

# Performance

A triannual topical digest for asset management professionals, issue 4, January 2011



## Market buzz

Marketing financial products towards increased client protection and harmonisation of practices

The evolving private equity market in China

Why should art be considered as an asset class?

## Tax perspective

Indian Direct Tax Code – A mixed bag

## External perspective

PRIPs and the retail consumer – A new chapter in cross-border distribution of retail investment products

EIB presents its first study on the Mediterranean Solar Plan

A Dodd-Frank primer for EU money managers

UCITS IV – Opportunities and challenges for the European and global mutual fund industry

Eurozone government bonds Safe haven no more?

AIFM Directive – Hedge fund managers' round table

## Regulatory angle

Basel III reform – Implications and opportunities for asset management

Solvency II challenges related to asset management

FIN 48 – One year on What have we learnt?

The FATCA effect

**Deloitte.**

# In this issue

6

10

14

24

28

34



4 **Foreword**

5 **Editorial**

## Market buzz

6 Marketing financial products  
towards increased client protection  
and harmonisation of practices

10 The evolving private equity market in China

14 Why should art be considered as  
an asset class?

## Tax perspective

24 **Indian Direct Tax Code**  
A mixed bag

## External perspective

28 **PRIPs and the retail consumer**  
A new chapter in cross-border distribution  
of retail investment products

34 **EIB presents its first study on the  
Mediterranean Solar Plan**

38

44

50

58

62

68

72

76



- 38 **A Dodd-Frank primer for EU money managers**
- 44 **UCITS IV**  
Opportunities and challenges for the European and global mutual fund industry
- 50 **Eurozone government bonds**  
Safe haven no more?
- 58 **AIFM Directive**  
Hedge fund managers' round table

#### **Regulatory angle**

- 62 **Basel III reform**  
Implications and opportunities for asset management
- 68 **Solvency II challenges related to asset management**
- 72 **FIN 48 – One year on**  
What have we learnt?
- 76 **The FATCA effect**
- 79 **Hot off the press**
- 79 **To be covered in our next edition**



Dear investment management professionals,

First, let us wish you all the best for the new year. As this edition goes to press, our digest on the investment management industry is blowing out its first candle: we are celebrating our first full year in print. What was initiated as a digest of valuable output solely from Deloitte's Luxembourg investment management practice has become a dynamic and global digest covering a host of new topics and major changes in the investment management world around the globe. On this first anniversary, we thought it appropriate to have this foreword come from the investment management leaders of Deloitte's U.S. and EMEA region practices, and to share brief thoughts on macro trends that will impact the industry in 2011.

On the U.S. front, investment funds continue to attract inflows as investor confidence increases amid signs of economic stabilisation. In addition, private equity deal flow is improving due to a rebounding debt market, and this trend is likely to continue. Although macro-economic concerns remain, analysts expect inflows into hedge funds, mutual funds, and exchange traded funds to increase in 2011, driven by increased allocations from institutional investors and a preference for lower risk. Asset managers will also continue to bolster their infrastructures to address the significant regulatory reforms that are expected in 2011 and beyond.

In the European region, investment funds are recovering from a downtrend, and positive inflows were recorded towards the end of 2010. While concerns about sovereign credit risk remain in some corners, the macro-economic environment is generally stabilising and inflation remains broadly under control. And with the addition of a quite stimulating interest rate environment and a decrease in volatility, we have observed a slowly but surely growing appetite to reinvest in higher risk profiled assets, a trend expected to continue in 2011. The forthcoming implementation of the UCITS IV Directive, the vote of the AIFMD, and the creation of three European supervisory authorities and a European Systemic Risk Board will lead to a new supervisory framework requiring significant adaptation from market stakeholders.

These perspectives and developments for 2011 and beyond call for prudence, but at the same time represent drivers for growth and the building of a globally strong and transparent investment management industry.

**Vincent Gouverneur**

Partner - EMEA Investment Management Leader

**Cary Stier**

Partner - U.S. 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.*

# Editorial

One year has passed since we released our first edition of the *Performance* magazine, Deloitte's investment management digest from experts to experts. Looking back at the three first editions of our publication, we can say that we are outstandingly happy about the evolution our publication has been subject to.

The first edition was released in December 2009 and essentially concentrated on the Luxembourg investment management industry. The warm feedback we received from our peer practitioners, clients and industry specialists reassured us that we were heading towards the right direction in our aim to build a forum for the business area we focus our energy on.

The second edition took us a step further by extending the geographical area of our contributors to an EMEA level. We were not only proud of having overcome the uncertainty surrounding the inception of this project, but also flattered to notice that we have been able to offer our colleagues of the Deloitte network a platform enabling them to share their views and thoughts on major topics that are shaping our days.

Right now, we stand at the second year and fourth edition of our paper and are delighted to welcome our colleagues from the U.S. and APAC as forthcoming regular contributors in *Performance*. What would be a better subject than FATCA to hand the stage to our U.S. professionals in order to highlight even more how global our firm is able to act? From the APAC side, this edition contains an outstanding trend report on private equity in China.

Cary Stier, U.S. Investment Management Leader, and Vincent Gouverneur, EMEA Investment Management Leader and initiator of this publication are co-signing the foreword of the magazine and are willing to demonstrate that we can join efforts to open our window of knowledge to the world of asset management and servicing.

What has not changed in our editorial objective is the will to carry on producing a paper up-to-the-minute of the most important topics influencing the evolution of our area of activity. We would like to encourage you, in your capacity of professional and experienced actor of the sector, to contribute to our release and further open our horizon and perspectives on the market.

We are dedicated to provide you with information on how you can be part of the adventure. Last but not least, thanks to everyone who has actively participated or helped to spread the word on this fourth annual rendezvous, and most important, a major thank to the readers.

Sincerely,

**Simon Ramos**  
Editorialist



**Please contact:**

**Simon Ramos**

Senior Manager - Advisory & Consulting

Deloitte S.A.

560, rue de Neudorf, L-2220 Luxembourg  
Grand Duchy of Luxembourg

Tel: +352 451 452 702, Mobile: +352 621 240 616  
siramos@deloitte.lu, www.deloitte.lu

# Marketing financial products towards increased client protection and harmonisation of practices

**Anne Hyvernaud**  
Senior Manager  
Deloitte France

**Pascal Koenig**  
Partner  
Deloitte France

Beyond the question of regulatory constraints, real challenge lies in reconciling marketing approach and development of new types of products with client protection.

The issues surrounding the marketing of financial products have recently evolved in France as well as in Europe, and is driven by four main factors:

- Regulatory developments
- New risks threatening companies (reputational risk, risk of sanction by the authorities)
- The need to improve client relations
- Increased competition

Whilst different types of companies are still subject to specific regulatory constraints (e.g. investment management companies, insurance companies and banking networks), the new provisions generally tend to increase their responsibilities with respect to client protection and information transparency, and common principles tend to emerge amongst the different industries.

### French example of how regulatory developments aim at increasing client protection

Firstly, with the merger of banking and insurance regulators in France, monitoring procedures are under harmonisation. Merging the authorities responsible for the banking and insurance sectors has indeed involved regulatory convergence for the marketing of financial products. *The Autorité de Contrôle Prudentiel (ACP)*, in cooperation with the *Autorité des Marchés Financiers (AMF)*, is now responsible for ensuring the marketing activities of the banking and financial services are monitored through its new 'common goal'. In particular, this collaboration is intended to bring about the convergence of practices as regards to monitoring the fulfilment of obligations towards the investors and overseeing advertising campaigns for 'financial products' and savings.

Secondly, the obligations and responsibilities of the parties concerned will be clarified via several guideline texts. In many respects, the principles of these texts are based on the 2005 Delmas-Marsalet report. The principles for the marketing of 'insurance products' have been modified by an '*ordonnance*' or 'Order', which particularly stipulates:

- The obligation to prevent misleading advertising
- The obligation to provide advice, through the formalisation of the requirements and needs expressed by the client, and the motives behind the advice provided
- The request for information enabling the client's needs and risk profile to be understood

A series of texts further stipulated the respective responsibilities of producers and distributors. They prescribe the settlement of distribution agreements and the definition of the responsibilities as well as the conditions whereby:

- The distributor must submit promotional documentation to the product producer prior to its distribution to ensure consistency with the producer's own documentation (e.g. insurance contracts, UCITS prospectus)
- Information enabling the assessment of the product characteristics must be provided by the producer to the distributor





Lastly, initiatives at a European level must be anticipated, especially in relation to the UCITS IV Directive, the drafting of KIIs (Key Investor Information documents), and the work related to PRIPs (Packaged Retail Investment Products).

### **Rethinking the marketing process in the light of diverse challenges**

Firstly, in respect of marketing documentation, the challenges for European insurers are considerable. As it has been the case for companies submitted to the MiFID, they will have to improve the documentation of their procedures (drafting, communication to existing and potential clients, and updating client files). From a marketing point of view, this also means that for each product, service and business activity that is offered, information documentation must be drawn up and regularly updated. Other requirements include the creation of a typology of information and associated checks, a standard way of presenting performance as well as standard presentation models.

Some companies saw the constraints of the MiFID as an opportunity, and leveraged on these regulatory constraints to enhance their visibility towards clients thus developing new marketing strategies and strengthening relations with their clients by systematising the information-sharing process, developing or adapting tools.

Organising the relationship between producers and distributors is another area for development which concerns investment services firms as there are in fact loopholes for companies such as platforms or asset-management advisers, who are still not captured by the current regulations, even if CESR have recommended to address this issue through the MiFID revision. Producers will have to be vigilant in their relationship with distributors: the information must enable all the financial characteristics of a product to be assessed, both by the distributor and the client. Producers may be held responsible if advertising materials do not comply with regulatory documentation. On their side, distributors will be responsible to initiate the agreements/SLA and implement procedures to ensure that the documentation has been previously submitted to the product originator. The audit trail for the drafting of the documentation will be of the utmost importance.



---

Whilst the different types of companies are still subject to specific regulatory constraints, the new provisions generally tend to increase their responsibilities with respect to client protection and information transparency and common principles tend to emerge amongst the different industries.

Within banking groups made up of both 'origination' and 'distribution channels' entities, intra-group relations will need to be fostered between subsidiaries to ensure compliance with these requirements. Compliance departments can thus play a fundamental role in defining a coherent, overall system.

These developments will require far-reaching changes involving both the characteristics of the services offered and the methods and practices employed in managing the client relationship, how sales networks and systems are organised. Relations with intermediaries will need to be dealt with from a global perspective by taking full control of the different responsibilities among actors. Companies can use these regulatory challenges to their own advantage in order to realise new opportunities by ensuring client protection forms a central part of their compliance programmes and internal control procedures, as well as their marketing approach.

#### Recent texts in France

- Order No 2010-76 of 21 January 2010 on merging the approval and monitoring authorities of the banking and insurance sectors
- Order No 2008-1271 of 5 December 2008 on establishing codes of conduct and agreements governing the relations between producers and distributors with respect to marketing financial instruments, savings products and life insurance
- Order No 2009-106 of 30 January 2009 on marketing life insurance products and on fund and insurance transactions
- Decree No 2010-40 of 11 January 2010 on agreements between producers and distributors with regard to marketing financial instruments and life insurance products
- Delmas-Marsalet report (November 2005) on marketing financial products
- Report of the advisory mission on monitoring adherence to professional obligations to clients in the financial sector, drawn up by Mr. Bruno Delétré (July 2009)



# The evolving private equity market in China

**Jennifer Qin**  
Partner - Management Leader  
Asia Pacific Investment

Two developments frame CRIC's (Deloitte owned China research centre) commentary this year. In the recent 12 months, China has seen continued expansion and diversification of financial players in the marketplace, with a significant part of the domestic capital flows largely unregulated. The pace of RMB fund (investment funds whose capital commitments and contributions are denominated in China's domestic currency) growth in the first half of 2010 was approximately three times that of 2009, taking many observers by surprise.

---

## Two developments frame CRIC's commentary this year. In the recent 12 months, China has seen continued expansion and diversification of financial players in the marketplace, with a significant part of the domestic capital flows largely unregulated.

Secondly, the window is opening wider for foreign financial investors, both through the opening of some previously restricted sectors and the further liberalisation of sectors already open. Several formal pronouncements have fuelled this discussion, including the April 2010 circular (the Several Opinions of the State Council Concerning Further Improving the Work of Utilising Foreign Investment) from the State Council on improving the use of foreign investment and the 'New 36 Measures' document from the State Council in May 2010 which focused on guiding the healthy development of all private investments. But as new sectors open, the actual opportunities they present remain somewhat unclear, pending formal publication of detailed catalogues and the testing out of regulator behaviour.

From both market and regulatory perspectives, the changes underway may mark an inflection point in China's engagement with the global financial system. The recent developments unfolded against the background of intense debate over the post-crisis and

post-stimulus role of the state and role of markets in China. And externally, international trade and investment-related disputes are heating up.

After the review of RMB funds, developments and issues, 2010 will be remembered as the year that RMB funds found their pace and became the major factor in China's capital landscape. The regulatory framework for foreign-managed RMB funds has taken shape over several years, led by the Pilot Programme of Foreign Capital Participating in RMB Equity Investment, settled in Shanghai and initially launched in Shanghai's Pudong New Area in April 2010. With publication of the long-awaited Administrative Measures on the Establishment of Partnership Enterprises by Foreign Enterprises or Individuals (Partnership Measures), by the State Council, which went into effect on 1 March 2010, the process accelerated. Now, with a number of large municipalities actively competing for RMB funds, new local rules are appearing, differentiating the various opportunities available in cities such as Shanghai Pudong, Beijing, Tianjin, and Chongqing. The yet-to-be explored consistencies and inconsistencies with national partnering, investment, and currency regulations, have made the landscape both confusing and interesting. In the first half of 2010, 32 new private equity funds were set up, 26 of which were RMB-denominated, with US\$4.5 billion worth of capital raised. The 100 plus RMB funds in existence have so far raised US\$9.13 billion in 2010, making up 77% by value of all China-focused private equity funds raised in 2010 to date. Yuan-denominated private equity funds have taken the lead since 2009, with deals worth at least US\$3.6 billion since the beginning of 2009, while non-yuan funds have done US\$2.8 billion in deals.

As of June 2010, 18 funds have been marketed to investors with an aggregated value of RMB85.3 billion (US\$12.5 billion), a 67.9% increase on the 12 funds out in the market at the start of 2010 valued at RMB50.8 billion (US\$7.5 billion), according to data provided by Preqin ([www.preqin.com](http://www.preqin.com), a data research provider for alternative investments).

Foreign funds have encountered regulatory and market challenges in meeting their RMB funding goals. Nonetheless, foreign-run RMB funds have raised a disclosed RMB23.8 billion (US\$3.5 billion) to date.



Of this, RMB15.1 billion (US\$2.22 billion) was raised in 2010. This means 64% of all foreign-managed RMB funds raised to date were raised in the first three quarters of 2010. The pace is clearly accelerating, but challenges remain. There are many different kinds of RMB funds, and those managed by global fund managers are significantly different in many respects from the burgeoning purely domestic funds. The domestic playbook calls for fast action, shorter diligence, simple documentation, and reliability of commitment that is more relationship-based than the legal framework familiar to globally managed RMB funds. Foreign funds are adopting various approaches, with some focusing on a single location and single RMB funds, others on multiple locations with strong local partnerships. In addition to reflecting the very strong growth in the number of new RMB funds and their aggregate capital, the scale of new funds is decreasing, a result of the large numbers of new, domestic players entering the playing field.

### The trust model

A private equity strategy in China cannot be considered comprehensive without at least an understanding of the recently proliferating trust model. Trusts are as old as China's reform itself, dating back to the establishment of China International Trust and Investment Corporation (CITIC) in 1979. After nearly three decades of rather tumultuous ups and downs and regulatory shuffling, China's current trust model was established under the regulatory authority of the Chinese Banking Regulatory Commission (CBRC) in 2007.

Trusts were under intense scrutiny beginning about the time China joined the World Trade Organization (WTO) and intensifying in 2004. The major new regulatory framework implemented in 2007 both tightened regulatory oversight and expanded the activities of trusts, creating a uniquely Chinese financial services player that combines several functions of wealth management, banking, and private equity. After three decades of liberal oversight, the CBRC has recently undertaken a closer look at their performance and risks. The policy interest is clearly focused on improving the professional investment channels for investable corporate assets. In the third quarter of 2007, the CBRC issued regulations explicitly permitting foreign investment in trusts, up to anything under 20%. In that respect, foreign investment in trusts mirrors that in banks, but unlike banks, there is no limit to the total equity that can be owned by multiple foreign investors. Foreign investors are, however, limited to investments in no more than two trusts, and they must certify assets of at least US\$1 billion to participate. The first such foreign investment occurred in 2007, and since 2008 the number has expanded significantly.

In our classification of private equity fund types in China, trusts are most like foreign invested RMB funds, in that they can move quickly without the State Administration of Foreign Exchange (SAFE) process burdens and entrain local investment capital in their projects, either as direct investors in the trust or co-investors with the trust. But in some respects they are more flexible, because they have access to sectors that are open to trusts but may be closed to private equity funds, foreign and domestic. These include several types of financial services and real estate. Trusts can sell financial products, make loans, make direct investments, fund leases, and underwrite securities.

The tangled history of trusts in China invites close regulatory oversight, and there is clearly concern about the relatively liberal market space given to them. Entering the second half of 2010, as China tried to tighten lending to the property development sector, commercial banks have decreased their lending, but trusts have not. In the first half of the year, trusts issued RMB66.7 billion in real estate products, 65% more than that in all of 2009. The CBRC, perceiving the large exposure to a potential real estate downturn, has urged the trusts to undergo stress tests of their real estate exposure. In a more recent regulatory move, the CBRC has scrutinised the securitisation of commercial bank loans, which are being sold to investors through trusts, a practice which potentially moves high risk loans off the banks' balance sheets.

Like RMB funds under management of foreign private equity firms, the direction in which foreign-invested and wholly domestic trusts will develop is as yet unclear. But they are likely to be important channels for cash-rich State-Owned Enterprises (SOEs) in particular, to diversify their asset management, reduce exposure to highly volatile sectors, and improve returns. Serving that function, they are likely to continue to grow in their role, with unavoidable regulatory ups and downs. During the early years of development, they may offer truly unique opportunities for foreign funds to gain access to some of the more attractive yet elusive corners of China's economy. At the same time, the 20% investment ceiling limits the degree of control over the activities of the trust a foreign investor might exercise through legal right, and that invites careful consideration of the relationships among the owning parties.

In China's current business environment, the central and local leadership exerts influence through two major channels. One is obviously through regulation and the implementation of regulation, extending from licensing business scope to setting tax and benefit levels to setting pricing along the supply chain. The other is non-regulatory, with what we call 'opportunity management', through the agency of a number of players working directly or indirectly with public resources to shape the investment and operating environment.

For example, a strategic or financial investor that is state-owned and with access to public funds can impact the transaction price of an enterprise that is targeted by a private equity institute or impact the land transfer price targeted by a private developer in municipal auctions, as has happened recently with startling upside impact.

They might prefer investments to support sectors financially, in what could fairly be called rescue operations, or support pricing in others, in what could fairly be considered protectionist action. In approaching an investment, both foreign and domestic investors should understand the chains of capital in the sector as a whole, as well as the typical diligence issues associated with a specific target.

---

## The tangled history of trusts in China invites close regulatory oversight, and there is clearly concern about the relatively liberal market space given to them.

In that way, the competition can be met, while risks of non-commercial pressures distorting the pricing and post-deal operation of the target can be identified and appropriate provisions made. The diversification of investors in China's booming financial services sector, including an increasing number and variety of private equity and trust investors, could be seen as liberalising in some instances but not in others. Not all players competing as financial investors operate under the same commercial imperatives and toward the same market goals, bringing to financial services in China what has been true for decades for competition in industrial sectors. The expansion of the FDI catalogue, similarly, will have an upside and downside, as the state refines its interests and significantly improves its technical skills in reaching its development goals.

# Why should art be considered as an asset class?

**Adriano Picinati di Torcello**  
Senior Manager  
Deloitte Luxembourg

## Introduction

For three years now, Deloitte organises an annual conference to explore the emergence of art and other collectible assets as new financial asset classes alongside traditional asset classes such as bonds, equities or real estate and gold. This year it took place on 20 and 21 October 2010 in Paris.

The main question that we will try to address briefly in this paper is: Why should we look at art as a new asset class?

The main characteristics usually used to define art markets can be summarised in the following way: high-risk investment, illiquid, opaque, unregulated, high transactions costs, at the mercy of erratic public taste and short-lived trends. Artworks do not generate any cash flows that can be discounted, except to the extent that income can be obtained through lending and incurring expenses in the form of storage, insurance and associated costs. The art markets are also currently virtually 'unhedgeable'. This short description of the art markets might be enough to discourage many to look at it.

However, if we take a closer look at the latest trends which are directly or indirectly affecting the art markets' environment, they suggest the emergence of a financial fine art market where fine art is considered as a new asset class. The simultaneity of those trends creates an environment that in the past has never been very favourable to supporting the materialisation of such a transformation.

While this analysis mainly focuses on paintings, a similar phenomenon is experienced by other groups of collectible assets, such as fine wines, rare watches, precious stones or stamps.

'Paintings' is one of the categories of the fine art markets which includes various subcategories, such as drawing-watercolour, painting, tapestry, prints, posters, sculpture-installation, photography as well as audiovisual and multimedia. The fine art markets are a subset of the arts and antiques market.

The paper is structured around three sections: a set the scene section, an analysis covering some of the factors explaining why art is considered as a new asset class and finally a glance at the market size of this new asset class.





### Set the scene

*Joseph Schumpeter once observed “Queen Elisabeth owned silk stockings. [...] The capitalist achievement does not typically consist in providing more silk stockings for queens but in bringing them within the reach of factory girls in return for steadily decreasing amounts of effort”.<sup>1</sup>*

The fine art markets are viewed by many as a fascinating but worrying world and not so long ago, there was a perception that fine art assets were reserved for the rich and the very rich. However, fine art markets also follow the laws of capitalism, mainly due to two main phenomena: globalisation and research. With the long-termed, worldwide trend of increasing wealth, alongside the growth in knowledge about collectible markets, a much larger community has started to be interested in collecting and/or investing in rare collectible assets.

Those phenomena have created discussions on art as new asset classes to unprecedented proportions, fuelled by an explosion of art prices, especially contemporary art prices, in terms of volume of sales and record prices having been reached. Since 2004 and despite the art markets crisis in

2008, such an environment stimulated the emergence of new types of collective investment vehicles dedicated to art or other collectible assets in different places of the world to a certain level, however limited, not seen before. By applying the securitisation techniques to artwork and with the emergence of art financial products, one could wonder if art could be poised for a similar transformation to what happened to real estate 40 years ago. Real estate is today a widely accepted investment class, accessible to a large community, and is commonly included in portfolios for diversification purposes.

Another important phenomenon to point out is the increasing interest from the financial industry. While a tacit relation between art and finance has been existing for centuries, we can now see a development of art services among financial institutions and small financial boutiques. The offering mainly consists of three categories of art services, each being at a different stage of maturity.

**Art advisory services**, the most common in the financial sector, tend to complement the traditional range of private banking services to provide ‘non-financial lifestyle services’ in order to offer a holistic approach to wealth management.

<sup>1</sup> *The Economist*, 19 September 2009. “Taking flight”. p. 70

Generally, art advisory services include:

- Art research: authenticity – art historical analyses – information on art market – price research
- Art transactions: purchase and sale – representation of interests
- Art management: valuation – insurance – storage – transportation – collection advisory and management
- Structured solutions: inheritance planning – art foundations and trusts - philanthropy
- Art lending: Organise lending portions of private or corporate collections

**Art lending**, not very developed by the financial sector and mainly supported by specialised boutiques, seek to turn art into a working asset. The main services include:

- Term loan: borrow against art
- Acquisition financing
- Revolving lines of credit
- Dealer inventory financing
- Bridging loans, advances and auction guarantees
- Arranging loans to museums and exhibitions

The third category, **art investment services**, is still in its infancy. It finds its source in the growing recognition of art as a new alternative asset class and supports the development of art investment products, the role of art to positively diversify investment portfolios and the integration of art into wealth portfolio analysis. No large bank has successfully entered this space so far. Initiatives mainly come from the academic world and from individuals or groups of individuals that combine a strong expertise in art and finance. Main art investment services are:

- Art investment research
- Portfolio management
- Monitoring and selection of art funds
- Structuring of art investment funds, funds of art funds and art investment clubs
- Art securitisation

Finally, it is interesting to note that today art markets provoke substantial press coverage and are covered by nearly all main financial newspapers such as The Economist, Bloomberg, CNBC, Financial Times, New York Times, Les Echos, and Wall Street Journal.

### Factors explaining why art is considered as a new asset class

In this context let's try to understand why the 'painting category' is considered as a new asset class. To discuss this point, we will briefly address the following questions:

- 1) What are the structuring variables of fine art markets?
- 2) What is the financial performance of fine art markets?
- 3) How to value fine arts?

### What are the structuring variables of the fine art markets?

Looking at the historical evolution of fine art markets, we can observe that fine art markets have been in continuous evolution expanding to new countries and new customers around the world. Today they have reached a truly global dimension in the sense that nearly everywhere on earth people are buying and selling artwork every day and are moving around the world to find the desired item. This also showed that the art market can experience stressed periods, like a bubble period and a crash period.

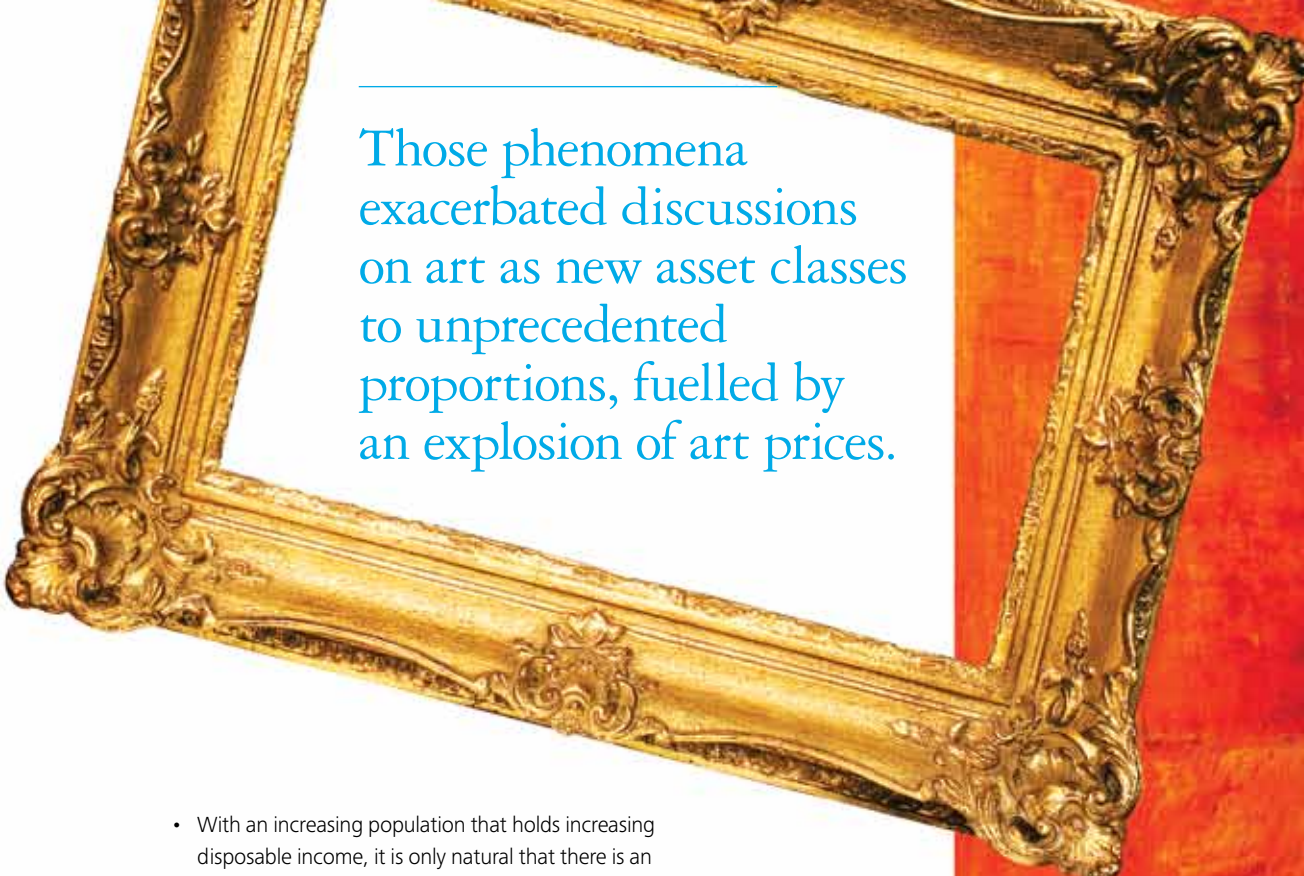
Art markets are global, large and growing. It is estimated that the outstanding value of artwork is in excess of US\$3 trillion with annual sales of the art and antiques market in the range of US\$50 billion in 2009 down from its peak of US\$65 billion in 2007<sup>2</sup>. After the triangulation of data, we estimated that the art markets experienced a compounded annual market growth of 8% for the period 1993-2009.

The conjunction of economic, social and technological factors supports the view of a continuous growth of fine art markets. Some of the key economic macro trends are:

- There is a worldwide increase in prosperity especially in emerging countries. Once a nation grows richer and its citizens reach a certain level of affluence, they start to buy art. This has been the general financial trend since the beginning of the industrial age. China is now third in term of sales of fine arts at auctions after the U.S. and the UK
- Art markets become more transparent due to research in finance and economics as well as data dissemination
- As more and more countries are becoming wealthier, there are more artists and an increased interest in art from a larger community
- The proportion of all luxury spending on art will continue to increase as investors look for assets that would retain their value in the longer term especially in a period of economic uncertainty

<sup>2</sup> The Economist. A special report on the art market p.3. Clare McAndrew, founder of Arts Economics, November 2009.





## Those phenomena exacerbated discussions on art as new asset classes to unprecedented proportions, fuelled by an explosion of art prices.

- With an increasing population that holds increasing disposable income, it is only natural that there is an increase in demand. In 2003, Sotheby's biggest buyers came from 36 countries. Four years later, they were spread over 58 countries and their total number had tripled (The Economist, 2009)
- The supply of best works of art will always be limited and tends to appreciate in value over time. Especially for deceased top-artists as paintings are lost, or bought by museums and collectors
- Art markets are more robust. According to Christie's CEO, Edward Bolman, the reduction of auction sales experienced at the end of 2008 and in 2009 is mainly not due to a reduction of demand but rather a reduction of supply
- Around 80% of the auction transactions are estimated to be below €10,000 which leaves the door open for many more newcomers

Social macro trends will also support the expansion of the art markets. We live in an era strongly characterised by the globalisation of cultural activities, which creates an interest in art to unprecedented levels. All societies seek to reinforce their national and/or individual identities through the acquisition of artwork of their own place and time and new museums will continue to be built: more than 100 museums over the last 25 years. However, in times of cultural spending cuts in old economies, the cultural sector has a growing need of private funding.

Technological evolutions strongly support the positioning of art as a new asset class. It increases transparency as new market opportunities and business models in an internet and digital world emerge, such as online auction houses, online databases, online and real time market data dissemination, online catalogues and fairs, artist websites and new communication channels. More people are discovering that possessing prized paintings, prints, sculptures and valuable collectibles is now within their reach.



Finally, there is a growing recognition of art as an investment asset class by investors. People become more sophisticated in their financial planning and estate planning and they begin to view art as an investment. Some take on a more in-depth and measured approach to portfolio management and are willing to consider diversification strategies that encompass more exotic investment classes, such as art and other collectible assets.

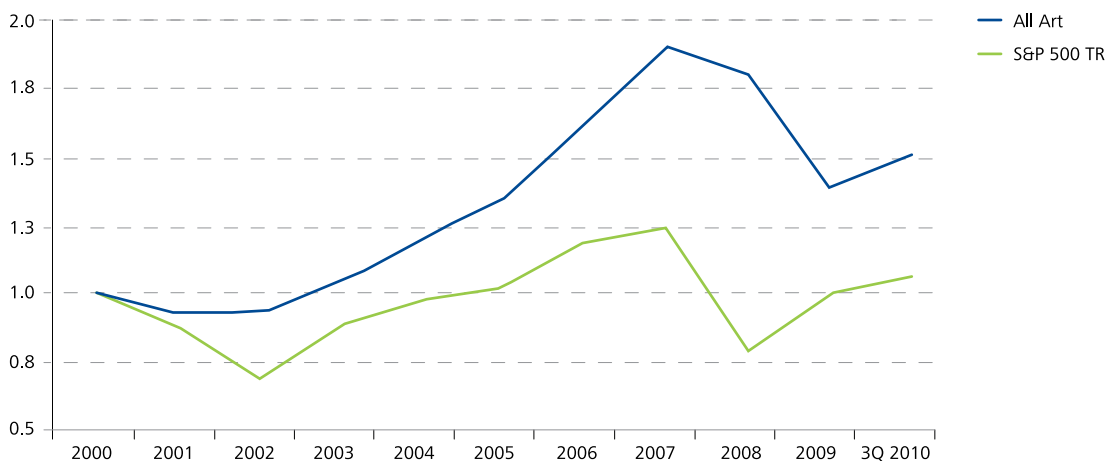
And not the least, the current socio-economic context creates a demand for 'real assets' because many lost a lot of money in the financial crisis by investing in products they did not understand and are turning back to things that are closer to their heart and which at the same time offer protection and a return on investment.

With financial markets still in flux, some High Net Worth Individuals (HNWIs) indicated they are approaching their passion investments as 'investor-collectors', seeking out those items that are perceived to have a tangible long-term value. The two categories that are the most attractive to these 'investor-collectors' are art and other collectibles (coins, antiques, wines, etc.) (World Wealth Report 2010).

#### **What is the financial performance of the fine art market?**

Performance analyses of the art markets have been conducted for more than 30 years. A study carried out by Wolfgang Wilke from Dresdner Bank in 2000 explained that the long-term trend in inflation adjusted for art prices follows the general economic trend, i.e. art prices rise above average compared to the prices of other goods. However, most segments of the art markets react quickly and lead to a worsening of the economic environment. This is especially true for objects in the lower price category, with broad markets. An economic slowdown leads at least to a drop in demand and an increase in supply due to, *inter alia*, forced selling. This, however, does not (or only rarely) apply to all artwork in the top price category, since wealthy individuals have a substantial purchasing power even in bad economic times. Thus, the distribution of income and wealth plays a key role in assessing the price sensitivity of the individual sectors of the art market.

Mei Moses® Annual Art Index and S&P 500 Total Return Index (2000-2010) updated Q3 2010©



Several researchers and private companies have begun to periodically publish art indices to track the movements of the fine art markets. The results of their analysis look extremely valuable, in particular if we consider the impact on transparency, provided that the methodology used is sound. Art is a heterogeneous asset that requires a methodology that does not compare apples with oranges. Currently 32 indices are accessible on Bloomberg using the ticker all ArtQart index.

The historical performance monitored by these professional indices tends to demonstrate that paintings generate moderate positive real returns that have a low correlation with the return on stocks and treasury bonds, which may give it a place in a well-diversified portfolio of financial assets, but only at the margin 5% to 10% of total assets (Artvest 2010) (Barclays Equity Guilt Study 2005).

Jianping Mei's and Michael Moses' 2010 mid October tracking report for the Mei Moses® family of fine art indices®, illustrates that the most recent ten year compound annual returns for art, 4.15% exceeded the returns of stocks, 0.5%.

Stocks outperformed art over the last 25 years with a CAR of 9.01% compared to 6.11% for the All Art Index. However, for the last 50 years the returns were very close with art achieving a CAR of 9.06% compared to the 9.56% for equities.

The risk associated with the Mei Moses® All Art Index is less than the risk of the S&P 500 total return index, 13.8% vs. 20.0% respectively, over the last ten years and 17.3% vs. 18.3% respectively over the last 25 years. The risk for the equity index over the last 50 years, 17.2% is slightly better than the art index 17.8%.

The very low correlation factors are negative 0.035, positive 0.102 and 0.135 between the All Art Index and stock indices for the last 50, 25 and 10 years respectively and its negative and small correlation with bonds for the same time periods indicates that art may play a positive role in portfolio diversification in normal market conditions. In case of a major crisis, all assets move in the same direction.

According to a recent academic study (Luc Renneboog, Christophe Spaenjers, 2009) based on data from over 1.2 million auction house sales of paintings, drawings and prints real returns in US\$ term were 4% per annum from 1951 to 2007. Real returns from 2002-2007 have been 11.6%; higher over the longer term than bonds, but less than stocks which also demonstrate that art is a storage of value and a hedge against inflation which could meet investors' needs provided that an art tradable index would be available.

Professor Rachel Campbell from Maastricht University, who performs a lot of research on the subject, also came up with similar results and is setting up the International Institute of Art Finance and a set of European art indices using the same methodology as professors Mei and Moses.

These indices should be understood as only an indication of the painting category movement as they do not capture all the auction house information and any of the dealers or private treaty sales prices. Also there are not tradable and do not include the costs of buying and selling art that can be large.

Also very important to note is that the painting category is composed of several sectors that do not react in the same way. For example the old masters sector does not have the same return/risk profile as the contemporary sector. The most liquid and globally tradable sectors will most likely outperform.

- Higher transaction costs should be expected with fine art investments, especially at the high end of the market which makes art a difficult asset for short term trading
- The risks of fraud and/or forgery exist

However, as the functioning of fine art markets is complex, it allows those with great inside knowledge to make substantial benefits. Therefore, it is not surprising to notice that the few art investment funds set up so far are generally set up by individuals who spent a significant amount of time in the art markets and are able to negotiate key agreements to lower transaction costs.

Under these conditions, it is most likely that they could deliver announced targeted annual return by profiting from market inefficiencies in order to buy and sell advantageously, by finding interesting opportunities when objects are sold in the event of death, discretion, debt or divorce and by anticipating trends, with substantially less transaction costs.

Finally, besides a potential increase in value, art provides additional financial benefits:

- Art provides a hedge against inflation and currency devaluation
- There is little risk of losing your principal if you purchase wisely
- No minimum investment is required
- Art investments enjoy favourable tax treatment
- Reduction of risk because of its low correlation with other financial assets
- Possibility of earning extra revenue by lending out the work or of participating in events, such as exhibitions and meetings of experts
- Art has no geographical risk and can be moved easily
- Art can be insured against calamity risk

---

## There is a growing recognition of art as an investment asset class by investors. People become more sophisticated in their financial planning and estate planning and they begin to view art as an investment.

If art offers a real positive return on top of the aesthetic return, as an investment it is important to keep in mind that it also has some drawbacks such as:

- Art is a heterogeneous product as artwork are unique
- There is little chance for quick profits for not informed investors
- Art markets are unregulated
- No dividends or interest payments are made to the investor but it is also the case for other asset classes such as gold or oil
- Art is not highly liquid but neither are other asset classes, such as private equity
- Substantially more time needs to be spent to acquire specialised knowledge to be successful with fine art investments than with traditional financial investments

### How to value fine art?

Valuation is one of the most critical points when offering investment products investing in works of art. How can investors trust the performance announced when there is no transparent art pricing mechanism commonly accepted?

In finance, the price of a financial asset is determined by the market, an index and some specific factors. However, today there is no standardised art valuation methodology and there is no guarantee that the fair price of a work of art is the result of an independent quantitative analysis.

The fair price of a work of art is usually the result of a qualitative analysis provided by expert appraisers using relative valuation, i.e. by looking at how similar assets are priced in the market and at a combination of qualitative aspects of the work of art, the scarcity of supply relative to demand, consumption utility and individual perceptions.

To resolve such impediments, a suggestion made by Professor Moses is to define a methodology that combines a qualitative and quantitative approach. This methodology combines the expert appraiser's valuation to cover the emotional part embedded in the art price, the auction house appraisal to have a sense of the market and to mark to market the work of art using an index. Mei and Moses research indicates that the single strongest independent explanatory variable of the future price at auction of a work of art is the prior sale price inflated by an appropriate art market index. Their research indicates that art indices can explain 80% of the variability of the price and if you add the hedonic variables you can explain up to 88% of the variability of the price.

It is important that art markets structure themselves by recognising an index, such as the S&P/Case-Shiller home price indices created 20 years ago, and a commonly accepted transparent valuation methodology. As the research on indices progresses and more compelling databases are developed, it is quite likely that soon a family of indices will be used as recognised benchmarks which will ease and increase the use of art as an asset class.

### A view of the market size of this new asset class

**Direct investment in this market is substantial and is creating opportunities for indirect investment provided that financial instruments as well as advice exist**

What is the value of art held by private individuals? To our knowledge, a true answer does not exist. However some have tried an educated guess.

Baird asset management (2009) defined three types of collectible buyers, the pure collectors, collector/investors and investors for whom buying collectible assets is a pure financial game. In their report, they assume that the last two categories own 1/3 of the total collectibles valued around US\$4.3 trillion. This estimation of direct investment into collectibles puts the value of collectibles viewed as financial assets on par with the US\$1.9 trillion invested in hedge funds and the US\$2.5 trillion invested in private equity funds.



Using the first Artvest Newsletter (2010) and the World Wealth Report 2010 one can compute that Ultra High Net Worth Individuals (UHNWIs) and High Net Worth Individuals (HNWIs) should have art holdings in the range of US\$2.8 trillion. The total wealth of UHNWIs and HNWIs was estimated to be US\$39 trillion in 2009, passion investments are estimated to comprise approximately 33% of HNWIs' and UHNWIs' overall holdings and in 2009 art holdings represented 22% of HNWIs' passion investment.

Taking a wealth driven approach and assuming that HNWIs have allocated 5% of their wealth to art and UHNWIs have allocated 10-15% to art, you end up with a market size of around US\$1.5 trillion held by private individuals.

So currently, HNWIs and UHNWIs may have a direct exposure to art in the range of US\$1 to 3 trillion that are barely served by financial institutions.

**Current offering of investment products investing in collectible assets is very limited**

Currently the only way to buy an indirect exposure on art is by investing in one of the few art investment funds existing or in the few companies involved in art markets, such as Artprice S.A., Sotheby's Holding Inc. or Artnet AG, traded on a stock exchange. This is a very young 'industry' in a pioneering stage which still needs to convince private and institutional investors of its place in the asset management world.

The 20<sup>th</sup> century has been marked by very few successful cases. The first one was probably in 1904 when André Level, a French financier, set up the art investment fund called La Peau de l'Ours ("the skin of the bear") which after ten years, quadrupled the initial investments of the partners. Another example is the British Rail Pension Fund which realised an overall return of 11.3% per annum during the period 1974 to 1989.

Over the last 20 years, a number of attempts (Finacor Fund, the Athena Fund marketed by Merrill Lynch, Chase Art Fund, Fernwood Art Fund, the ABN AMRO Art Fund, Falk Art Management, Christie's Art Fund, Meridian Art Fund, SGAM Art Fund, etc.) failed to take off mainly because of the difficulties to raise enough capital.

As of today, there are most likely not more than 20 existing art investment funds in the world and only one with a six year track record: the Fine Art Fund I. In terms of returns as of September 2010, the Fine Art Fund Group claims a gross internal rate of return per annum for realised assets for The Fine Art Fund I of 27.4%. The Art Photography Fund has nearly three years of existence, with only one negative month and so far has achieved an annualised performance of 8.92%. Other successful collectible funds exist, such as the Elite Advisers Wine Fund, with also three years of existence, two negative months and an annualised performance of 12.8%. Elite Advisers recently launched a fund dedicated to rare watches.

Adding the investment funds investing in other collectibles, such as wines, diamonds, musical instruments, jewellery, we estimate that the offering of public collectible investment funds is very limited. Most likely their number is inferior to 100 worldwide, with a market capitalisation that should be below US\$1 billion.

As some HNWIs and UHNWIs view art as a pure financial investment and with the growing interest, there should be space for more investment products that offer an indirect exposure to art and other collectibles assets.

Hence art funds and other art structured products have to meet investor expectations by offering proper guarantees, transparency and measures to overcome the trauma caused by the Lehman Brothers and Madoff cases. They need to demonstrate that they have sound organisational structures, both from organisational and legal perspectives. They need to be transparent, explain how they deal with liquidity and performance calculation, adopt a mark to market valuation methodology, and have a track record and a critical mass to gain institutional support.





## Conclusion

Beside the aesthetic return generated by art, there are good reasons to consider art as a new asset class. Art is attractive from a financial investment point of view over the long run as it is a store of value that generates moderate positive real return. Art has also a low correlation with stocks and bonds which offer diversification possibilities over time and across the business cycle.

Art and collectible assets represent sizable assets for many HNWI currently barely served by financial institutions. There is an opportunity for private banks and family offices to integrate the concept of collectible assets into the overall asset allocation strategy to assure adequate liquidity, avoid over-exposure to risk, minimise income taxes and organise appropriate transmission to heirs or donation to charity.

Also the gap between the estimated amount invested directly by collectors/investors in art and the existing offering of art financial products is impressive. Most likely we will see more new financial products offering opportunities to invest in this asset class and services to support customers such as advisory, legal, tax, wealth structuring and insurance.

Finally external forces, such as globalisation, knowledge sharing, democratisation, increased cultural interest or new communication channels, support the growth of the fine art markets, transform it and push for its 'financialisation'. This environment provides room for innovation. New business opportunities are created and some players have already embraced them. Several new different initiatives search to securitise several billion of US\$ of artwork, such as art investment funds, tradable art structured products or dedicated art trading exchanges. Provided that they are successful, they will substantially increase the market size of art available for indirect investment by monetising a percentage of the outstanding volume.

Moreover, when dealing with tangible assets, developing these financial activities will have ripple effects on other sectors of the economy. This evolution should create a new era for the art markets and for the benefit of the society as a whole by fostering culture, knowledge and creativity.

The story is not finished yet and at Deloitte we are committed to monitor this evolution and supporting its development. Meet us at our next conference in 2011. Details will be available soon at [www.deloitte-artandfinance.com](http://www.deloitte-artandfinance.com).



# Indian Direct Tax Code

## A mixed bag

**Vipul Jhaveri**  
Partner  
Deloitte India

The existing Indian Income Tax Act, 1961 (the Act) has been subject to numerous amendments since its passage five decades ago, with the result that the average taxpayer was finding it difficult to decipher the Act. The Indian Government therefore decided to revise, consolidate and simplify the language and structure of the direct tax laws. Towards this end, a draft Direct Tax Code (DTC) was introduced in August 2009. The same has undergone two rounds of amendments based on the feedback received from various stakeholders. On 30 August 2010, the Government of India placed the revised version of the DTC before the Parliament.

The DTC is scheduled to come into effect on 1 April 2012. While DTC is a step in the right direction and to an extent simplifies the tax provisions, it has also upped the ante by targeting transactions structured on the back of aggressive tax-treaty shopping and lacking appropriate substance, transactions involving non-resident entities where underlying Indian assets are involved, etc. The following paragraphs cover the relevant provisions for overseas funds investing in India.

### Residency test

Determination of the residency status for an overseas entity is critical, considering that the scope and coverage of income taxable in India depends upon this. Generally, an overseas entity would not wish to be categorised as resident for Indian income tax purposes, since in such a case, its worldwide income would be subject to taxation in India.

Under the existing provisions in the Act, a foreign corporate is treated as a resident in India if the control and management of its affairs is situated wholly in India. On the other hand, a foreign non-corporate is treated as a resident in India if the control and management of its affairs is situated wholly or partly in India.

Under the DTC, the residency test for a foreign company has been altered. A foreign company would now be treated as a resident in India if its place of effective management is in India **at any time** during the year. Place of effective management has been defined to mean:

- The place where the board of directors of the company or its executive directors make their decisions
- In a case where the board of directors routinely approve the commercial and strategic decisions made by the executive directors or officers of the company, the place where such executive directors or officers of the company perform the functions





The expression 'at any time' may potentially create issues where, for example, a single board meeting of a multinational company is held in India. Tax authorities could possibly argue that since the place of effective management during that period was in India, the overseas entity would be a resident for Indian income tax purposes. Ideally, the provisions should be made watertight in order that occurrences such as the one outlined above would not be included within its ambit.

### Capital gains

Capital gains earned by overseas investors on the sale of shares of unlisted companies would be taxable at the rate of 30%, irrespective of the period of holding. However, shares which are transferred after one year from the end of the financial year in which they are acquired would be eligible for indexation (to provide for inflation, etc.) benefits for the purpose of computing the cost of acquisition. In India, the financial year runs from April to March.

The capital gains regime on transfer of listed equity shares and units of equity-oriented mutual funds remains unchanged. The gains earned on transfer of such securities on which Securities Transaction Tax has been paid will effectively not suffer any tax liability where the securities are held for more than one year. On the other hand, where the securities are held for one year or less from the date of acquisition, the gains would be effectively taxed at the rate of 15% on the gains so earned. The retention of the existing regime is a positive development for the capital markets.

### General Anti-Avoidance Rules (GAAR) and treaty override

A key provision in the DTC is the introduction of General Anti-Avoidance Rules (GAAR). GAAR aims to curb sophisticated forms of tax structuring arrangements. The GAAR provisions are applicable to all investor classes which include foreign as well as domestic taxpayers and effectively provide sweeping powers to the tax authorities. The tax authorities can treat a particular arrangement as an 'impermissible avoidance agreement' provided that it has been entered into with the objective of obtaining tax benefit and satisfies any one of the following conditions:

- It is not at 'arm's length'
- Results in the misuse or abuse of provisions of the DTC
- Lacks commercial substance
- Carried out in a manner not normally employed for *bona fide* purposes

The tax authorities, in such arrangements, have the power to disregard, combine, reallocate or recharacterise the particular transaction (in part or as a whole), including the rights/obligations arising therefrom or the instruments used therein. Also, the tax-treaty benefits can be denied in such cases. These provisions would be applicable as per the guidelines to be framed by the competent authorities in this regard. These are awaited and will be issued in due course.

Considering the prevailing environment where the tax authorities are aggressively seeking to tax certain high profile cross-border transactions (having Indian underlying assets) between non-resident entities, the GAAR provisions are likely to empower them even more. Sustainability of tax-treaty protection with Mauritius, Cyprus, etc. can prove to be a challenge in the absence of appropriate substance/commercial rationale. The (awaited) guidelines should clearly lay down more specific parameters/conditions where the tax authorities can invoke such provisions. Without these, the GAAR provisions have all the makings of resulting in increased tax litigation and, more importantly, uncertainty in the eventual outcome for overseas investors. One hopes that in practice, the provisions will be applied judiciously.

The issue becomes even more critical considering that the DTC also provides that in a situation where GAAR provisions are applicable, any beneficial provisions under the respective tax treaties would not be available to the taxpayer. This is a significant departure from the established existing principle that a taxpayer in all situations can avail himself of the beneficial provisions between the tax treaty and the domestic tax law.

### **Transfer of assets by non-residents: a paradigm shift**

Another provision of interest is the proposed taxation of transactions between non-resident entities which fulfil the specified criteria at any point during the twelve months preceding the transfer. Any income earned from the sale of shares in a foreign company by one non-resident to another will be taxed in India if the fair market value of the assets owned (directly or indirectly) by such a company in India is 50% or more of the fair market value of the total assets owned by it.

The provision has been inserted to tax transactions in India similar to the Vodafone transaction. This case involved a multi-billion dollar acquisition of Hutchison-Essar India by Vodafone. Hutchison Hong Kong, through an indirect transfer of a complex holding structure comprising entities situated in various jurisdictions, transferred its holdings in Hutchison-Essar India to Vodafone. Although the transfer of shares was between two non-resident entities, the Indian tax authorities alleged that through these transactions, a controlling stake in an Indian entity was transferred. The matter is now pending before the Supreme Court in India.

The amendment is a game-changer and empowers the tax authorities to make the transfer of companies having significant underlying Indian assets liable to taxation although the transaction in effect involves the sale of shares of an overseas company by one non-resident to another. Although the taxpayer can still resort to the provisions of the respective tax treaty and seek to avoid taxation through these rules, the provisions add an altogether new dimension to taxation of overseas investors. It also clearly reflects that India has heightened its scrutiny of offshore transactions where underlying Indian assets are involved.



### Taxation of Foreign Institutional Investors (FIIs)

FIIs are registered with the Securities Exchange Board of India and generally invest in securities listed on the stock exchanges in India.

#### Gains on transfer of investments

Under the existing provisions, most FIIs offer gains on sale of shares as capital gains.

In so far as income on derivatives is concerned, the position adopted is not uniform. While certain FIIs offer these gains as 'capital gains', there are others which offer these as 'business income'. FIIs falling in the latter category from jurisdictions such as the United States, the United Kingdom, etc., have not submitted such income for taxation in the absence of a permanent establishment in India.

In a significant change, DTC now provides that any security held by the FIIs would be investment asset only, thus giving rise to capital gains or loss (and not business income). This is not a positive development for the above-mentioned category of FIIs which have been offering income from derivatives as 'business income' and taking shelter on the grounds that they do not constitute a permanent establishment in India. Such FIIs would now have to offer the gains on derivatives as 'capital gains'. Further, since the respective tax treaties do not have a favourable Capital Gains Article, the gains earned on such derivatives would be subject to taxation in India.

However, on the positive side, since the profits arising on transfer of securities should be capital gains, the question of whether the brokers, custodians, fund managers, etc. in India constitute a permanent establishment in India should now not be relevant.

Tax rates on capital gains would be the same as mentioned earlier for other investors.

#### Dividend income

Dividends earned on shares and income from units of equity-oriented mutual funds (as defined) would be exempt from tax. This is because the distributing company/mutual fund would have paid distribution tax on the dividends so declared/paid.

#### Interest income

Interest (including interest on debentures/debt securities, etc.) income earned by the FIIs would be taxed at the rate of 20%. Interest stripping provisions are specified in the Code whereby interest stripped by sale and buyback are to be included in the income of the seller and the loss arising from such transaction for the buyer should be ignored. Further, the broken period income (as defined) shall be calculated as if the income from such securities had accrued from day-to-day and been apportioned accordingly for the broken period.

Presently, in the case of FIIs, based on judicial precedent, the broken period interest on purchase and sale of securities is considered as cost of acquisition or sale consideration respectively as the debt securities are held as investments. The profit and loss on transfer of securities are considered as capital gains/loss. Further interest income is taken only on coupon dates and interest accrued, but not due, is not offered for taxation.

With the introduction of the above provision in the Code, taxation of debt securities will now need to be examined.

#### Conclusion

For the investor fraternity, the DTC would come as a mixed bag. The continuation of the existing tax regime for investments in listed shares certainly augurs well for the capital markets. However, the introduction of GAAR provisions, taxation of transfer between non-resident entities, and the obligation to treat gains earned by FIIs on derivatives solely as capital gains are some of the provisions that could possibly lead to challenges in the times to come.

# PRIPs and the retail consumer

## A new chapter in cross-border distribution of retail investment products

**Philip Warland**  
Head of Public Policy  
Fidelity Investment Managers

**Rohan Malhotra**  
Public Policy Manager  
Fidelity Investment Managers

The European Commission is expected to bring forward legislation in 2011 to address deficiencies in the distribution of retail investment products after four years of deliberation.

### **Opening a new chapter in cross-border distribution of retail investment products**

The European Commission's services (DG Internal Market and DG Health and Consumer Protection) have identified deficiencies in the areas of advice and pre-contractual information inhibiting consumers and, at the point of sale, leading consumers to purchase unsuitable retail investment products. This situation is intolerable since it results in poor investor outcomes and a lack of trust and confidence in the financial services industry, reinforcing a vicious spiral of discontent and disengagement. Within the broader context of Europe's changing demographic

profile and fiscal constraints member state governments must ask their citizens to take more responsibility for their own retirement planning.

Since this work stream was initiated in 2007 by former Commissioner McCreevy it has been the subject of a Commission communication in April 2009 (*'Communication on Packaged Retail Investment Products'*) and an update presented in December 2009 (*'Update on Commission Work on Packaged Retail Investment Products'*). The roadmap for financial reform published by Commissioner Barnier confirms his intention to proceed with this initiative via legislative proposals in 2011.



### What is 'Packaged Retail Investment Products' (PRIPs)?

Today, retail consumers looking to save for the medium/long term are faced with a plethora of competing products including the following:

- Investment funds (UCITS)
- Unit-linked insurance products
- Structured securities
- Structured deposits

If we look at these products from the perspective of the retail investor we see that they all offer a similar economic proposition, namely the possibility of capital accumulation in exchange for exposure to investment risk. We are firmly of the view that the scope of the PRIPs project should be defined from this core economic perspective, irrespective of the legal form in which the product is packaged. Adopting any other approach will not be in the best interests of consumers and will only encourage regulatory arbitrage between competing products.

Standing in the way of this rational treatment of consumers are the structure of the industry and, more importantly, the structure of the regulators. Whilst it makes eminent sense for the prudential regulation of an insurance company to differ from that of a bank or asset manager, it makes no sense whatsoever for the way products are described and sold to vary depending on the provider or regulator if they have a similar economic outcome for the consumer. There is, in short, no case in the future for there to be separate texts for the distribution of similar investment products.

Today, however, all these groups of products are subject to differing sets of European conduct of business regulations which lack consistency. This means that the investor is unable to compare competing offerings for their performance, risks and charges and is at risk of purchasing inappropriate products. Differing or non-existent point of sale regulations can mean that the consumer can be exposed to very different sales processes and is at risk of being sold inappropriate products as a result of remuneration structures that encourage commission biases. We believe the PRIPs initiative should be judged against the criteria of promoting simplicity, transparency, choice and value. We explore these criteria in more detail below.

### The first pillar: pre-contractual information

The purpose of pre-contractual information is to inform the consumer about the key features of the investment product, notably the investment objectives, investment performance, investment risks and investment charges. And yet, consumer testing by the European Commission has demonstrated that all too often consumers are provided with incomprehensible, insufficient and misleading information, as well as information about different products which is presented in different ways, making it impossible to compare competing offerings. The use of complex financial jargon needs to be avoided. Complexity of language coupled with low levels of financial knowledge means that, all too often, consumers are left none the wiser after reading through financial literature. The promotion of simple language which is free of technical terminology will be a key test of the success of the PRIPs initiative.

---

Complexity of language coupled with low levels of financial knowledge means that, all too often, consumers are left none the wiser after reading through financial literature. The promotion of simple language which is free of technical terminology will be a key test of the success of the PRIPs initiative.

In addition, the volume of retail disclosure is a barrier to engagement. Policy solutions that favour the slimming down of pages of disclosure can save time and enable consumers to focus on what is important in making an informed choice. Another important consideration is the timing of retail disclosure. Provision of retail disclosures just at the time of making a financial decision can reduce their effectiveness; disclosures need to be made very early on.

This lack of simplicity puts barriers in the way of the cross-border purchase of financial products. The Commission has begun addressing the specific case of UCITS funds through the replacement of the simplified prospectus by a Key Investor Information document (KII) with effect from July 2011. Under the PRIPs banner, the Commission intends to use the KII as a benchmark for a new standardised disclosure document for all packaged retail investment products, thereby eliminating gaps and inconsistencies in European disclosure regulations. This will mean, for example, that consumers will be in a position to compare a mutual fund with a structured term deposit. Of course some tailoring to the specificities of the product will be necessary, but the aim is to achieve, as far as possible, standardised disclosures. This will go some way to empowering consumers.

#### The second pillar: sales processes

Because of generally low levels of financial knowledge and lack of familiarity in dealing with financial products, consumers look for advice from friends and family to help them navigate the options available to them.

Research carried out by Fidelity earlier this year suggested that investors would like to be independent, but found the documentation and products so complex that, almost reluctantly, they turned to an adviser who is, in many cases, a salesman.

They recognised this, with many saying they did not believe the adviser was working in their best interest. Thus, advice was a distressed purchase. This evidence chimes with that of the Commission.



In its report on the Consumer Markets Scoreboard for retail financial services the European Commission remarked:

*"The problems of reliability of advice and the inbuilt conflict of interest faced by advisers due to remuneration systems that can bias them towards selling particular financial products are clearly matters which deserve further attention. There is growing evidence that consumers often do not obtain suitable advice on financial services. The financial crisis further drew attention to deficiencies in the advice given to consumers at point of sale, leading people to purchase inappropriate products. Furthermore, bank employees or intermediaries may often be faced with inherent conflicts of interest. One of the causes of such conflicts of interest may be remuneration structures which are driven by the profit of the financial services provider rather than by the suitability of a product for the consumer."*

They continued:

*"In a Eurobarometer survey, 79% of European citizens thought that it would be useful if all financial services providers used a standardised information sheet."*

Further:

*"There is growing evidence that consumers often do not obtain suitable advice on financial services. In Germany, consumers terminate 50-80% of all long-term investments prematurely because of inadequate advice when buying the products. This leads to estimated damages for consumers of €20-30 billion every year. In one survey, where 25 German bank advisers were approached in a mystery shopping exercise, 24 of these provided unsuitable advice."*

And:

*"Furthermore, bank employees or intermediaries may often face an inherent conflict between their interests and the interests of their clients, given remuneration structures which create so-called 'commission biases'. A study on the impact of these conflicts for direct marketing agents reveals that firms gradually become more lax in relation to the promotion and selling of unsuitable products. The results of a survey on (inter alia) retail investment products revealed that 72% of the investment professionals surveyed consider the fee structures rather than the suitability of investment products for customers as the main driver for sales."*

The head of the French regulator's Ombudsman service has said:

*"There are cases when we have seen products sold that are not suited to the risk profile of the investor. The salesman has pushed the product because of his or her own interest [...] mis-selling was certainly behind the recent sale of 12-year subordinated notes to octogenarians [...] there was a risk of exiting the fund that was not fully explained."*

The investor may also turn to financial advisers who may or may not be independent. The lack of transparency over the status of the adviser needs to be repaired – consumers should be informed from the outset whether the adviser represents their interests or the interests of the provider/intermediary and whether the adviser is working on a wide or narrow set of options. The promotion of a transparency agenda will be a key test of the success of the PRIIPs initiative.



EFAMA recently put it well:

*"A crucial requirement is that the information is provided proactively, in an understandable format and early in the sales/advisory process. In this respect, the customer needs to know the nature of the advice he or she is receiving.*

*In particular, the following information should be disclosed:*

***The distributor's duties to the client***, including general duties under MiFID. In particular the adviser should make clear at the outset of the provision of advice whether she/he is acting independently and will be remunerated solely by the client, or whether she/he will receive remuneration from a product provider or distributor.

***The range of investment product categories*** on which the distributor advises, e.g. mutual funds, investment products within life insurance policies, etc.

***The number and names of product providers*** on which the distributor advises, identifying any product providers with whom the distributor has a potential affiliation.

***The basic principles of the fee arrangements*** that the distributor has with different product providers and distributors for different product categories together with a table of comparable commissions/revenues payable on related, competing PRIPs.

***The basic criteria and process for selecting products*** on the distributor's shelf. Restoring the balance between investors and the distributor helps the former better compare the offering of different distribution channels, with the understanding that clients are not necessarily best served by incurring the lowest possible cost, but rather by finding the right product combination that meets their investment goals. It ultimately increases competition for products that best serve investors' needs. Effective implementation would also lead to more competition between distribution channels for the most client-centric distribution model."

Consumers also have a right to expect their adviser to be professionally qualified. This requires a step change in the training and continuous professional development of financial advisers. Selling a financial product is not akin to selling other retail products because of the market risk inherent in the product. Professionalising the retail adviser market throughout the EU will bolster the reputation of the financial services industry and give retail consumers trust and confidence in their adviser. This requires a marked increase in the training of customer-facing advisers so that they are equipped with the skills to fully understand the range of available products in the market and to professionally advise consumers on their relative merits and risks. The promotion of a choice agenda will be a key test of the success of the PRIPs initiative.

The European Commission's MiFID legislation seeks to regulate conflicts of interest and inducements. However, it only goes so far. Whole swathes of investment products currently sit outside the remit of the MiFID legislation. The current revision of the MiFID Directive and the IMD, together with the PRIPs workstream, provides the Commission with a unique opportunity to propose a comprehensive regulation covering the sale of all packaged retail investment products, irrespective of legal form.



# WHERE NEXT?

The European Commission is currently reflecting on the best way forward before proposing the legislation on PRIIPs in 2011. It needs to avoid the trap of simply going through the motions and updating the patchwork of regulations currently in force. Continuing to deal with the distribution of retail investment products on a sectoral basis is unlikely to dispense with the regulatory patchwork. In addition, the diverging timeframes for revisions of these sectoral directives mean that these review processes will inevitably lack consistency.

An approach that starts with the interests of those retail consumers who aim to save, rather than the structure of the retail financial services industry, will transform the retail investment marketplace into one which is coherent and relevant to the needs of retail consumers in the 21<sup>st</sup> century.







# EIB presents its first study on the Mediterranean Solar Plan

**David Capocci**  
Partner  
Deloitte Luxembourg

In the most recent period, investments in renewable energies have increased. This trend has also been mirrored in the Mediterranean region, which benefits from favourable conditions in terms of Renewable Energy (RE) sources, in particular, regarding sunshine and wind.

The Mediterranean region as a whole, and the European Union will face major energy and climate challenges in the coming decades due to the impact of the rise in temperatures, the decrease in rainfall, the possible rise of the sea, etc. Energy demand will consequently rise significantly, while fossil fuel prices will most likely continue to follow a soaring trend. To address these challenges, the countries of the EU and the Mediterranean Partner Countries<sup>1</sup> will have to intensify their efforts to developing adequate policies in the field of energy efficiency and energy savings, renewable energies and reduction of greenhouse gas emissions.

One of the major initiatives proposed by the Union for the Mediterranean to address the common energy and climate challenges that region faces is the Mediterranean Solar Plan (MSP). The MSP is one of the strategic processes for sustainable development facing the foreseeable increase of energy demand in the Euro-Mediterranean region, and the need to cut back greenhouse effect gas emissions. Its main objectives are to develop an additional capacity of 20 GW of renewable electricity by 2020, as well as the necessary infrastructures for the electricity interconnection with Europe, thus addressing both supply and demand.

<sup>1</sup> Algeria, Egypt, Gaza/West Bank, Israel, Jordan, Lebanon, Morocco, Syria and Tunisia

Since 2002, EIB's operations in the Mediterranean Partner Countries have been brought together under the Facility for Euro-Mediterranean Investment and Partnership (FEMIP). With more than €10 billion invested between 2002 and 2009, FEMIP has established itself as the main financial partner in the Mediterranean region. In addition to project investments, FEMIP carries out field studies financed by its Trust Fund (FTF) to facilitate its understanding of the challenges facing the Euro-Mediterranean region. The FTF is conceived as a multi-donor, multi-purpose and multi-sector fund, whose main objective is to support private sector development in the Mediterranean Partner Countries and to promote the economic modernisation of the countries of the region.

In October 2010, the EIB published its latest FTF study on the 'Financing of RE Investment in the Southern and Eastern Mediterranean Region'.<sup>2</sup> This study was aimed at assessing the level of maturity of the existing or planned RE projects in the different Mediterranean Partner Countries, the economic impacts of developing these projects, as well as the main obstacles that may affect their implementation.

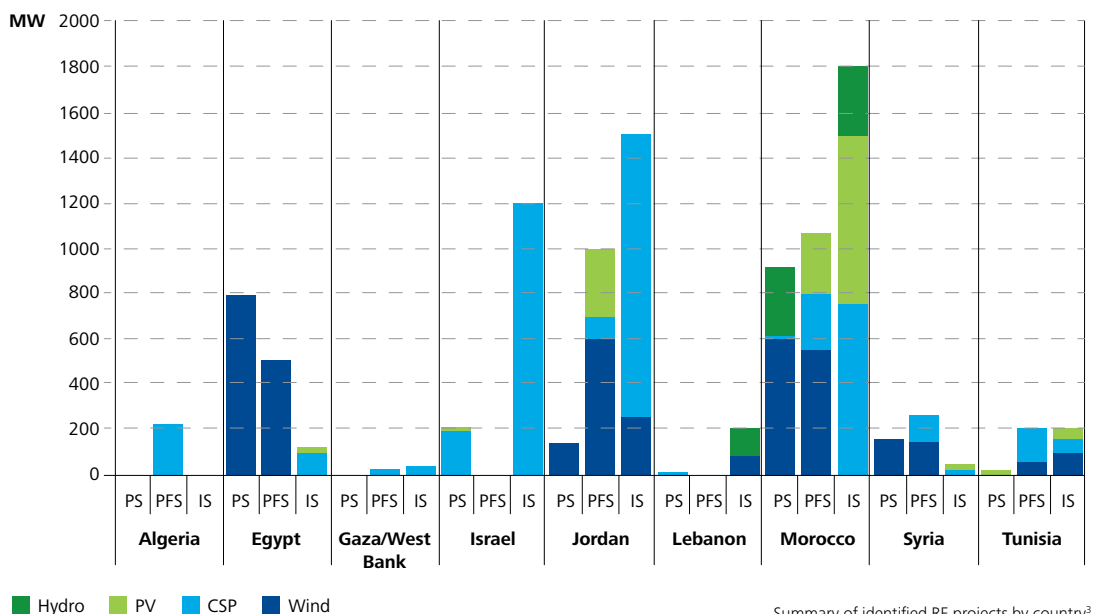
The study posted three complementary objectives:

- Identify the RE projects that the different countries foresee to implement that could be part of the MSP
- Analyse the main economic impacts of the development of these projects (investments needs, gaps between the costs of renewable power and alternative electricity production means, and CO<sub>2</sub> emission reductions)
- Identify the main obstacles to successful implementation of the projects

On the basis of RE plans and targets announced by individual Mediterranean Partner Countries, the study identifies a potential for 26.1 GW of additional RE capacity by 2020. However, at present, actual projects identified in the national pipelines represent a total capacity of 10.3 GW only for approximately 90 RE projects, and out of the identified projects pipeline:

- Only 2% are under construction
- 21% of project proposals are at the feasibility stage
- 77% are at the pre feasibility stage or at an earlier identification stage

#### Summary of identified RE projects by country



Summary of identified RE projects by country<sup>3</sup>  
Source: MWH/EIB modelling results

<sup>2</sup> The study is now available on the EIB website: [www.eib.org/femip](http://www.eib.org/femip)

<sup>3</sup> FS (Projects at Feasibility Study stage): those at an advanced level of preparation, since a feasibility study has been completed and/or the bidding process is in place; PFS (Projects at Pre-Feasibility Study stage): those under preparation, since a pre-feasibility study has been completed and/or further studies are to be developed; IS (Projects at Identification Stage): those at a conceptual level of preparation, since preliminary calculations have been performed and/or studies are at an early stage of preparation. PV: photovoltaic. CSP: Concentrating Solar Power

The need for RE investments can be as high as €20 billion; these specific investments are just a small share of the total investments in electricity generation in the region which are estimated to be between €120 and 140 billion by 2020.

The different countries involved are fully aware of the region's huge potential with regards to RE deployment, although the means to achieve national objectives are not yet in place. During the last two decades, Mediterranean Partner Countries have developed different institutional schemes for the promotion of renewable energies and have passed legislation regulating the RE sector or are in process of approval. Countries have focused on different technologies to promote RE. For instance, countries like Israel, Jordan and Morocco have preferred to develop solar technologies, whereas Egypt expects to rely more on wind energy. Nevertheless, incentive measures for the development of RE are rather limited. Only a few of these regulations foresee the support of the RE by feed-in tariffs, more often only simplified authorisation procedures or tax exemptions are in place.

In addition, subsidies will still be necessary to cover the financial gap between the cost of generation from solar plants and the cost of their fossil fuel alternatives. Carbon credits may cover a small fraction of the gap, but the rest has to be covered by subsidies from other sources (e.g. feed-in tariffs). Financial needs might come from export of RE to other EU member states however it would need to develop the electricity transmission capacity with EU countries, as the existing capacity is limited. Certainly, Mediterranean Partner Countries will need to reinforce their electricity transmission networks, as well as adapt their grid codes in order to increase the maximum capacity acceptable in their systems.



One of the obstacles is the lack of predictable and stable regulations in many countries that ensure a minimum investment return and hence, facilitate attracting investment for RE sources. Private investors will only invest in RE projects if they can get a minimum certain profitability in return.

Both renewable and 'clean energy' energy have become inescapable in the agenda of Mediterranean Partner Countries. Governments of the region recognise the positive contributions and impacts of RE on the environment and the long term growth. Amongst other initiatives, countries have established targeted regulations and incentives, as well as RE institutions to promote the use of clean energies.

A lot of projects still need financial support to bring RE to cost parity with fossil-fuel alternatives and although technological progress is allowing more and more renewable projects to be profitable without subsidies, national and international incentives may be required to initiate a sustainable development of green energy and attract private investors.

For any questions or additional information, you can contact Ms. Liyan (j.liyan@eib.org).

# A Dodd-Frank primer for EU money managers

**Stuart Fross**  
Partner  
K&L Gates LLP

In July 2010, the United States adopted the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act).



Dodd-Frank is, if nothing else, long: it weighs in at over 2,300 pages. It is both the single most significant rewrite of financial services legislation since the 1930s and a response to perceived failings in the U.S. financial system evidenced by the financial crisis.

It is also a statute that brings along with it regulatory initiatives that have a direct impact on EU money managers if:

- They manage funds that have been sold into the U.S. on a private placement basis
- They are owned by a bank with a U.S. subsidiary or branch
- They trade in OTC derivatives, short sales or securities loans with U.S. dealers as counterparties

### Summary

This article will not seek to make sense of the Dodd-Frank Act holistically, other than to say that each title passed reflects a consensus that certain sectors of the U.S. financial services industry were in need of reform urgently, on the one hand, and that a significant restructuring of the regulatory framework was simply not possible.

### Limited structural reform

Early suggestions of a rationalisation of U.S. regulators (perhaps to 'simply' merge the Securities and Exchange Commission (SEC) and CFTC, for example) were abandoned and the art of the possible set in. What proved possible was (for the most part) to bring forward initiatives pertinent to defined sectors of financial services and to charge multiple regulators with joint rulemaking. Thus, the U.S. retains its approach of state regulation of insurance companies, state and federal regulation of banks, federal regulation of banks that offer deposit insurance, multiple federal banking regulators, state and federal regulation of securities laws, and separate federal regulators for securities and commodities trading. Dodd-Frank did modestly simplify federal banking regulation by consolidating one bank regulator, and also made it possible to define the boundary between the CFTC and the SEC with respect to 'swaps'. But this approach stands in contrast to the UK Financial Services Act of 2000 in that the U.S. chose or felt compelled to remain highly balkanised in its financial services regulators, and did not create an FSA.

### New regulation

If our regulators remain much the same, widespread change has been made within the existing regulatory framework, including (among many other topics): a process designed to ensure financial systemic stability and the resolution of potentially insolvent financial firms; rationalisation of the regulation of derivatives; new rules for derivatives trading; the creation of a consumer financial protection watchdog within the Federal Reserve; the registration and regulation of hedge and private equity funds; the regulation of credit rating agencies; and new federal requirements for residential mortgage loans.

As noted above, within these sector-specific reforms, lurk changes with direct impact on EU money managers.

### SEC adviser registration: the new look through era

The Act will have a profound effect on the regulatory regime governing investment advisers and so-called 'private funds', meaning funds that have not been registered under the Investment Company Act of 1940 for public sale in the U.S. Among other things, the Act reshapes registration, recordkeeping and reporting requirements for advisers, changes accredited investor and qualified client requirements, limits the ability of U.S. banking entities to sponsor or invest in certain private funds, raises potential for additional regulation of large funds and fund complexes under systemic risk regime, affects nearly every phase of the current OTC derivatives trade cycle and requires certain trades to be centrally cleared and margined, and mandates that the Government Accountability Office (GAO) and SEC conduct certain studies on issues affecting private funds and their advisers. Many provisions will be implemented by follow on regulations, and the SEC is now soliciting comments on rulemaking too numerous to summarise here. The SEC has a month-by-month implementation calendar on its website.

- Private adviser provisions are generally effective on 21 July 2011



### Adviser registration and new exemptions

The Act rescinds the private adviser exemption, effective 21 July 2011. This is the exemption that most EU advisers rely upon **to avoid** registration as an adviser in the U.S., particularly if the EU manager has conducted a private placement of its collective investment schemes in the U.S. For all advisers, Section 203(b)(3) of the Investment Advisers Act of 1940 (Advisers Act) currently exempts an adviser that:

- During any rolling 12-month period had fewer than 15 clients
- Does not serve as an adviser to a registered investment company or Business Development Company (BDC)
- Does not hold itself out to the U.S. public as an investment adviser

Generally, a collective investment scheme counts as a single client (post *Goldstein v. SEC*, 451 F. 3d. 873 (D.C. Cir 2006)), and the implication of the Goldstein case is that as a fund is the client, a fund formed in an EU member state would not be a U.S. client at all. This is about to change and is about to put EU managers in a position of either registering with the SEC or changing its business model. Essentially, the U.S. will now look through funds and will count U.S. resident investors as clients.

Specifically, under the new legislation, from July 2011, most advisers that rely upon the private adviser exemption today will be required to register either with (1) the SEC or (2) state regulator(s) because of the limited scope of the new registration exemptions in the Act.

The Act creates a number of new exemptions from registration, including one for foreign private advisers. This is putting it backwards: EU managers will have to register (putting this in the affirmative) if they do not live within a new statutory exemption. The Act provides an exemption from registration for a foreign private adviser.

- 'Foreign private adviser' is defined to mean an adviser that:
  - Has no place of business in the U.S.
  - Has, in total, 15 or fewer clients and investors in the U.S. in private funds it advises
  - Has aggregate AUM attributable to clients and investors in the United States in private funds of less than US\$25 million or a higher amount determined by the SEC by rule
  - Neither:
    - Holds itself out to the public in the U.S. as an investment adviser
    - Serves as an adviser to a registered investment company or a BDC



A private fund is defined for the Act's private adviser provisions as one that would be an investment company but for the exclusion in Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940, as amended (the 1940 Act). This definition of 'private fund' is important, and was developed by the SEC in its hedge fund adviser registration Rule 203(b)(3)-1, which was vacated by the DC Circuit Court of Appeals in the Goldstein case. The SEC staff has held fast to this definition, and it appears again in Dodd-Frank in the Volcker Rule provisions in the definition of 'hedge fund'. The implications are that a fund that is exempt from registration under the 1940 Act by operation of Section 7(d)(because it is not conducting a public offering in the U.S.) and that also is not relying on Sections 3(c)(1) or (7) is not a private fund. That is, until an offshore fund makes its first U.S. offer, it is not a private fund. Thereafter, it may be.

The Act captures other forms of collective investment schemes in addition to those that invest in transferable securities. Generally, any collective investment scheme managed by an EU based manager may lead to registration with the SEC as an investment adviser, including specifically private equity funds. However, there is a registration exemption referred to as the 'Venture Capital Fund Adviser Exemption'. In reality this exemption creates a light regulatory burden, but creates a new one nonetheless.

- Provides exemption to advisers that manage **solely** venture capital funds
- The Act requires the SEC to define venture capital fund within one year of Act's enactment
- The Act mandates that SEC require venture fund advisers to "maintain such records and provide to the SEC such annual or other reports as the SEC determines appropriate"
- No similar exemption for private equity fund advisers, *per se*

There is no statutory or commonly accepted definition of venture capital fund. This has been left to rulemaking by the SEC. It appears that the Venture Capital Adviser Exemption will be unavailable to advisers with other types of clients (such as separate accounts).

The Dodd-Frank Act provides SEC with the authority to require records and reports regarding private funds, which would apply to EU based funds if they have conducted a private placement in the U.S.

The Act requires records to include the following:

- AUM and use of leverage, including off-balance sheet leverage
- Counterparty credit risk exposure
- Trading and investment positions
- Valuation policies and practices
- Types of assets held
- Side arrangements or side letters
- Trading practices



Other information, such as the SEC, in consultation with the Financial Stability Oversight Council (FSOC), determines necessary and appropriate in the public interest and for protection of investors or for the assessment of systemic risk information contained in the reports.

#### **Effect on EU money managers that are owned by banks**

Dodd-Frank has made it fairly complicated for U.S. banks that are owned by foreign bank holding companies to sponsor funds. In the main, the prohibitions on dealing with hedge funds and private equity funds imposed upon banks are limited to U.S. insured deposit takers, and generally will not affect the EU parent bank holding company and its EU subsidiaries. But some care will need to be taken with respect to buying securities from proprietary funds by any adviser that is a member of a foreign bank holding company. That is, if you are part of an EU banking organisation with a U.S. branch, and if you want to bail out your fund, for example, by buying a defaulted bond at book value (as in a bail out of a money market fund), you may be prevented from doing so, if the fund has been sold in the U.S. While no one wants to bail out a fund, it can be better than not doing so. Dodd-Frank will make that harder to do, and may prohibit it for U.S. bank affiliated advisers. With this in mind, advisers of funds privately placed in the U.S. should consider their position under Dodd-Frank well in advance of a crisis.

#### **Regulation of OTC derivatives**

The Dodd-Frank Act completely overhauls the regulation of the OTC derivatives market in the U.S. The primary objectives of the Dodd-Frank Act in the derivatives arena are to bring about greater transparency and to enable regulators to better manage individual counterparty and broader systemic risks that are inherent in the OTC derivatives market. In general, the increased transparency and efficiency resulting from these changes should benefit fund managers and facilitate board oversight of derivatives. The principal changes effected by the Dodd-Frank Act include:

- Imposing substantial requirements on the most active OTC derivatives market participants, major swap participants and swap dealers, including reporting, capital and margin requirements
- Subjecting many derivatives that are currently traded OTC to central clearing and exchange trading in regulated trading systems
- Establishing more clearly the jurisdiction of the key regulators of derivatives, the SEC and the Commodity Futures Trading Commission, and repealing exemptions and exclusions that stood in the way of their regulation of the multi-trillion dollar OTC market

These changes have the potential to significantly change the relationship with counterparties. At a minimum, dealers will engage in 're-papering' and existing ISDAs are likely to be replaced or supplemented with new terms. As the goal of clearing derivatives ought to be to reduce counterparty risk, attention will need to be paid to the financial health of the new clearing organisations as well as those of counterparties.

In addition, the Dodd-Frank Act places additional regulation on short selling of securities by amending the Exchange Act to prohibit any manipulative short sale of any security and to authorise the SEC to issue rules to enforce this provision. The SEC must issue rules providing for public disclosure at least monthly of short sale activity in each security. Brokers must notify customers that they may elect not to allow their securities to be used in connection with short sales, and brokers must disclose that they may receive compensation for lending their customers' securities. The SEC may, by rule, specify the form, content, time, and manner of delivery of such customer notifications. The Dodd-Frank Act requires the SEC, within two years, to promulgate rules designed to increase the transparency of information available with respect to the lending or borrowing of securities. In addition, the Dodd-Frank Act amends the Exchange Act to make it unlawful to lend or borrow securities in contravention of the new SEC rules.

---

Dodd-Frank is, if nothing else, long: it weighs in at over 2,300 pages. It is both the single most significant rewrite of financial services legislation since the 1930s and a response to perceived failings in the U.S. financial system evidenced by the financial crisis.



# UCITS IV

## Opportunities and challenges for the European and global mutual fund industry

**Sebastian Chaker**  
Managing Director  
Calastone Luxembourg

Sebastian Chaker, Head of Calastone's Luxembourg operations, examines the opportunities and challenges that UCITS IV presents for the European and global mutual fund industry.

The growing popularity of Undertakings for Collective Investment in Transferable Securities (UCITS) worldwide has created a tremendous opportunity for global asset managers to expand their distribution reach by taking advantage of a single cross-border fund vehicle. This single global approach offers potential economies of scale for asset managers and, ultimately, their end-investors thanks to increased fund sizes and reduced Total Expense Ratios (TERs).

In an industry of perpetual evolution, managing charges has become a key requirement for fund providers and distributors. New regulations imposed on UCITS fund managers and distributors, combined with important infrastructure changes, are expected to significantly impact the way in which investment funds are distributed globally.

Firms using robust, scalable and flexible operating platforms will be well positioned to take advantage of the new sales opportunities on offer, and ensure they can effectively manage an increasing number of distributor relationships and increased trading volumes coming from multiple countries. For any firms which may have under-estimated the legal, compliance and operational impact of moving from captive and domestic distribution to global third party fund distribution, they face considerable challenges ahead.



### The UCITS success story

There is no disputing that the global success of the UCITS directives has driven considerable benefit for fund managers looking to expand distribution. Taking advantage of a single fund structure, domiciled in one European country, fund providers face the potential to expand distribution to over 50 international markets.

Today, Germany, France, Italy, Spain, Benelux, the UK and Switzerland represent the nucleus of most European distribution strategies. As an example of the penetration of cross-border UCITS funds, the latest statistics for Germany from Cerulli Associates illustrate that foreign funds outstrip domestic funds by more than €23 billion with foreign fund investment representing €234.2 billion<sup>1</sup>. But in the last few years, non-European Union markets have become a growing source of distribution for UCITS fund promoters. In fact, non-EU sales have accounted for approximately 40% of aggregate UCITS sales in recent years<sup>2</sup>, with a large proportion coming from Asian markets such as Hong Kong, Taiwan and Singapore where the UCITS brand is held in high esteem.

From our observation of the global mutual fund industry, only the largest U.S. and European fund groups have been able to fully capitalise on the wide acceptance of the UCITS brand to distribute their funds in multiple markets. We are witnessing increasing interest from the top Asian asset managers also looking to leverage UCITS to distribute across Asia and potentially expand into Europe. However, medium-size and boutique asset managers have been much slower to join the UCITS train. We see two key reasons for this. Firstly, although launching a UCITS structure is a relatively straightforward process, the complexities tend to follow when the fund providers start to register and market their funds into multiple markets. This requires substantial legal, compliance, operational and marketing resources and skills which many smaller and domestically-focused players may not have. Secondly, the cost of launching, administering and servicing a UCITS structure remains much higher than most other type of fund structures available. This is due to the rigorous regulations imposed on UCITS funds to ensure investor protection and the often high operational costs linked to the need to deploy a global servicing model.

<sup>1</sup> Source: Cerulli Associates, August 2009, *The Cerulli Edge Europe Q1 2010*. Assets under management of domestic funds equated to €211.1 billion; foreign invested funds €234.3 billion.

<sup>2</sup> Source: Cerulli Associates, August 2009, *The Cerulli Edge Europe Q1 2010*.



### How are new trends and regulations re-shaping fund distribution globally?

UCITS promoters are now set to embrace the latest phase of regulations with the implementation of UCITS IV in July 2011. The main objective of UCITS IV is to address the shortcomings of previous directives, for example the current passport facility and the limitations of the simplified prospectus.

We don't doubt that UCITS IV will further broaden the appeal of the UCITS brand. It will provide further opportunity for domestic and international fund providers to consolidate, merge, and distribute cross-border as well as offering a chance to streamline operational and back-office activities. But how will these new regulations affect distribution?

There are three aspects of the new regulations which we believe will directly impact fund distribution. The first is the revamp of passport procedures which allow funds authorised in one country to be sold into another country. The current fund registration process is regarded by many in the industry to be somewhat inefficient as it gave an opportunity for domestic regulators to set-up barriers to delay acceptance of foreign funds into their country. Some may argue such barriers were constructed with a hidden objective of favouring domestic funds. By providing free movement and easy registration, UCITS IV is expected to lower costs and contribute to creating a level playing field between local and cross-border products. From ongoing discussions with our fund provider clients, we anticipate that those funds which until now had restricted distribution into a few selected countries, will be in a position to quickly expand their distribution into other, if not all, European markets and be able to capitalise on any further sales opportunities.

The second aspect which will directly impact fund distribution will focus on the UCITS IV master feeder structure. This allows fund promoters to quickly set up a domestic fund (the feeder) to enter a new specific market or client segment, allowing fund managers to be more responsive to investor demand. This structure is seen as an easier, cheaper and faster route to market compared with having to add a new share class or sub-fund in an existing flagship fund.

---

## Fund distribution is also a source of the regulatory and market changes taking place at local levels. Fund distributors are now taking a more rigorous and methodological approach when they select which funds they will carry on their platforms.

Finally the introduction of the Key Investor Information (KII) to replace the simplified prospectus will force fund management companies into a standard and short, simple prospectus for the investor. Although the effect on distribution will probably not be substantial, it should help to re-build investor trust in investment funds.

Fund distribution is also a source of the regulatory and market changes taking place at local levels. **Fund distributors are now taking a more rigorous and methodological approach when they select which funds they will carry on their platforms.**

Investors are seeking more advice and recommendations from their financial advisers when selecting financial products. This has led to fund platforms moving away from a full open architecture to a guided architecture model with greater attention on selecting the right fund provider partners and the right funds.

As we see it, several other industry trends will, we believe, re-enforce the move towards more open or guided architecture in fund distribution. We anticipate the emergence of alternative and independent distribution channels, such as IFAs and online brokers. In France, for example, we see clear evidence of this trend.

According to a recent study by Roland Berger Consultants<sup>3</sup>, IFAs now capture around 8 to 10% of net inflows into financial and unit-linked products and are expected to grow twice as rapidly as the market in the next few years. In Italy, new regulation is imposing a separation between the distribution and manufacturing of funds, and across Europe and an increasing number of banks – such as Credit Suisse – are choosing to sell their asset management business enabling independent asset managers to penetrate these banking groups in the future.

In the UK, the FSA has taken a more radical approach to try to eradicate advisers' conflict of interest created by the current commission rebate model with its Retail Distribution Review (RDR). Other markets such as India are also moving in that direction. There is no doubt European regulators will carefully examine how these new regulatory models evolve and may well re-visit their positions on this topic. If nobody can really estimate the impact this new regime will have, the recent acquisition by Blackrock of the largest ETFs provider serves as a good indication of how global asset managers are reacting to these new trends.

<sup>3</sup> 15 September 2010

Finally, new initiatives in the trade and the post trade processing of the fund industry are also re-shaping the way investors, distributors and fund providers are accessing investment funds globally. In our opinion, this is the weak spot of our industry today. Unlike the equities investment industry, where huge strides in automation have been achieved, the fund market has been much slower to follow suit. The fax still plays a fundamental role in the transaction and settlement of funds.

We believe that creating an efficient trade and post trade infrastructure to make investment funds more easily accessible to global investors and distributors is a critical development for our industry.

Despite more than ten years of intensive efforts to automate fund order processing between distributors and fund managers, or their respective transfer agent, the position today remains both frustrating and concerning. New industry standards have been created. ICSDs and CSDs have extended their legacy systems to cover investment funds. We estimate that less than 20% of global fund buyers into UCITS funds use an industry standard to purchase funds. More worrying, there are less than a handful of Asian distributors – the fastest growing market for UCITS distribution – which can today generate ISO messages to fund providers.

Too often, however we hear the industry protest of the cost and resource involved in moving to the utopian ISO 20022 standard. Yes, we are to encourage a transition, however, where there is a challenge, the industry will doubtlessly innovate.

As we see it, the solution is not necessarily an expensive investment. It is interoperability. We believe in a market model built on a simple premise: that whatever the operating protocols and standards adopted by market participants today, technology will enable interoperability at the heart of the buy and sell transaction and in understanding the post-execution settlement positions. Once interoperability is resolved, all participants can benefit from STP irrespective of their size or location.

## Conclusion

There is no doubt that UCITS funds will continue to appeal to more investors and to more fund providers with the new UCITS IV measures. It will reinforce its dominance as the global brand for cross-border distribution, will allow fund providers to become more flexible to respond to investor demand and to expand distribution and will provide many opportunities to reduce overall back-office costs.

With more specialised asset managers from all over the globe joining the large western asset managers in using the UCITS structure, fund distributors and investors will enjoy greater choice of funds available, which in our view, will contribute to accelerate the ongoing move towards an open architecture in fund distribution.

In order for the industry to fully benefit from these exciting developments, it is crucial that fund providers take more ownership in finding solutions to improve their trade and post trade infrastructure. Adopting an industry messaging standard is a step in the right direction but allowing distribution clients and investors to easily and efficiently access these standards is even more important. Many fund providers and distributors have found ways to become immediately compliant without needing to invest in their internal system and without the need to change their internal processes. Global interoperability is now a reality. There are no longer barriers to STP in the processing of mutual funds.







# Eurozone government bonds Safe haven no more?

## Nadine Crépin

Head of Product management  
Asset & Fund Services  
BNP Paribas France

## Valérie Nicaise

Head of risks and performance  
solutions  
Securities Services  
BNP Paribas France

## Diogo Malato Moura

Manager  
Front Office Solutions  
Security Services  
BNP Paribas France

### Eurozone government bonds: history repeating itself?

We always hear history repeats itself. This is usually true if we look at very long periods of time, however, less visible within a year's time. This year, in the eurozone government bond market, not only is this year-end a repetition of the first half of the year, but we can actually say that the first half of 2010 did not even wait to be history before repeating itself. History lessons tell us that we must learn from history to avoid mistakes in the future. Thus, we think that it is important to have a clear view on what happened in the first half of the year, as closely revisiting recent events can help to better understand and deal with what is currently happening on the euro government bond market.

In order to do this, we look deeply into this market up until June 2010, using performance attribution as a means to go further into detail:

- We explain why performance attribution is one of the best means of analysis for this case
- We briefly describe the method used

- We analyse the euro sovereign debt universe, each time going further in detail:
  - Split yield variation on these bonds into variation due to risk-free rate movements and variation due to specific country factors
  - Analyse how the specific country spreads varied with the main market events
  - Within what the market traditionally calls specific spread, determine how specific this is by adding an analysis by rating and showing that there is a 'rating systemic' part in this so-called specific spread

The aim of this study is to highlight the eurozone sovereign debt segregation that was being carried out by the investors, because this same phenomenon is happening again.



### The use of performance attribution analysis to better understand the euro sovereign bond market

The financial markets have been deeply impacted by the recent crisis which laid stress on transparency issues from some financial actors, especially towards final investors and control departments. This has led to the will of reinforcement in the financial reporting area.

Financial reporting gathers all the tools that enable an analysis of performance and risks on portfolios and other investment vehicles. They should, however, always be adapted to the investment process. For example, what is the aim of performing a complex performance attribution, that details results on the capacity an asset manager has in choosing proper asset allocation, within each asset the choice of the correct region to be invested in and, within it, the stock-picking capability by region (a top-down investment process), if the investment manager is a pure equity stock-picker, that doesn't look at regions or assets? The performance attribution field has been evolving fairly quickly to cope with all of these challenges, as, on one hand, it needs to adapt to the investment process and, on the other, a comparison between portfolios of different fund management companies ought to be possible.

The most important example of the performance measurement area increasing interest is perhaps the enhancement of bond portfolio performance attribution models. There are actually no industry standard models concerning interest rate and credit portfolios attribution. Which is a paradox, since this asset class is the most important part of institutional and insurance portfolios and has known an important growth on the number of specialised fixed income asset managers, especially since

June 2008. From June 2008 to February 2009 there has been a 'fly-to-quality' process, bonds being – or used to be – safe assets. This increase in bond industry specialists, each with its own insight on coming events in the market, does not mean that this type of investment managers will always be right. For instance, at the beginning of 2010 most of the investment specialists were likely to say that governmental bonds would encounter an increase of their yield during 2010. As we now know, the German 30-year rate is at its lowest (around 3%). We can thus assess, ex-post, that they were wrong. This shows that even on the seemingly simple, pure governmental European debt market, there is a need to verify fund managers' ex-ante intuition through ex-post analysis.

Bond asset managers have a multitude of investment angles to look at. They can currently focus on emerging markets debt, which still offer good outlook of performance with a decreasing risk level. They also have to consider new regulation concerns, such as Solvency II, which is perceived as favouring insurance companies' asset management business lines to invest even more in government bonds over other type of assets. And, as shown during the last auction of Treasury Inflation Protected Securities (TIPS), which were sold at a negative yield, they have to keep an eye on inflation.

Due to this growing attention on all the fixed income instruments market, bond studies have to go into greater detail, whether to take advantage of interesting investment opportunities or to understand where an investment process has failed or succeeded. Bond performance has, in particular, to be fully broken down and understood. This can be accomplished through conducting quality detailed bond performance attribution.

### Bond performance attribution at a glance

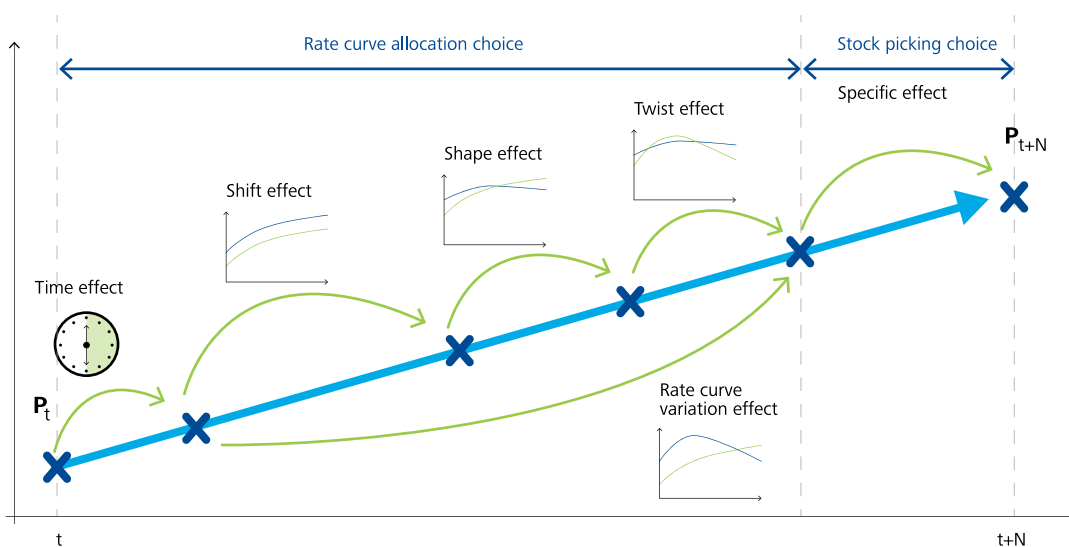
The methodology we advise is the successive spread methodology, an attribution method that breaks down the portfolio's performance into relevant risk and price bond market factors. It is the result of the works of a think-tank based in France, *Groupe de Recherche en Attribution de Performance (GRAP)*, formed by asset managers, performance analysis experts and investment management consultants. This methodology has been spreading through other main investment management specialist countries, such as the United Kingdom or the United States.

Accounting for price formation, several factors enable to successively re-price each fixed income instrument.

Thus, the impact of each factor can be measured and the performance can be broken down in order to better understand which factors contributed the most to price variation over a period of time. Advantages lie in calculation accuracy and flexibility regarding the choice of performance breakdown axes of analysis. A bond price movement is broken down into a systemic (i.e. risk-free interest rate) and a specific part (i.e. re-calculated credit or specific spread). Then, each effect can be decomposed in several sub-effects, allowing the breakdown to match any specific management process.

Here is one possible illustration of a bond's performance breakdown analysis over one period, on a given investment process:

Bond performance breakdown over one period



Two major factors that influence a bond performance within this investment process:

- Rate curve allocation choice – the result of this type of decision is impacted by systemic factors
- Stock picking choice – the result of this type of decision is impacted by specific factors

Within the systemic part, it is even possible to see how a bond price varies with curve movements that are different according to the maturity we look at (i.e. a curve movement where short term rates rise

and long term rates fall): shift, shape, and twist effects. The time effect is the impact on bond price due solely to the passage of time.

In the case of government bonds' price movements, the traditional analysis done in the market is: what part of their price variation is explained by the risk free yield curve movement (risk-free effect) and what part of their price variation is explained by their idiosyncratic factors (in which debt quality, rating, liquidity and its volatility are included in one single effect – specific effect).

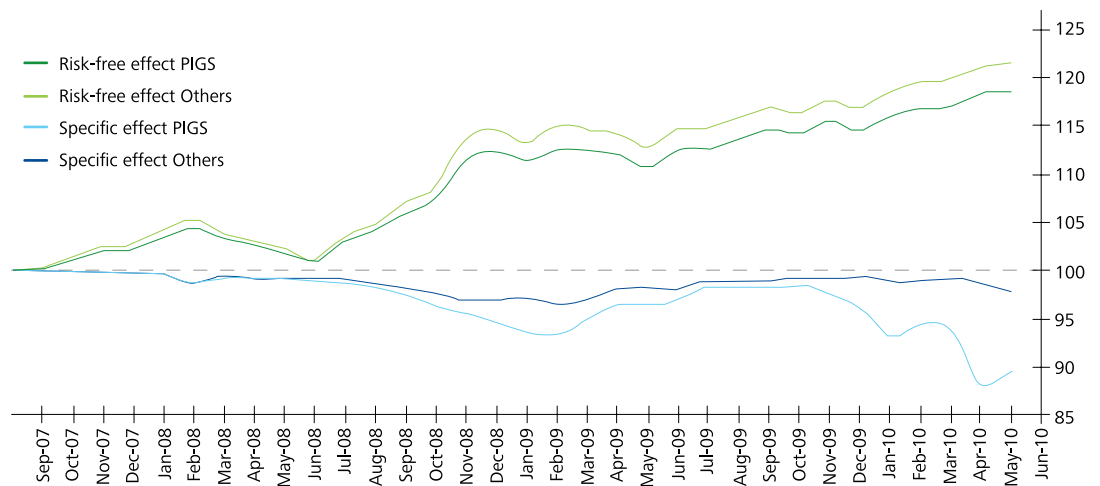
### Eurozone bond market evolution: systemic vs. specific

During the first semester of 2010, great focus was placed on governmental public debt, as these bonds were no longer considered to be completely safe. The issue being that due to the rescue of banks, private risk had turned into public risk. Governments' solvency was then at stake and investors were no longer confident about their ability to recover their debt.

The specific part of price variation has thus become significant. Investor's doubts during the bank recovery plan within the eurozone were indeed starting to show

on bonds' valuations. An illustration of this can be seen by aggregating calculated effects per country of issuance in two groups: PIGS and Others. While doing so, a difference between specific debt quality within the same monetary zone appears clearly. As we can see in the graph below, the specific effect is clearly different for these two types of countries, whereas the risk-free effect is quite close between them. Bond price movements for Others are explained in their majority by the risk-free effect. As for PIGS, we can see that their specific effect is quite strong, demonstrating that there are clearly at least two distinct types of government debt issuing countries within the eurozone regarding risk.

Risk-free and specific effects of two kinds of country

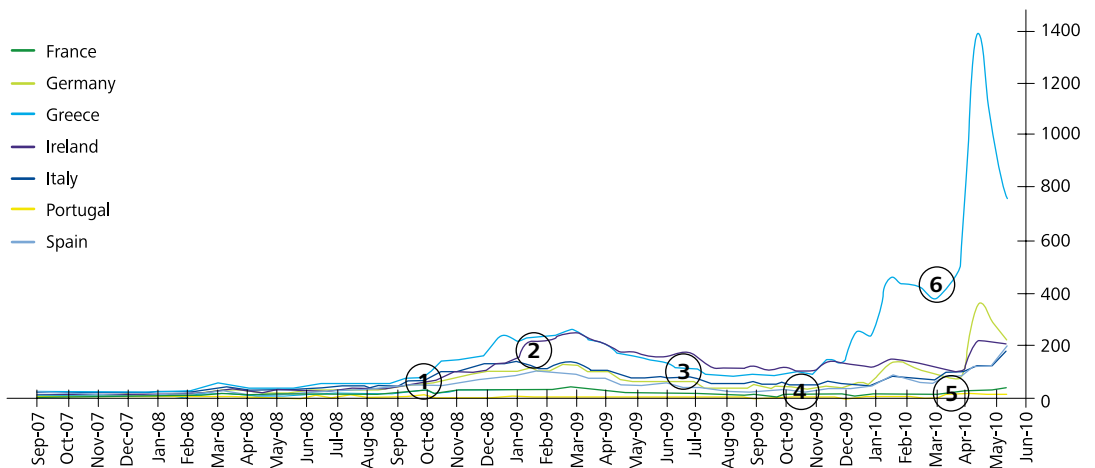


PIGS: Portugal, Ireland, Greece and Spain Others: Austria, Belgium, Germany, Netherlands, Finland, France and Italy  
Source: BNP Paribas Securities Services (Investment Reporting and Performance department)



## Specific spread related to market events

### Spread trends within the eurozone



Source: Investment reporting and performance/BNP Paribas Securities Services

#### Recent events:

- ① September 2008, de-correlation within the eurozone countries due to the banks' crisis.
- ② At the end of 2008, in Ireland, real estate bubble blow up and in September 2008 recovery of *Allied Irish Bank* and *Bank of Ireland*. Investors' awareness of budgetary issues of Spain, Italy and Portugal.
- ③ Spreads' tightening, with the highest spread for Ireland due to *Fitch* decision on 1 March 2009 to depreciate its rating from AAA to AA+.
- ④ Stabilisation of France and Italy, taking advantage of a high liquidity on the markets (e.g. on 14 September 2009 creation of a future on the Italian debt by the Eurex).
- ⑤ In the meantime, tension on Portugal spread due to its rating depreciation (at the end of March 2010, *Fitch* lowers the rating from AA to AA-).
- ⑥ Widening of the Greek spread due to new government awareness of an underestimation of their debt (at the end of 2009 it was higher than 110% of the GDP) and due to the successive depreciations of the rating of Greece, current value of BB+ for *Standard & Poor's* (S&P). In February 2010, spreads tightening following the announcement of an austerity plan, welcomed by the European Central Bank. In March 2010, another widening accounted by speculation and wondering about eurozone governance and a possible intervention of the IMF within European affairs. Finally, big spread widening, countries within the eurozone taking too much time to make decisions about an eventual recovery plan. At the end of April 2010, brutal depreciations by S&P of Greece's, Portugal's and Spain's rating, respectively from BBB+ to BB+, from A+ to A- and from AA+ to AA.

During the early second half of the year 2010, the bond market was stabilising or at least, relaxing slightly. The European recovery plan, joined by IMF participation, reaching €750 billion overall, as well as non-conventional measures taken by the European Central Bank concerning buying sovereign debt, were contributing to this lull.

### How country-specific is the specific spread?

Up until now in our study, performance has only been split between risk-free effect and specific effect, which requires looking at only one yield curve, the risk-free one.

As mentioned before, within the specific effect analysis usually performed, one of the hidden factors is the sovereign debt quality as perceived by credit risk specialists such as the rating agencies. To go further in the current analysis and better understand just how country-specific the bond price movements seen above really were, it is possible to consider a second rate curve. The more pertinent is the rating curve, to see if there isn't a 'rating systemic' effect within the specific curve.

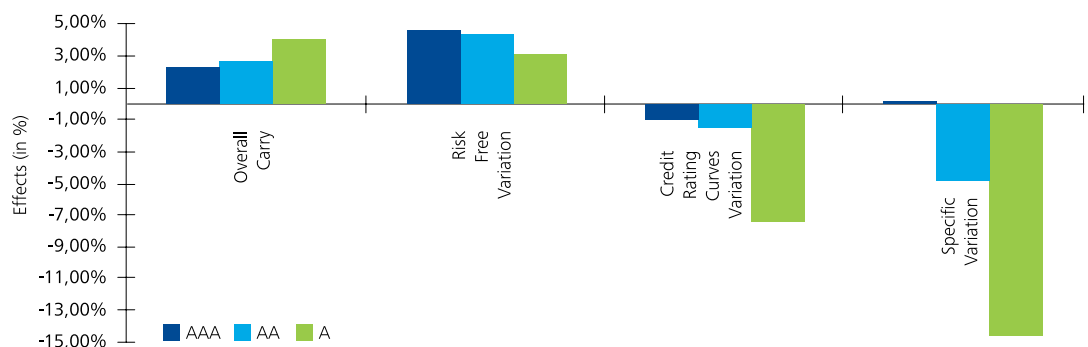
These curves are rebuilt with sovereign eurozone bonds that have the same rating. They represent the following ratings (first half of 2010): AAA, AA and A or less. Hence, one can group countries as follows:

- Rating AAA: Germany, France, Netherlands, Austria and Finland
- Rating AA: Ireland, Spain, Belgium, and Italy
- Rating A or less: Greece and Portugal

*Remark: In spite of a rating A+ (S&P), Italy benefits from a high liquidity on its sovereign debt. A complementary analysis (not shown in this document), has allowed us to confirm that Italy's bond behaviour was more like the one of a country rated AA.*

In the histogram below, we can see results of the effects explaining sovereign debt performance, within the EuroMts Eurozone Bond Index, one of the available market indices representing eurozone sovereign debt price evolution as a whole, during the period from 2 October 2009 to 10 June 2010. Within this index, the AAA group represents on average 52% of this index, the AA is 41% of the index, and the A or less around 7% of the index. From this universe of bonds, we created an equally weighted portfolio, on which each rating class has the same weight within the portfolio (AAA performed 5.95%, AA performed 0.69% and A or less performed -14.89% over the period), in order to be able to compare results among rating classes. The histogram below is a performance breakdown for the period. The sum of the effects per rating class is equal to the performance of each of the sub-rating classes as detailed above. The results are regrouped by effect in order to easily compare the impact of the movements of each one of the interest rate curves, as well as the specific effect among rating classes.

Performance breakdown



Source: Investment reporting and performance/BNP Paribas Securities Services



We thus have the countries regrouped by rating. The overall carry is the 'time effect' mentioned above, the part of the performance of a bond due to the passage of time. For this effect, we can see that the three groups are quite similar and in line with what we would expect (higher carry income from higher risk bonds). The risk-free effect (price variation from risk-free curve variation), that we would expect to be equal between the three groups, is not. However, this comes from the fact that the maturity (duration) exposures of the three rating classes is not the same within the chosen index.

We can now see that almost all of the performance of AAA government bonds is explained by carry and risk-free variation, confirming that they are indeed 'safe havens'.

This is not the case for the AA and the A or less rated countries. For these, we can see that the rating systemic variation (credit rating curve variation) explains a part of the large negative performance for the AA countries, and that the real country-specific effect still explains most of the negative performance of AA and A and less. The specific spread has thus been refined, however, even if we can now see that an important part of the performance is due to a systemic credit rating effect, a large portion is still country-specific. This would include liquidity, volatility and others, like investor fear or real doubts on the solvency of the country at a given moment, not captured by the rating given to the country. If investors followed rating as a sole criteria of making a distinction between countries when investing in government bonds, we would have seen all of the remaining performance (apart from carry and risk-free) explained by the credit rating curve variation. In any case, what is certain is that there is a strong idiosyncratic behaviour of government bonds that are part of the same monetary zone, the eurozone.



### Conclusion

The results of this study highlighted the discrimination carried out by markets between the sovereign debts within the eurozone, showing at the same time that part of it was credit rating systemic rather than specific to each country, even if the largest part was indeed country-specific.

---

**Budgetary issues have consequences on the Euro currency and European governance. Being at the end of 2010, we can see that this is a question that will remain unanswered for an unknown period of time.**

In the long term, whether European sovereign bond markets will relax or not is the question at stake. Budgetary issues have consequences on the Euro currency and European governance. Being at the end of 2010, we can see that this is a question that will remain unanswered for an unknown period of time. Ireland, one of the countries in focus in this study that seemed to recover in the end of the first half of the year, is now again in distress. The market yield of the Irish 10-year sovereign debt grew to more than 8%, before the country was forced to accept the European and IMF help and launch austerity measures. The crisis is not over, as along with these events, the fear of contagion to other eurozone countries was renewed, accentuating even more discrepancies between sovereign public debt within the region.

As seen in this study, performance attribution results can help to better understand the economic and financial news, by going into further detail. A detailed analysis of the second half of the year 2010 would undoubtedly show even more bond behaviour specific to Spain, Portugal, and others. Rating was one of the angles looked at, but we can easily imagine other analyses that look at the specific spreads of countries and determine whether or not they are specific to one country or to several at a given time.

We believe this kind of analysis to be a step forward on this fast-evolving industry. When performance on fixed income instruments can be explained by effects expressing their own risk factors, this means that asset managers and institutional investors have tools that allow them to better understand what happened in a given market, either to confirm their intuitions or to better understand how the market went against them.

In a regulatory environment where the current Solvency II draft propositions (implementation planned for the end of 2012) are pointing to an equal treatment of all government bonds in terms of capital requirements (0% in capital requirements for all OECD and EEA bonds), whereas corporate bonds or equity will be charged in capital requirements, this type of study demonstrates that we can no longer consider all eurozone government bonds as 'safe havens' and that it is time to look at them in more detail, as there is a strong idiosyncratic aspect in this market nowadays, and it is probably here to stay.

# AIFM Directive

## Hedge fund managers' round table

**Mike Hartwell**  
Partner  
Deloitte Ireland

**Malcolm Goddard**  
COO  
Altima Partners

**Frank Goasguen**  
COO  
TT International

**Tim Pearey**  
COO  
Odey Asset Management

There has been a significant amount of debate over the past 18 months around the likely impacts that the AIFM Directive would have on the investment management industry.

Up to this point, the Directive has been something of a moving target, and so it has been difficult to gauge how significant any impacts might be. Following the European Parliament's vote of approval of the Directive on 11 November 2010, much of this uncertainty has been eliminated. Now is a good opportunity, therefore, to gain an insight into how significantly the Directive will have an impact on the alternative investment management industry.

In this roundtable **Mike Hartwell (MH)** of Deloitte Ireland discusses the potential impacts of the AIFM Directive with three leading hedge fund managers based in the city of London:

**Malcolm Goddard (MG)**, COO of Altima Partners

**Frank Goasguen (FG)**, COO of TT International

**Tim Pearey (TP)**, COO of Odey Asset Management

**MH:** Thank you all for taking the time to join this round table. Given the recent European Parliament vote of approval of the Directive, I would like to get some feedback about how the Directive is likely to have an impact on your organisations.

**What are your initial thoughts on the Directive? How far-reaching do you think the effects might be on how you go about your business?**

**MG:** It's going to affect the business in a number of ways; there's good news and there's bad news. A lot of the detail still needs to be agreed on in level 2, so we need to see how this pans out. However, at a high level, I don't think investors get that much benefit out of it and it's an additional cost the funds will have to pick up.

**TP:** I think at a very high level I would agree. I see the potential for increased costs, without a significant benefit to investors. Another factor is that we didn't really hear what investors had to say throughout this whole process other than "*much of this is unnecessary and will be restrictive*". The process seems to have been led by politicians rather than investors, which is never good.

**FG:** I would say that there will be a limited impact for a business like ours, which is an EU based manager with a very institutional platform and a relatively low risk profile. However, the devil is in the detail in terms of level 2 regulation – but our level of anxiety on the Directive has dropped dramatically since the initial draft was issued.

**MH:** In terms of preparing for the Directive, what level of analysis have you been able to perform?

**FG:** We have had a policy of not investing too much time and money in preparing the business for hypothetical changes. We consider that the worst that could happen is that we would have to change the domicile of our funds. And it would take less time to organise than the time it would take for the Directive to be implemented.

**MH:** So, have you been able to do any sort of analysis at this stage in terms of the impact of the Directive on your business, or is it just too early to start?

**TP:** No, it's very hard. Any analysis is likely to be scribbled down on a bit of paper rather than being a formal plan. Until the detail's there, it's hard to know what to do.

**MG:** Too early. The detailed regulations are not done and dusted yet. We know what the key issues are and we have several plans to deal with these issues.

**MH:** And those will stay firmly under wraps at this stage, I'd imagine. Do you have a view on the level of cost that will be incurred due to the Directive? Should investors welcome the Directive as providing valuable protection at a reasonable cost?

**TP:** I can see it adding a couple of basis points or so to the TER of the fund. However, I don't think this is a bad thing in a way, because the safeguarding of assets is a critical issue and I am not sure that everyone understands it enough. But the function has to go all the way in terms of really giving people comfort around safeguarding—if it's simply another layer for someone to fob off their responsibilities onto someone else then it won't work particularly well.

**FG:** I believe we are going to have additional costs fixing something that isn't broken and so this will be an additional burden with, in our view, no necessity behind it.

**MG:** I would have to agree with this last view. Investors will end up bearing the additional cost as it relates to the fund. However, given the sophisticated nature of hedge fund investors, do they get the commensurate benefit from the Directive? I don't think so.

**MH:** What impact might the valuation provisions of the Directive have on your business? Do you believe the Directive will achieve more accurate and reliable valuations throughout the industry?

**TP:** For us, having a third party administration is absolutely straightforward, it's how we do it. There was nothing within any of the valuation provisions that worried me or made me think, "*well that's not something we can comply with*". In fact we are already doing it.

**MG:** 'Hard-to-value assets' is a complex topic and the methods used will vary case by case. The weakness with this part of the Directive is the assumption that everything is priced for NAV purposes at fair value. This isn't always the case, as with the funds we manage. The overwhelming majority of what the funds invest in is priced by the administrator from a screen, so in this respect there shouldn't really be any impact. However, the funds contain some illiquid and private equity investments which are in side pockets and are priced for NAV purposes at the lower of cost or impaired value. Notwithstanding this, the funds are required to produce financial statements under US GAAP, so they have to produce fair values for these side pocket positions, even though this is meaningless for the purposes of NAV and thus performance and fees. We have instituted robust valuation procedures for these positions,



including the use of a Valuation Committee containing non-execs so, given the funds' NAV methodology, the bit I am struggling with is the benefit investors will get from having the entire portfolio valued independently on a basis different to that on which NAV is calculated, versus the cost of doing so. Given fair values per the financial statements are subject to independent audit anyway, surely making the auditors comfortable with this would suffice.

---

Given this structure, we cannot take risks for the funds in excess of what is outlined in the fund documents. This is part of the investment contract and any infringement may be subject to legal redress.

**MH:** Have investors themselves started to do more in terms of due diligence etc.?

**FG:** Undoubtedly. We have definitely seen more scrutiny and much more verification. People are no longer taking words as a sufficient answer, but checking things in much more detail. This has definitely been a change over the last two to three years. It is a much better solution to see clients taking responsibility for strengthening controls over the activities of fund managers, rather than to see the EU imposing ill-conceived stringent regulation.

**MG:** I agree, the due diligence process is a lot more thorough these days, which is a good thing in my book. Investors seek independent corroboration of much of what we tell them, as well as requiring information from other providers to the funds, particularly the administrator. I don't see the introduction of the Directive changing this level of enquiry.

**TP:** Absolutely, we've always been pretty transparent. We are principally a 'long only' house, so we're used to a more retail client base in terms of the transparency for our funds and the information about ourselves, so that's second

nature to us. What you have seen is that the time taken for institutional investors to come in and carry out due diligence has increased, particularly with the consultants, etc. This is always a good thing because that due process keeps everyone focused.

**MH:** And on the positive side? What impact might the Directive have on your distribution model?

**MG:** I'm not convinced. It's a generalisation, but most Cayman funds are owned by investors in the UK and Switzerland; other EU countries can invest (subject to private placement rules), but don't. We could passport these funds in Germany, France, Italy, Spain, but will investors out there buy hedge funds? They're still hedge funds. Who knows, but I'm not convinced. This is particularly so, as many managers are looking at UCITS alternatives which, traditionally, other EU countries prefer. Remember also that hedge funds are generally not for retail; I don't see a passport changing this characteristic as the associated risks do not change massively.

**FG:** We are positive on passports, probably more positive than the industry. We know the value of not having to go through specific procedures to register in different countries and therefore we welcomed the passport. The problem is, the compromise at the last minute seems like a halfway house, with the passport not being available and then coming in later. It is a bit confusing now, but we would have welcomed the passport as an administrative simplification because, I think, we would have applied for it for most of our funds.

**MH:** Would you expect that the Directive will change the way you structure your fund products? Will it affect the selection of fund domicile?

**FG:** We think that Cayman funds for professional investors are perfectly good vehicles. If some investors prefer a UCITS format we are happy to evolve and offer UCITS, but it is not led by regulation.

**MG:** Not at the moment and I don't think there will be less hedge funds as a result. Hedge funds will still be of interest to professional investors and also those in the U.S. If there is an advantage to investors though, we'll look at it.

**MH: How engaged are you on the impact of the remuneration policies?**

**MG:** If the concern is that we're taking excessive risk, ask yourself, excessive risk in relation to what? Our activity is governed by what is in the fund documents and the IMA; these funds are sold only to sophisticated investors, who, in most cases, carry out all sorts of due diligence to understand these risks and how they are being managed. Given this structure, we cannot take risks for the funds in excess of what is outlined in the fund documents. This is part of the investment contract and any infringement may be subject to legal redress. Trying to further control this through arbitrary controls on remuneration achieves nothing. Also, the assumption that you can alter the fee mechanism from the funds to hedge fund managers just by waving a magic wand is wrong. It is not in our gift. The fund is a legal entity in a non-EU domicile and has shareholders. Surely it is up to these shareholders to make such a change. Hopefully common sense will prevail in level 2 drafting.

**FG:** The current rules would really be dramatic, because that would make us unable to align our interests with those of our investors. The whole principle of our industry is to be earning money when our clients have made money – as long as this remains true, then we should be OK.

**MG:** Beware of the law of unintended consequences. As I have said, the mandate that we manage the fund by is spelled out in the investment management agreement, that says what we can do and takes into account conflicts of interest. The fact that the funds have loss carry-forward mechanisms, the fact that the funds have a high watermark and, with this in mind, the fact that performance fees are charged only when profit is incurred, means we are aligned with our investors, not in conflict with them. It would be a tragedy if the results of level 2 drafting altered this.

**TP:** The FSA appears to acknowledge the fact that copying bank remuneration rules into a fund management industry simply doesn't work and one hopes that this will bear fruit in terms of a sensibly drafted, proportionate code. Our interests are wholly aligned with our shareholder, so there's simply no need for a detailed quantitative remuneration code. Shareholders are well aware of the remuneration to the fund manager by virtue of investing in the fund.

**MG:** I agree with this and I believe that common sense should prevail. The arbitrary application of the worst parts of the code would not be positive for London.

**MH: That's an interesting point. Could the Directive be that much of a game changer for London?**

**TP:** One really fears for the industry, which isn't going to disappear overnight but certainly, if you were starting again, you wouldn't necessarily look at London as your first choice and that's the danger. I think one must be very careful at this stage not to give away too much, otherwise five years down the line people are going to turn around and realise that this is an industry in perpetual decline.

**MH:** Well on that note, we might wrap things up. Again thank you Malcolm, Frank and Tim for your time today. It was certainly very interesting and I look forward to discussing some of these points further as the level 2 discussions progress.

Just to finish, one thing that has really struck me is how significant the remuneration piece could be for the industry. This is certainly something that we will all be watching closely in December, when the FSA publishes its policy statement on the Remuneration Code.

For more information on the remuneration provisions and for updates on the development of the level 2 discussions visit our website at [www.deloitte.com](http://www.deloitte.com).



# Basel III reform

## Implications and opportunities for asset management

**Martin Flaunet**  
Partner  
Deloitte Luxembourg

**Alan Picone**  
Directeur  
Deloitte Luxembourg

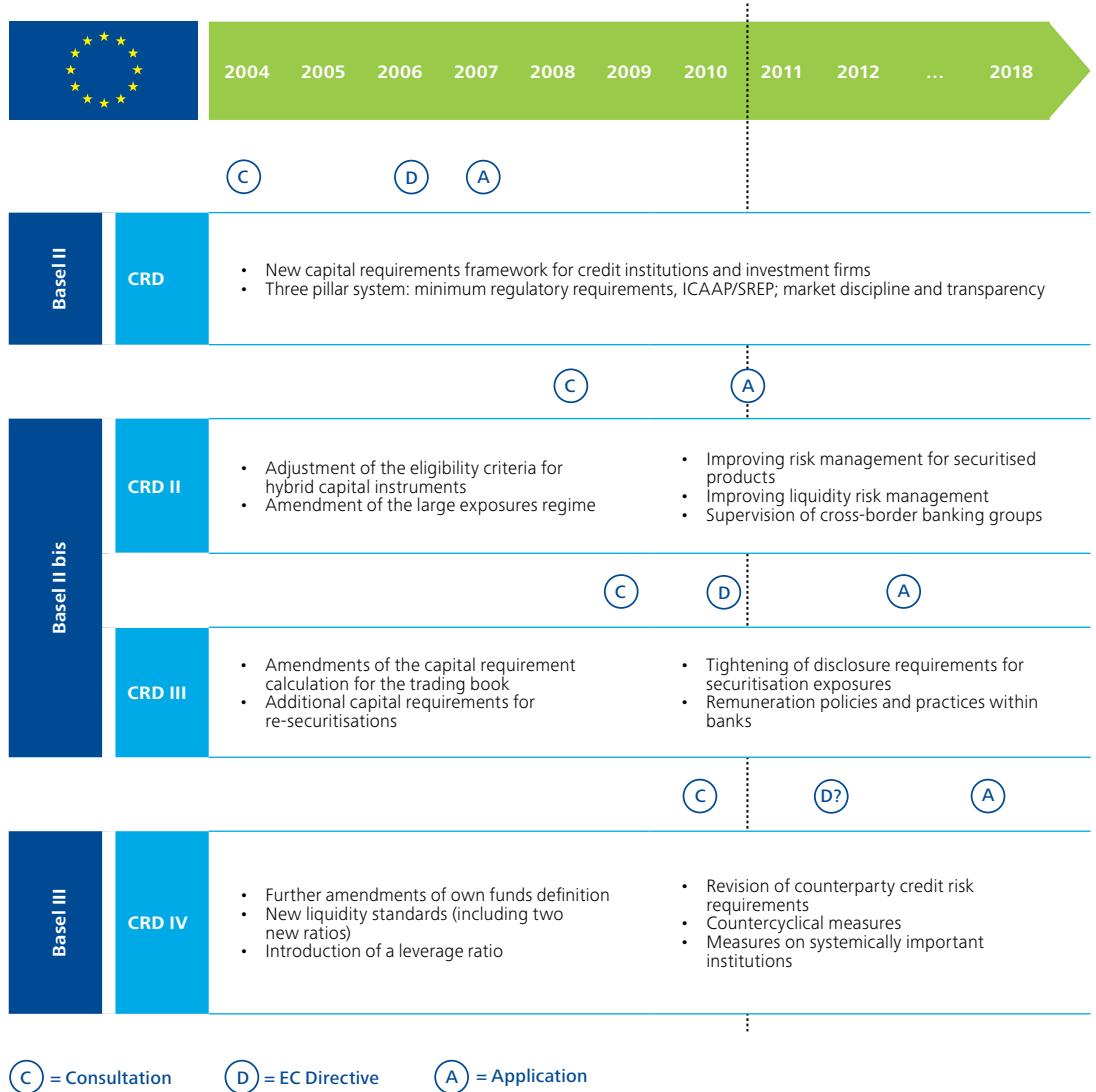
A new wave of regulation is underway and the rationale behind is somewhat simple: taking measures today to prevent history from repeating itself tomorrow.

### Background and regulatory evolution

Over the last three years, the Basel Committee on Banking Supervision (BCBS) has tried to debug the supervisory regime in order to address the roots for the failure of the financial system in western economies. At European level, this has resulted in a series of three directives amending the Capital Requirements Directive (CRD), the EU translation of Basel II. The last one (CRD IV) resulted in proposing a completely renewed framework, now commonly called Basel III, which was endorsed last November by the G20 summit.



This set of changes essentially pursues qualitative objectives to strengthen the resilience of the financial system with the following timeline:





**Basel III can be subdivided into seven main blocks:**

1. Reshaping the definition of eligible own funds, rationalising its classification, reinforcing tier 1, harmonising tier 2 and suppressing tier 3
2. Introducing a set of new guidelines for liquidity risk management, including new liquidity standards
3. Introducing a leverage ratio measuring leverage activity as a non risk-related matrix
4. Dealing with procyclicality through counterbalance measures focusing on forward-looking provisioning, capital conservation and building capital buffers in times of excessive credit growth
5. Strengthening counterparty risk requirements for derivatives and repo-style transactions
6. Defining measures to limit systemic risk implied by the existence of very large institutions
7. Harmonising the regulatory corpus applicable to banks at European level

Over the first semester of this year, these proposals have been heavily commented and criticised, especially based on the consequences for the economy in times of recovery and for the financial industry in particular. Most of the criticisms have been concentrated on the proposed rules on capital definition (including capital conservation buffer), the liquidity ratios (including eligibility criteria for liquid assets) and the leverage ratio (as non risk-related metric).

On a macroeconomic level, the cumulative impact on GDP of this regulatory reform has been estimated to a range between 0.4% and 3% for the period up to and including 2015. This impact mainly stems from a continued shortage of funding, an increased price charge to reflect incremental liquidity costs and a reduction of the available amount of lending impacting the real economy.

Regarding the financial services industry, we read almost everyday in the press figures related to capital injections. These figures range from zero arising from sound and/or optimistic current own funds situation of some banks to €50 billion for some more pessimistic institutions. The consequences of this reform on the level of capital requirements for institutions in the years ahead is undoubtedly quite uncertain, but the banking industry will definitely suffer from a conjunction of factors such as more costly capital, reduced lending capacity, costly funding leading to lower levels of profitability which will generate deep modifications of business models for both retail and investment banks' investments.

Likewise, in a press release dated 26 July 2010<sup>1</sup>, the BCBS has adjusted several parameters of the overall reform as a result of feedback from the industry. More significant is that the whole reform has been phased throughout a transition period which will continue over the next eight years.

<sup>1</sup>[www.bis.org/press/p100726.htm](http://www.bis.org/press/p100726.htm)



## Timeline for the new regulatory minimums

	As of 1 January ...								
	2011	2012	2013	2014	2015	2016	2017	2018	2019
<b>Leverage ratio</b>	Supervisory monitoring		Parallel run 1 Jan 2013 – 1 Jan 2017 Disclosure starts 1 Jan 2015				Migration to pillar 1		
Minimum common equity capital ratio			3.50%	4.00%	4.50%	4.50%	4.50%	4.50%	4.50%
Capital conservation buffer						0.63%	1.25%	1.88%	2.50%
Minimum common equity plus capital conservation buffer			3.50%	4.00%	4.50%	5.13%	5.75%	6.38%	7.00%
Phase-in of deductions from common equity tier 1				20%	40%	60%	80%	100%	100%
Minimum tier 1 capital			4.50%	5.50%	6.00%	6.00%	6.00%	6.00%	6.00%
Minimum total capital			8.00%	8.00%	8.00%	8.00%	8.00%	8.00%	8.00%
Minimum total capital plus conservation buffer			8.00%	8.00%	8.00%	8.63%	9.13%	9.88%	10.50%
Capital instruments no longer non-core tier 1 capital or tier 2 capital			Phased out over ten year horizon beginning 2013						
<b>Liquidity coverage ratio</b>	Observation period				New minimum standard				
<b>Net stable funding ratio</b>	Observation period							New minimum standard	

### The asset management industry perspective: challenges...

For the asset management industry, this reform will affect the current business models, putting the industry under pressure but also allowing some opportunities in enabling the banking industry to address some of the regulatory changes.

First of all, UCITS are not treated advantageously under the forthcoming liquidity ratios:

- The Liquidity Coverage Ratio (LCR) includes the narrow definition of 'high quality liquid assets' which could drive some outflow from the asset management industry. This definition was amended in July: it is still restrictive to sovereign debt instruments qualifying for a 0% or 20% risk weight and PSE qualifying for a 20% risk weight under the current regime. UCITS which are characterised by their quite high liquidity requirements are excluded from this mandatory pool of assets.
- Furthermore, on the other side of the LCR, the stress-test scenarios which are supposed to map outflow of resources, have been recalibrated in particular for operational activities with financial

institution counterparties. These activities are still stressed with a 25% outflow bucket, covering custody, clearing and settlement activities, as well as selected cash management activities. The run-off factor applied to this bucket is still quite heavy, and the implementation of this rule will be subject to specific supervisory approval before the funds specifically related to those activities could be considered 'operational' (i.e. not all funds from the counterparty would qualify). On top of these constraints, contractual cash inflows from intra-group exposures, for example, may not be taken into account for the calculation of the net liquidity inflows. Custodian banks, usually long in resources and providing liquidity to their group, will thus be required to locally maintain and manage a stock of high quality liquid assets to square potential liquidity outflows from their funding sources, as inflows from the mother company may not be considered. This will also require the institutions to gather and monitor data on resources from their institutional clients in order to undergo regulatory approval.

- The complementary standard, the Net Stable Funding Ratio (NSFR), addresses long-term structural liquidity mismatches and is consistent with its short-term 'brother' since investment funds are not considered as an available 'stable funding category'.

**Two new ratios will be made mandatory as part of pillar I:**

Liquidity Coverage Ratio	$\text{LCR} = \frac{\text{Stock of high quality liquid assets}}{\text{Net cash outflows over 30-day horizon}} \geq 100\%$	<ul style="list-style-type: none"> <li>• Aim to strengthen short-term liquidity profile</li> <li>• Defines level of liquidity buffer to be held to cover short-term funding gaps under severe liquidity stress</li> <li>• Cash flow perspective</li> <li>• Predefined stress scenario</li> <li>• Time horizon: 30 days</li> </ul>
Note: To be applied as from 2015		
Net Stable Funding Ratio	$\text{NSFR} = \frac{\text{Available amount of stable funding}}{\text{Required amount of stable funding}} \geq 100\%$	<ul style="list-style-type: none"> <li>• Aim to strengthen medium-to long-term liquidity profile</li> <li>• Defines minimum acceptable amount of stable funding in an extended firm-specific stress scenario</li> <li>• Balance sheet perspective</li> <li>• Predefined stress scenario</li> <li>• Time horizon: 1 year</li> </ul>
Note: To be applied as from 2018		

Furthermore, the leverage ratio is simplistic as it ignores the quality/risk of assets. As a consequence, and being part of pillar I, the leverage ratio will imply more capital to be held by institutions without any risk justification. This could lead to inefficient risk management practices. The leverage ratio also ignores the business models of the institutions. Treating all types of leverage equally, based on notional amounts/accounting figures, may have adverse effects on custodian banks which usually have a low risk profile and sound interbank and collateral management procedures.

Thirdly, the large exposures regime has been amended (CRD II), removing many of the previous exemptions and establishing a new limit system which imposes more stringent rules on the group of connected clients. To address the potential challenges for credit institutions caused by this new large exposures regime, collateral management practices could be improved, as credit risk mitigation techniques to reduce exposures are still recognised. In fact, in order to maximise the advantages of the credit risk mitigation techniques, it is essential to consider the collateral portfolio as a whole and to monitor it with the same care and principles used to manage the firm asset portfolio. This is particularly relevant for custodian banks in order to mitigate/reduce large exposures resulting from overdrafts from investment funds: these overdrafts are mostly unexpected and usually very significant in amounts.



### ... and opportunities

On the other hand, the reform also creates more stringent rules in how assets will have to be managed: a greater amount of assets will have to be kept for regulatory purposes and this creates a variety of opportunities for asset management professionals.

---

The foundations of the CRD amendments logically increase the role and importance of risk management, but also of asset management within banking institutions.

First, **more restrictive asset eligibility criteria** for liquidity purposes increase the need for efficient processes in securities picking and portfolio optimisation in order to maintain a sustainable level of profitability.

Secondly, CRD IV also aims at a dynamic process of accumulation and utilisation of reserves (**countercyclicality**): from an institution perspective this means **forward-looking dynamic capital provisions** on top of the static capital charge. In other words capital shall be stored, 'when cows are fat', with a view to be liberated to help sustain times 'when cows are lean'. It is evident that these provisions still need to be embedded in a proper asset management process: while return on static and countercyclical provisions should be achieved, it must be ensured that a predefined risk envelope is respected to ensure ongoing compliance with minimal capital requirements.

Thirdly, the asset management industry will have to understand and adapt to this set of new rules in order to optimise asset allocation of its products, but can potentially extend the **use of Capital Adequacy Ratios (CAR) as a distribution incentive**. This is of course highly dependent on the final papers that the BCBS will issue before the end of the year.

The foundations of the CRD amendments logically **increase the role and importance of risk management**, but also of **asset management** within banking institutions; be it due to the amended definitions capital, the new large exposures regime, liquidity risk requirements or countercyclical capital buffer. Some institutions will even have to **learn a brand new business** to adapt to this new reality: **managing a large portfolio of assets**.

# Solvency II challenges related to asset management

**Xavier Zaegel**  
Partner  
Deloitte Luxembourg

**Mickaël Durand**  
Manager  
Deloitte Luxembourg

As of end of October 2012, Solvency II will be effective and will offer insurance companies an incentive to better measure and manage their risks exposures. The new system will include both quantitative and qualitative risks and will have tremendous impacts on insurance companies' current risk monitoring.

However, this should not be considered as a major challenge for insurers only, as several provisions of Solvency II will lead to consequences for asset managers' offers and relationships with insurance companies.

Solvency II is organised on the same principles as Basel II concerning credit institutions, under the three pillars framework which cut across the different types of risks insurers may face. Pillar I introduces two capital requirements on regulatory capital requirements :

- Minimum Capital Requirement (MCR) representing unacceptable risk for policyholders and thus requiring supervisory action (calculated with a simple formula)

- Solvency Capital Requirement (SCR) indicating the target capital an insurance company should reach in order to absorb significant losses over a specified time horizon with reasonable assurance to policyholders that payment will be made when expected

One of the key provisions of the Directive is the requirement both for assets and liabilities to be valued either at mark-to-market or mark-to-model approach. As a consequence, insurance companies will put the emphasis for asset managers on the quality of data used for valuation, valuation model validation and adequate documentation.

In order to determine SCR, insurers will have to assess all their risks exposures, i.e. health, default, life, non-life, intangible, operational and market risks, according to level 2 implementing measures from the European Commission (EC). The EC has requested the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) to run the Quantitative Impact Study (QIS) 5 to define technical specifications in the calculation of the SCR. SCR can be calculated through the use of the standard formula or approved proprietary models, which need to be developed based on in-depth knowledge of the insurance company's operational and risk profile.

The capital charge (i.e. the SCR) is computed by mapping all assets and liabilities insurers may have to different kind of market risk exposures and further observing changes in the Net Asset Value (NAV), i.e. asset – liabilities following pre-defined scenarios. The latter aims at reflecting the impact of a shock or a stress-test on specific variables on the market value of the NAV, such as credit spreads, increase in interest rates, decrease in real estate values, etc.

Besides, a correlation matrix aggregating all these risks is used to determine the SCR for market risk.

Through Collective Investment Funds (CIF) offered to insurance companies for their asset liability management needs, asset managers are directly concerned by such specifications, as these will require a more active role in the assessment of the market risk, which is part of the SCR and encompasses interest rate, equity, property, spread, currency, concentration and illiquidity risks.

In order to assess the market risk inherent in CIF, an analysis of the economic substance will need to be completed, i.e. applying a **look-through** approach in order to assess all risks affecting the underlying assets of the fund whenever possible. In the case of fund of funds, i.e. when a CIF invests in another fund, iterations should be performed to ensure that all risks are captured. This will require the asset managers to be able to provide all the necessary information and market data as regards to their CIF assets and risks borne by them. This is quite similar to Basel II regulations regarding calculating credit risks created by CIF in the non-trading book of credit institutions.



As an example, a convertible bond CIF carries several kinds of market risks, such as interest rate, equity, spread, currency risks, for which insurers may require asset managers to provide information to perform their capital requirement calculations according to pre-defined scenarios.

When the CIF is not sufficiently transparent to perform the look-through approach, QIS 5 foresees the mandate-based approach in which one has to assume the CIF invests in accordance with its mandate in a way to produce the maximum overall capital requirement for the CIF.

Asset managers may face an increasing pressure from their insurance clients as the latter will ask for more transparency and less capital consuming investments.

We believe asset managers that will most benefit from Solvency II regulations will be those:

- Developing CIF designed to optimise the capital requirement for a targeted level of return
- Ensuring high level quality of data and potentially additional data/reports they will have to provide to insurers, which will imply contractual agreements and investment management mandates reviews for compliance with Solvency II. Asset managers will further have to perform these due diligences with any third party they are working with

---

## Winners will be those identifying key issues and accompanying their insurance clients to solutions offering the best capital saving/expected return ratio.

Finally, when the two above-mentioned approaches are not feasible, CIF should be considered as an equity holding and therefore equity shocks should be considered to determine the SCR of these CIF. According to the scenario described in the QIS 5, equity shock would be 30% if CIF is only made of equities listed in the European Economic Area or in an Organization for Economic Co-operation and Development (OECD) country or 40% in all other cases.

Thus, holding CIF from the insurers perspective can be very capital consuming for their regulatory provisions and therefore, damaging for asset managers as we may observe shift in investments decisions into more 'Solvency II friendly' assets. There is a potential threat especially for asset managers of private equity funds and hedge funds for which their clients' transparency requirements used to be balanced with confidentiality of their investments strategies.

Opportunities may also exist in the calculation of technical reserves, as QIS 5 foresees, aside of the well-known best estimates/risk margin approach by actuaries, the possibility to use market value of traded financial instruments which replicate reliably the uncertainty in amount and timing the cash flows associated with insurance obligations. As an example, for non-life catastrophe risk, one could use under specific conditions, market value of cat bonds to value technical reserves linked this specific underwritten risk. Therefore, asset managers have tremendous possibilities in the financial engineering are to think and develop financial instruments (such as cat bond, life settlement fund, etc.) that will fulfil CEIOPS requirements as potentially, technical provisions would be lower than the ones computed using the best estimates/risk margin approach.

Implementation of the Solvency II Directive for the insurance sector is not a simple compliance exercise, but an opportunity for the industry to review their entire risk procedures and how the business is conducted within an enterprise risk management approach. Asset managers should not underestimate the impact of the Directive on their own business and consequences on how they run their business with insurers. Winners will be those identifying key issues and accompanying their insurance clients to solutions offering the best capital saving/expected return ratio.





# FIN 48 – One year on

## What have we learnt?

**Deirdre Power**  
Partner  
Deloitte Ireland

In July 2006 the Financial Accounting Standards Board (FASB) in the U.S. released an interpretation (FIN 48) with the goal, through the use of consistent criteria, of reducing diversity in approaches to recognising, measuring and presenting income taxes for uncertain tax positions under US GAAP.



## Background

Initially the interpretation was applicable only to public companies issuing US GAAP financial statements for calendar years ending 31 December 2007 and subsequent years; however, after a reprieve that lasted almost three years, the standard is effective for all non-public companies for annual periods beginning after 15 December 2008.

The interpretation applies to all 'tax positions' related to income tax subject to FAS 109 and outlines clearly that, for a tax position to be recognised, it must have a 'More Likely Than Not' (MLTN) chance of being pursued on its technical merits by a relevant tax authority. Once a MLTN position has been established the next task for a fund is to assess the amount of the exposure to be recognised.

FIN 48 is almost certainly amongst the most significant tax developments to affect investment funds in a number of years. Many funds are now reviewing FIN 48 exposures one year on. This article outlines the key lessons learnt from reviews to date.

Although FIN 48 does not directly apply to funds reporting under IFRS, the tax issues highlighted by FIN 48 are relevant to all funds in all jurisdictions. IFRS will soon be updated to incorporate similar provisions, however, even in the absence of these regulations, all funds should be considering the tax exposures relevant to their investments. These tax exposures can include withholding taxes and capital gains taxes over many years in multiple jurisdictions. This presents a key challenge for funds to keep abreast of tax law in each jurisdiction in which investments are held and to quantify exposures and provide for material uncertain tax positions on an ongoing basis.

We should not lose sight of the fact that these requirements serve to highlight good procedures which should already be in place. Where these procedures are absent, it is the responsibility of every fund to implement appropriate structures to manage these risks.

In examining a fund's tax position, the key areas to be reviewed include:

- The relevance of possible exposure
- The location of the investment and tax residency of the fund

- The taxes to which the investment is exposed and the quantum of same
- The party responsible for the FIN 48 analysis
- The administrative practices in relevant jurisdictions
- The disclosure requirements for an uncertain tax position

## Relevance

The first issue funds face with regard to FIN 48 is the task of assessing the tax exposures that funds may have. To do this, a fund will be required to review existing investment structures and consider the tax treatment and status of each investment, e.g. equities, bonds, exchange traded funds, swaps, etc. When looking at the possibility of an exposure for the first time, a fund should look at whether each of their investments is material enough to warrant a FIN 48 analysis in its respective jurisdiction, as incurring the cost of a FIN 48 analysis is not logical should the amount of investment held be immaterial. Funds should also look at how the investment is held, i.e. is it held through CFDs, prime brokers, etc. as this will have an impact on whether a fund is exposed to taxes in a particular jurisdiction. This is worthwhile as, in some jurisdictions, because of how the investments are held, the fund does not fall into the tax net. An example of this is Spain, where fund investments held under certain prime broker arrangements may not give rise to a technical liability to the fund for such taxes.

Often the board of directors engage the funds tax advisers to perform a high level review of the portfolio of investments in order to highlight any known or potential tax risks or exposures. This typically includes consideration of any tax issues identified during any earlier due diligence process.

After the initial high level review, the board of the fund can then consider the jurisdictions in which they potentially have exposures and seek opinions from their tax advisers as to whether they are required to provide for the potential exposure.

Another option open to the board is to obtain a ruling from the tax authority in a jurisdiction certifying that it is not MLTN and that the entity will be required to pay tax in the jurisdiction. This will give the entity a definitive basis for not providing for any possible exposures in the said jurisdiction.



### Location

In order to correctly identify tax exposures in each jurisdiction of investment, funds should first look at the location of each investment held, including country of registration and the relevant stock exchange where the investment is listed. This will indicate the jurisdiction which has the authority to impose taxes on income and gains arising from the investment.

The fund should also consider its own tax residency status. Investment funds are usually treated as being resident for local tax purposes, if effective management and control of the entity is exercised in that location. The goal of the fund's board is usually for the tax residence of the fund to remain in the country of establishment. In order to maintain the residence status of the fund in jurisdictions that provide more favourable tax conditions and avoid potentially unfavourable FIN 48 disclosure requirements, the fund will need to introduce and implement robust control policies to ensure the management and control continues in the jurisdiction in which the fund was established.

Along with the concerns around the tax residency of the fund, another issue that requires consideration is the risk that the fund may create a potential Permanent Establishment (PE) in the countries in which it operates. As an investment manager has discretion to undertake transactions on behalf of a fund, which may give rise to a PE for the fund in the country where the investment manager is located. Therefore, the fund should consider the activities of their service providers and also review the permanent establishment laws in the jurisdictions in which they operate to determine if such a PE exposure might exist.

Another issue to be considered when looking at the relevant jurisdictions is whether a tax treaty exists with such a jurisdiction. Where a treaty exists, consideration of whether the fund can gain access to the benefits of the treaty must be determined. In this regard, for example, although a treaty exists between the UK and Ireland, the UK authorities currently do not tend to permit gross roll up Irish funds to avail of the treaty rates. Therefore, the fund needs to ensure that the investments will be able to obtain the more favourable tax rates contained in the treaty, based not just on the wording of the treaty, but also on current revenue practice and application.

### Taxes on investments

Where investments are concerned, there are two main taxes that a fund could become exposed to when investing in jurisdictions. These are withholding tax on income/distributions and capital gains tax on disposals. These taxes should be addressed separately in each jurisdiction. The fund should also investigate if there are other taxes, such as transaction taxes, that exist in the relevant jurisdictions that the fund may become exposed to, as they may also need to be considered.

In assessing the relevant taxes that the fund may be exposed to, the board should also look at the possible penalties and interest that may apply to the late payment of these exposures, and provide for these, along with any uncertain tax positions. In addition, tax authorities can impose tax for past years under their relevant legislation and apply interest and penalties to the cumulative potential liability, which could be material in the context of the net asset value of the fund.



### **Responsible party**

Where investments are held in foreign jurisdictions the responsible party performing the FIN 48 analysis should be identified. This responsibility initially falls on the fund and its board, who will then gather advice from their investment manager and other third party advisers, such as the custodian, tax advisers, etc.

### **Administrative practices**

The interpretation permits an enterprise and its auditors to take into account 'past administrative practices and precedents of the taxing authority in its dealing with the enterprise or similar enterprises (that) are widely understood'. In this regard, another option for the funds is to look at the past administrative practice of the tax authority in the particular jurisdiction. An example of a jurisdiction in which this is currently occurring is Australia. It has been noted that due to a longstanding administrative practice the Australian tax authorities have not pursued such liabilities, some funds may take the position that a provision is not warranted.

### **Disclosure requirements**

In addition to assessing the possibility of potential tax exposures in jurisdictions, FIN 48 has a number of additional implications and concerns for a fund. A major concern facing a fund's board has been the level of disclosure required in light of FIN 48 and its impact on the ultimate outcome of negotiations with tax authorities. There is a concern that FIN 48 has resulted in increased transparency of a funds tax exposure in many jurisdictions, which could in turn lead to tax authorities reacting to a local disclosure by pursuing such taxes, where previously they may not have done so.

### **Best practices**

In order to ensure compliance with this interpretation, a fund should put in place a set of best practices, if not already present, that will be rolled forward on a yearly basis. This work will be most significant in the first year, as all previous years that are not time barred may need to be reviewed and documented. Such work will include the documentation of all possible uncertain tax positions, along with the recognition position and measurement amount of each uncertain tax position. It will also include summaries of potential penalties and interest relating to each position. A relevant disclosure note to the financial statements will also need to be prepared. Although this work is quite significant in the early stages, once the initial work is done in the first year and best practices have been established, the work in subsequent years should be more manageable.

### **What have we learnt?**

One year on, we can certainly see that FIN 48 has put a spotlight on tax as an important consideration in the management of investment returns. It has led to many funds monitoring jurisdictions in which they operate and further being more proactive in assessing the implications of investing in new jurisdictions. It is clear that taxation should be a key consideration for all funds and it should be under constant review with particular attention to materiality, changes in tax legislation and the administrative practices of tax authorities around the world.

While FIN 48 may have been a shock to the system over the last twelve months or so, it has led to funds fine tuning the investment decision to also include a tax analysis, as well as resulting in enhanced procedures to manage any exposures. Over the next few months, when finalising accounts for many 31 December year ends, we see the true lessons learnt and progress made as a result of the FIN 48 tax debate.

# The FATCA effect

David F. Earley<sup>1</sup>  
Senior Manager  
Deloitte U.S.

On 18 March 2010, the Hiring Incentives to Restore Employment Act, commonly known as the 'HIRE Act', was enacted.<sup>2</sup> The HIRE Act includes various provisions referred to as the Foreign Account Tax Compliance Act, or 'FATCA'.<sup>3</sup>

The FATCA provisions expand information reporting requirements for specified financial institutions and impose withholding and documentation requirements related to payments with respect to certain accounts. While additional federal guidance is anticipated, managers of investment vehicles should perform specific action steps now to begin preparing for compliance with these new obligations.

## Backdrop

An appropriate tax policy objective is to establish tax compliance procedures such that a level playing field exists for all persons subject to the tax system. The FATCA

provisions represent an important development in this area with respect to tax information reporting, compliance, and collection.

On 8 July 2009, the U.S. Treasury issued a report titled 'Update on Reducing the Federal Tax Gap and Improving Voluntary Compliance'<sup>4</sup>, which the Internal Revenue Service (IRS) posted online under their tax gap resource page<sup>5</sup>. Based on 2001 tax data noted in that report, and calculated in 2005, the IRS estimated the total net tax gap, defined as the total tax liability minus voluntary and enforcement collections, at US\$290 billion. This estimated tax gap was almost 14% of the total estimated 2001 tax liability.

<sup>1</sup> The author thanks James N. Calvin, Edward Dougherty, and Julie Canty of Deloitte Tax LLP for their invaluable assistance. This publication contains general information only and Deloitte is not, by means of this publication, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This publication is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional adviser. Deloitte, its affiliates and related entities, shall not be responsible for any loss sustained by any person who relies on this publication.

<sup>2</sup> Pub. L. No. 111-147, (H.R. 2847).

<sup>3</sup> See Title V, Subtitle A of the HIRE Act, and specifically Section 501 of the HIRE Act.

<sup>4</sup> See [http://www.irs.gov/pub/newsroom/tax\\_gap\\_report\\_final\\_version.pdf](http://www.irs.gov/pub/newsroom/tax_gap_report_final_version.pdf).

<sup>5</sup> See <http://www.irs.gov/newsroom/article/0,,id=158619,00.html>.

The IRS breaks the tax gap into three components: (1) underreporting, (2) underpayment, and (3) non-filing. By far the largest component of these three is under reporting, which the IRS describes as where a return has been filed timely, but the full tax liability has not been reported accurately. One example of under reporting would be where a U.S. taxpayer has earned income in an offshore account but has not included this as taxable income on their U.S. tax return.

The information reporting required under FATCA addresses certain offshore account activities of U.S. persons. This information reporting is expected to provide additional transparency and allow the IRS to trace and match income earned within a foreign financial account to a U.S. taxpayer who earned it. According to the Third Party Reporting Information Center, maintained by the IRS, this type of information and data enhances taxpayer reporting accuracy and directly reduces the tax gap.<sup>6</sup>

The 2009 report goes on to state that the current Administration and Congress are working closely to narrow the tax gap, and describes the primary purpose of the report as providing a comprehensive overview of efforts to close the gap. The first element the report outlines as part of a seven-part strategy involves reducing

*"opportunities for evasion"*— one component of which is the *"Administration's proposals and efforts to combat under-reporting of offshore income."* The report states: *"The President has made addressing under reporting of income earned or held through offshore accounts or entities a top priority for his Administration."* Increased enforcement, enhanced ability to identify offshore 'tax schemes', and engaging in voluntary disclosure initiatives for taxpayers with undeclared offshore accounts are all listed as components of the overall strategy in closing the tax gap. The new reporting and withholding obligations under FATCA are an important part of this effort to narrow the tax gap.

#### **Foreign Financial Institutions and FATCA**

Foreign Financial Institutions (FFIs), which include virtually all offshore investment vehicles, will be required to enter into an agreement with the U.S. Treasury if they do not wish to be subjected to a statutory 30% withholding rate on certain payments from U.S. sources.<sup>7</sup> This agreement with the Treasury will obligate the FFI to collect specified investor account data from all investors and will also require the FFI to file an annual report with the IRS; this report will include certain information on each account held, directly or indirectly, by certain taxable U.S. owners.

<sup>6</sup> <http://www.irs.gov/taxpros/article/0,,id=225080,00.html>.

<sup>7</sup> Internal Revenue Code ('IRC') §1471(a).



---

In order for managers of investment vehicles to be in a position to enter into an agreement with the Treasury and meet the data collection, review, and reporting requirements associated with their U.S. account holders, assessment of the impact of the FATCA provisions and early preparation are specific action steps that fund managers should begin now.

To satisfy these reporting requirements each FFI enters into an agreement with the U.S. Treasury must obtain and report for each of these U.S. account holders the name, address, taxpayer identification number, account number, account balance or value, and information related to gross withdrawals and payments from each account.<sup>8</sup>

In return for agreeing to these reporting obligations, the FFI can avoid having 'withholdable payments' made to it become subject to a 30% withholding requirement under FATCA. The types of payments included as withholdable payments are broad and include: interest, dividends, rents, salaries and other gains, profit, and income from U.S. sources.<sup>9</sup> Importantly, withholdable payments also include gross proceeds from the sale of any property of a type which can produce interest or dividends from U.S. sources and 'portfolio interest' that currently would not be subjected to withholding under the current withholding rules. As the amount of withholding could be significant, as well as for counterparty business requirements, it is anticipated that virtually all FFIs, whether or not they receive payments from U.S. sources, will enter into agreements with the U.S. Treasury and satisfy the reporting requirements under FATCA.

#### What can, and should, hedge funds do now?

The 30% withholding provisions of FATCA are effective for payments made after 31 December 2012. In order for managers of investment vehicles to be in a position to enter into an agreement with the Treasury and meet the data collection, review, and reporting requirements associated with their U.S. account holders, assessment of the impact of the FATCA provisions and early preparation are specific action steps that fund managers should begin now.

Hedge funds and other financial institutions can begin to (1) identify and classify the numerous types of investors and account holders they have, (2) gain an understanding of the initial documentation requirements and begin the data collection process, (3) develop a process for reviewing new account openings and remediate existing accounts at periodic intervals to address compliance with the rules of FATCA, including adding provisions to fund legal documents requiring new investors to provide the necessary information required to comply with FATCA requirements, and (4) perform due diligence on the FATCA readiness plans of fund administrators and all third party payors and payees along each funds' chain of payments to confirm that investors are not inappropriately subject to multiple layers of withholding taxes. Any error in compliance along the chain of payments, including one committed by a third party such as an administrator or custodian, can cause withholding to apply to payments before reaching investors.

Additional formal guidance from the IRS is anticipated to clarify, amplify, and finalise the compliance reporting process that FFIs will need to undertake. A recommended approach is to begin assessing the likely impact on an organisation as soon as possible. This should prepare the organisation for an orderly implementation and remediation of FATCA compliance requirements so the potential disruption to investors and the business can be managed. For additional information please visit Deloitte's FATCA resource library at [www.deloitte.com/us/fatca](http://www.deloitte.com/us/fatca).

<sup>8</sup> See Section IV, Reporting on U.S. Accounts, in IRS Notice 2010-60, 2010-37 I.R.B.

<sup>9</sup> IRC §1473(1)(A).

## Hot off the press

### FATCA – EFAMA meeting with U.S. Treasury and IRS in the course of December

The objective of the meeting was to explain the concerns of the European fund industry, to detail the specificities of the European IM market and to explain the different propositions previously made by EFAMA to U.S. authorities in order to clarify the impact of FATCA on EU investment funds.

If the meeting did not allow the clarification of whether the propositions made by EFAMA will be retained, other significant information could be obtained:

- EFAMA members will initiate political discussions with their various governments on this matter
- EU Commission will start discussing impact of FATCA with U.S. authorities before year end
- U.S. authorities plan to issue a new set of draft regulation for comments in the 1st quarter of 2011
- EFAMA particularly insisted that the draft regulation should find appropriate solutions regarding Exchange Traded Fund and Passthrough Payments

It is highly recommended to follow up those developments in the coming months as all investment funds, as well as entities being part of the chain of payment of investment funds, should be compliant with the new regulation as from 1 January 2013.

### EU Directive on exchange of information and impact on investment funds

At the last ECOFIN meeting held on 7 December 2010, EU finance minister agreed on a Directive on administrative cooperation in tax matters between member states.

All EU investment funds are impacted by this new Directive that should enter into force :

- On 1 January 2013, when the exchange of information on demand (as currently covered in bilateral tax treaties) will be extended to all EU countries
- On 1 January 2015, when automatic exchange of information will enter into force. However, the automatic exchange will be restricted to 5 categories of income realised as from 1 January 2014 and only to the extent that information on the income derived by non residents is readily available for local tax authorities:
  - a) Income from employment
  - b) Director's fees
  - c) Life insurance products not covered by other Community legal instruments on exchange of information and other similar measures
  - d) Pensions
  - e) Ownership of and income from immovable property

In 2017, the EU Commission may propose to extend the scope of the automatic exchange of information to include dividends and capital gains.

This Directive comes in addition to the EU Savings Directive (EUSD) that is due to be revised.

In a statement, the EU Commission mentioned that it will closely monitor member states' correct and effective application of EUSD. An ad hoc report will be presented no later than mid-2011 by the Commission, who will also review the correct and effective functioning of the agreements with third countries, examining whether changes to these agreements are necessary, taking into account international developments.

The EU Commission confirmed its commitment to the promotion of exchange of information both within the EU and through relevant agreements between the EU and third countries.

## To be covered in our next edition

- Evolution of fixed income in the light of new products popularity (e.g. OTC)
- Role of open architecture/fund supermarkets within the cross border distribution activity
- QDII/QFII related challenges for the funds industry
- New tax regulation in Germany
- Fixed TER concept in investment funds



