset managers a chance for a smooth introduction into the Dutch market, again due to its simplicity and low costs.

#### **3. Commercial pension providers**

For existing Dutch commercial pension providers such as TKP, AZL, MN Services, Cordares, APG and PGGM, the PPI is a chance to manage new pension savings without the burden of administrative costs, governance and compliance issues.

#### **4. Multinationals headquartered in the Netherlands**

The PPI can be useful for multinationals, both big and small, headquartered in the Netherlands because of the simple way of incorporating the growth of pension capital from their Dutch and foreign employees, due to the PPI's European pension passport under IORP<sup>3</sup>. Besides simplicity, added benefits include the ease of multinational asset pooling; lack of Solvency II supervisory regime; the possibility for ring-fencing and low governance demands, as well as favorable tax arrangements including no corporation taxes, no turnover tax and the use of the delayed taxation system from the Income Tax Act 1964.

#### **5. Self employed without employees**

The PPI offers the self employed without employees a cost efficient alternative to build up their pension. There is however a need for the self employed to unite on this matter.

Despite some limitations, it can be concluded that the PPI offers many opportunities for both commercial organisations, and market parties as well as participants. The PPI is limited by its DC-character and the restriction that it cannot insure risks itself, but solutions can be found. Due to its simplicity, the PPI is relatively straightforward to establish and can perform within a definable framework. If the PPI's restrictions are seen as too strict, the last stage of the three-stage rocket, the General Pension Institute or API, can offer solutions. The API's role is foreseen to insure risks and perform DB-arrangements itself. However until API legislation is in place, the PPI can be used to gain valuable knowledge and experience.

<sup>3</sup> IORP: *Institutions for Occupational Retirement Provisions as among others described in the Pensions Directive (Directive 2003/41/EG)*.



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Deloitte is monitoring the development of the PPI s and will report again when legislation has been finalised and the first PPIs are up and running



# UCITS IV and the KII

## A new chapter in cross-border distribution

**Michael Flynn**

Directeur – Regulatory Consulting  
Deloitte Luxembourg

**Paola Liszka Draper**

Manager – Regulatory Consulting  
Deloitte Luxembourg

### The Recast UCITS Directive on UCITS IV (2009/65/EC) is finally reality after eight years of gestation.

The investment fund industry now has just nine months to decipher and implement this latest round of regulation prior to the transposition deadline of 1 July 2011. So far, France, Luxembourg and the Netherlands have emerged as the front runners releasing draft bills.

#### **A new chapter in cross-border distribution**

One of the main pillars of UCITS IV is the mandatory implementation of the Key Investor Information document ('KII') which is intended to provide harmonised and simplified investor information to facilitate fund comparison prior to investment. Another pillar, the simplified notification process, is designed to increase cross-border registration efficiency, resulting in quicker time to market, and to streamline the cross-border authorisation process across EU member states. These efficiency gains will however come at a price as both will lead to new challenges and increased regulatory risk.

So what are the upcoming challenges for the investment fund industry in relation to the KII and what of its impact on the current UCITS landscape? From the Directive, it is clear that marketing, risk management, legal and regulatory compliance will need to work together as never before. New processes and costs will emerge, all requiring close management supervision.

#### **Simplified Prospectus vs Key Investor Information**

UCITS III created the Simplified Prospectus (SP) – a framework for the provision of easily understandable and engaging fund disclosures with the aim of allowing retail investors to easily compare similar products. Regrettably UCITS III did not provide any clear or concise guidance on form or content resulting in many SPs simply becoming shortened versions of the full prospectus with identical content full of complex and technical language. Subsequently the SP became a non-added value administrative burden, with material variations across EU member states with no real investor benefits.

In an attempt to rectify these SP weaknesses, the KII was born. It is worth remembering that the KII forms a key element of the UCITS IV Directive obliging the European Commission to adopt implementing measures clearly defining the KII's scope and nature. The three aims of the KII are the same as for the SP – provide retail investors with better disclosure, easier to understand content and facilitate comparisons between products. Yet, in contrast



the KII will be a stand-alone, pre-contractual document, to be written in plain language with a pre-defined form, content and length, as stipulated in the Level 2 Implementing Measures. To prepare for Level 3 papers, on 20 July 2010, CESR published two consultation papers with responses due by 10 September 2010 – a model KII template and a guide to clear language and layout. These papers are potentially the industry's last chance to provide practical comments on the design of the KII.

However, will the industry really be able to simplify complex and technical investment objectives into plain language? Will the Synthetic Risk and Reward Indicator (SRRI), which, in most cases, measures historic volatility and takes no account of circumstantial factors such as economic forecast, really give investors sight of the potential risks involved when investing in the product? Will the KII provide investors with the ability to compare one European bond fund against another?

#### **Legal and marketing implications**

According to the Directive, the KII will be the only document that will need to be translated into either an official language of the host member state or one approved by their competent authority. Funds will have the choice whether to translate other fund documentation especially if it is already available in a language that is "...customary in the sphere of international finance". From the Prospectus Directive, which has the same form of words, this is understood to be English; consequently only having to translate the KII into local language will potentially reduce translation costs.

Material changes within the fund will require prompt revision of the KII which will inherently necessitate a timely notification to all regulators where the fund is registered for cross-border distribution and throughout its distribution network; as is currently the case under UCITS III. However, the Commission Regulation of 1 July 2010 states that the KII is subject to an annual update within 35 business days after 31 December, regardless of the fund's year end. This annual update will result in increasing the workload of the already stretched resources in legal, compliance, risk, fund accounting, sales and marketing, especially during the first quarter of the year. Fund managers must start introducing new processes and procedures now to ensure these departments work together to ensure this legal deadline is met.

If these requirements were not sufficiently challenging, the KII must state a warning that "a person does not incur civil liability solely on the basis of the key investor information, including any translation thereof, unless it is misleading, inaccurate or inconsistent with the relevant parts of the prospectus". As current fund documentation often carries a negative statement of such civil liability referring the investor to the full prospectus in case of inaccuracies or inconsistencies, this will only increase the legal responsibility to ensure the KII is fit for its purpose.



A final point of contention is the requirement to produce a KII on share class level rather than sub-fund level. Deloitte estimates that, on the basis of 1.5 annual KII updates, Luxembourg domiciled funds alone will produce in the region of 300,000 KIIs per year including translations. Considering KIIs will need to be revised for example due to a change in the calculated SRRRI over a 16 week period, or due to a change greater than 5% in the disclosed expenses, the number of new KIIs to be generated, including appropriate translations, will be substantial. For medium and large fund managers automation will be key as the implied volumes will become impractical to deal with on a manual basis in the long term.

In terms of costs, the European Commission estimates the implementation of new KII requirements to be 7.5% greater than those associated with the current SP. Their study goes on to suggest that potentially these increased costs can be offset against reduced levels of customer complaints and improved consumer confidence.

#### **KII transition phase**

It is not only the KII's technical, logistical and production requirements that will prove to be a major challenge; this is the only pillar within UCITS IV with a grandfathering clause. Individual member states can decide whether domestic funds can benefit from this grandfathering clause whilst foreign funds using their passport will be subject to the transition periods as imposed by their home state regulator.

Practically speaking, the transition phase will permit the KII to exist side by side with the SP. In its consultation paper on the transition process, CESR recommends that fund managers are consistent in their use of the KII vs. the SP; for example if the sub-fund still produces an SP and decides to launch a new share class, this share class should continue to be covered by the existing SP. The paper also suggests CESR would have no objections if fund managers continue to issue and revise their SPs during the transition phase and introduce certain KII elements e.g. the SRRRI, therein.

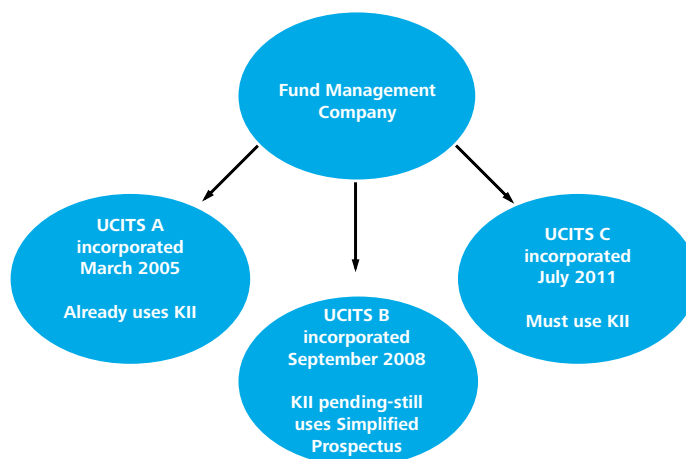
**Potential July 2011 scenario of KII vs. SP implementation**

Depending on when a fund implements the KII, processes will need to be put in place to manage transitional documentation and information flows between internal and external parties including regulators, distributors and above all investors. Again robust operations will be key to a successful transition. With the grandfathering phase lasting until 30 June 2012, the fund industry must start focussing their technical, risk management, legal and marketing resources on creating and producing the KII now.

**The future of the KII**

The introduction of the KII is keenly anticipated across member states as an enhancement to build on the global success of the UCITS brand, but what of its impact on other jurisdictions? Hong Kong has been a keen observer of the KII developments and has already implemented its own version, the Product Key Facts Statement, which forms part of the offering document, thereby adding another dimension to cross-border distribution for the European fund houses to contend with.

The full advantages of UCITS IV will only be achieved through the combination and synergies of its six key pillars rather than addressing each individually. The current UCITS landscape is changing with its future resting on consolidation and rationalisation of the investment fund market resulting in a dynamic, streamlined and more competitive UCITS environment.



We rank the three greatest quantifiable UCITS IV challenges resulting from the KII as i) increased coordination between legal, marketing and risk teams; ii) development of new processes and cost management, and iii) management of the information flow. If these are well managed, then their impacts will be beneficial. Perhaps the biggest unquantifiable challenge over the next 12 to 18 months will be the juggling of the UCITS IV agenda in parallel with the existing UCITS III schema until all member states have fully transposed UCITS IV.

# Interactive access to Deloitte knowledge



Through constant analysis of the latest developments and the multidisciplinary approach combining advisory & consulting, audit and tax, Deloitte has always been able to gain strong knowledge and expertise in financial services industries. Our firm has always been keen on sharing our experience and views.

As a further step in this direction, Deloitte has decided to open its knowledge resources to the professionals of the Investment Management community. Since their inception in 2009, our **free of charge** 'Lunch'n Learn' and 'Link'n Learn' initiatives have been warmly welcomed by the asset management industry.

The **Lunch'n Learn** sessions are hosted by our experienced professionals, who give training sessions at lunchtime on various topics of interest related to the investment management industry. Open to our entire client base, it has proven to be a great opportunity to introduce professionals to various areas or to build on already existing knowledge. The 38 sessions held in Deloitte Luxembourg's premises are a real success and fully booked for 2010.

Led by Deloitte's leading industry experts, **Link'n Learn** is a series of webinars conducted over the course of the year, specifically designed to keep you up-to-date with today's critical trends and the latest regulations impacting your business. An hour of your time is all you need to log on and tune in to each informative webinar. For access to the sessions do not hesitate to contact [deloittelearning@deloitte.lu](mailto:deloittelearning@deloitte.lu).

**Please find hereunder the Link'n Learn training programmes for the second semester of 2010:**

## September

- 09: Introduction to Target 2 Securities
- 16: Introduction to Pan European Regulatory Environment
- 23: Transaction cycles and NAV calculations
- 30: Treatment of errors and anti dilution techniques

## October

- 07: Introduction to UCITS IV
- 21: Introduction to Transfer Pricing
- 26: Investment restrictions of investment funds - Part 1
- 28: Introduction to 'Payment Service Directive'

## November

- 02: QFII/QDII Schemes and Potential Opportunities in and outside of PRC
- 09: Investment restrictions of investment funds - Part 2
- 11: Introduction to multi-class of shares
- 16: Introduction to performance fee and equalisation method
- 18: Introduction to risk and capital
- 23: Introduction to CAR-Basel II
- 25: Introduction to CSSF Circular 07/308
- 30: Hedge funds overview

## December

- 02: Introduction to IFRS for funds
- 07: Introduction to risk management techniques
- 09: Introduction to Pan European tax calculations
- 14: Introduction to globalisation techniques

## Hot off the press

### UCITS IV: transposition update

Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS IV Directive) was approved in July 2009 by the European Parliament and the Council and must be implemented into national legislation by July 2011.

The majority of EU member states have already started reviewing the Directive with a view to its transposition, yet only a few have, until now, publically issued draft bills. Consequently we have initiated our own review of progress and we present you with our initial findings.

France – In June, the National Assembly voted on the draft bill which will be now be put to the Senate.

Germany – In August, the Federal Ministry of Finance forwarded the draft bill to the Federal Government and other interested parties for consultation until 13 September.

Ireland – The Regulator starts a consultation process with revised draft UCITS notices, guidance notes and policy papers expected in Q4 2010. The Finance Act clarified that foreign UCITS managed from Ireland will not be subject to Irish tax.

Luxembourg – In August, the draft bill was deposited with the Luxembourg Parliament by the Minister of Finance. A transposition in the local legislation is targeted for the beginning of 2011.

Netherlands – In April 2010, the Dutch Ministry of Finance issued a draft bill, an explanatory memorandum and an explanation by article.

UK – The FSA intends to publish the first consultation in respect of the UCITS IV implementation in Q4 2010. The consultation period will last 3 months.

Italy – Starting on 23 September, Assogestioni, the Italian investment management association, will initiate a UCITS IV taskforce, aiming at analysing the regulatory and fiscal impacts of the EU directive on Italian products. The task force will submit an analytical report to the Italian authorities.

We will update you on the progress of this and other UCITS IV related topics as and when they occur.

## To be covered in our next edition

- Socially responsible investments
- Emotional and intellectual assets
- Market trends on offshoring
- QDII/QFII
- Fund cross border distribution
- Tax information exchange
- Liquidity issues and solutions to overcome performance dilution



