Revisiting transfer pricing for asset managers in the current economic environment

The COVID-19 pandemic has ushered in a new normal for both traditional and alternative asset managers. The sector has seen the combined effect of large asset outflows, a further tilt towards passive products, and lower asset valuations that are reducing the stream of management and potential performance fees. For alternative funds, the pandemic has also affected the quality of investment assets (e.g., considering its broader impact on the commercial real estate sector), triggering transfer pricing questions regarding underlying financing arrangements that are inherently linked to the quality of the financed assets.

In this article, we examine the transfer pricing impact of this new normal on regulated entities in the asset management sector, including the tax treatment of loss situations and support payments, as well as emerging regulatory considerations.

Impact on regulated entities

The pandemic's economic impact is a catalyst for asset managers to review whether their existing transfer pricing models are still appropriate to remunerate key functions and risks across their business' value chain. This covers the functions performed and risks borne by regulated management companies (ManCos) or alternative investment fund managers (AIFMs), as well as investment management and sub-advisory, capital raising/distribution, and fund administration functions.

While the full value chain subsists in a downturn, the total fees available to remunerate each activity may not suffice. The practical challenge is how to cope with reduced management fees and potential loss situations, especially for regulated entities like ManCos and AIFMs. Loss situations can result from implied losses (e.g., where the fee share allocated to ManCos/AIFMs under fee-split models are insufficient to cover their operation costs) or actual loss splits (e.g., where profit-split models on the alternative side turn into a loss split).



In Luxembourg, this mostly affects regulated ManCos/AIFMs that are set up under a delegation model. This is where the ManCo/AIFM is focused on the core risk management, compliance and oversight functions, while delegating the investment management, capital raising/ distribution and fund administration functions to related or third parties.

The key question is whether it is acceptable for a regulated ManCo/AIFM to incur operating losses in the current environment or during startup situations.

First, this question is complicated by the liquidity and capital requirements of regulated entities. These regulatory requirements around own funds and minimum capital must be respected regardless of transfer pricing policies. A loss-making ManCo/AIFM risks eroding these requirements and, as a result, regulators would likely insist on additional capital injections.

Second, we can look towards fee arrangements with third-party ManCos/AIFMs to answer how potential loss situations would be addressed in the open market. Third-party management companies operating in the Luxembourg market, which offer risk management, compliance and oversight services to unrelated parties, usually charge a minimum fixed fee (i.e., a minimum compensation clause) for their services that is unrelated to the assets



under management (AuM). The rationale is to ensure that these third-party management companies do not operate at a loss and at least cover their operating expenses.

In essence, a flooring mechanism could be defined as cost coverage or a cost-plus remuneration at the level of a ManCo/AIFM, with the costs in question being the operating expenses of a ManCo/AIFM. This mechanism would supplement the primary transfer pricing methodology that determines the arm's length remuneration for a ManCo/AIFM, expressed typically as a basis point fee of the AuM or percentage of the total management fee. This supplementary mechanism would kick in if the primary methodology leads to insufficient remuneration to cover the operating expenses of a ManCo/AIFM.

A flooring mechanism follows the same rationale in a related-party context and, therefore, could be considered as arm's length. It ensures that a ManCo/AIFM does not end up in a loss situation in a downturn or during the startup phase when the AuM are relatively low. Therefore, a flooring mechanism ensures that own funds and required regulatory capital are not eroded at the ManCo/AIFM level.

Asset managers should review their transfer pricing arrangements and, in the case of regulated ManCos/AIFMs, consider potential floor policies (i.e., minimum compensation clauses) and support payments to avoid loss situations. In addition, we recommend that asset managers actively monitor the effective distribution of profits or losses across the value chain by combining existing price setting with outcome testing approaches to corroborate actual results.

Interaction between tax and regulation

Transfer pricing documentation should be created and updated regularly to support the transfer pricing of asset managers, given the impact of the new normal and especially where potential loss situations/adjustments need to be supported. It should come as no surprise that tax authorities would be interested in this documentation, especially if their jurisdiction needs to absorb some newly generated losses. Although Luxembourg does not explicitly require transfer pricing documentation currently, having this documentation available could shift the burden of proof from the taxpayer to the tax authorities in the case of potential challenges.

In addition, regulatory authorities such as the CSSF have recently been showing interest in transfer pricing policies, documentation and agreements. As part of their onsite visits, the CSSF has been asking asset managers to demonstrate their compliance with transfer pricing rules and to present transfer pricing documentation. Transfer pricing compliance aspects were taken to reflect the proper management and good governance of asset managers.

Going one step further, on 3 July 2020, the CSSF published Circular 20/744 to complement the existing Circular 17/650 of 17 February 2017. This new circular added elements specific to asset managers (referred to as investment fund managers). It provided guidance on the extension of money laundering to incorporate aggravated tax fraud and tax evasion, and on the professional obligations that apply to anti-money laundering and counter-terrorist financing.

The new circular contains a list of tax fraud indicators that regulated entities like Man-Cos/AIFMs must monitor on an ongoing basis. One of these indicators is compliance with transfer pricing regulations: "The investment fund manager's business model results in a significant decrease of the investment fund manager's taxable earnings by using cross-border transfers, triggering questions regarding compliance with transfer pricing rules and more generally with Luxembourg laws implementing directly or indirectly BEPS related actions. Such cross-border transfers can be:

- Financial flows (e.g., management or marketing commissions and/or retrocessions but also interest or dividend flows); and/or

- Intangible assets."

Therefore, the new circular confirms the previously informal understanding that compliance with transfer pricing regulations could be checked when assessing the proper management and good governance of regulated entities. It also further emphasizes the importance of adequate transfer pricing policies and documentation.

Conclusion

The current downturn caused by the COVID-19 crisis has raised some important questions about asset managers' transfer pricing policies and documentation. As it could be a stress test for existing transfer prices, it is recommended that asset managers assess the sustainability of their existing transfer pricing policies during times of downturn and beyond.

And, another good reason to revisit compliance with transfer pricing regulations is the regulatory authorities' increasing interest in this topic. With the publication of the new circular, it is highly recommended that every asset manager considers transfer pricing and the extent of its compliance with these rules.

Consistency is key in terms of transfer pricing policies applied before, during, and after the economic downturn, but also in the information presented to tax and regulatory authorities.

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Research in Finance

On the matching between fund scale and skill

The academic literature typically documents that there exists a negative relationship between fees and abnormal performance measured by residual alpha from the Carhart 4-factor model. As suggested by Berk and Green (2014), in a rational neoclassical equilibrium, expected alphas of investment funds should be equalized with fees so that after fee performance is similar across funds.

Strangely, a negative relationship between fund alphas and fund fees is observed, meaning that investment funds with lower fees have higher alphas. In principle, alpha is supposed to measure skills and the value added of asset managers. The negative relationship between fees and alpha leads to a situation where the less skilled funds charge higher fees. Different explanations are suggested by Gil-Bazo and Ruiz-Verdu (2009). First, fees might simply reflect operating costs of the fund and low-operating cost funds might have high before-fee risk-adjusted performance. This would thus explain the negative relationship. Different rationales are suggested. vestors are less sensitive to marketing material and the costs and time spent to convince them to invest in the fund might be higher. Moreover, distributors might ask for a premium for the extra-effort and eventual reputation risk they face.

The average alpha for US Mutual Funds after correcting for risk exposure to the Carhart 4-factors is -0.66% (Lettau and Madhaven (2018)). Easley *et al.* (2018) generalize the model of fund management developed by Berk and Green (2004) and further elaborated by Berk and von Binsbergen (2015), in order to analyze the economic forces affecting the forms of active and passive fund management. The main analytical determinants of the Fund Manager earnings are the benchmark return, the decline of returns due to size, the amount earned from skill, the cost per unit of invested capital and the fixed costs of operating the fund. the so-called Fama-French size and value factors as skill. This implies that inflows in those funds are too high compared to what should be expected by the skills of the manager, as measured by potential alpha generation. This excessive increase of inflows by increasing the scale of mutual funds for eventually nonskilled managers implies that those managers can be expected to generate future underperformance.

In order to more formally test factor related returns, the author uses a 7-factor model of fund returns as in Barber, Huang and Odean (2016), which is an enlarged version of Carhart's (1997) 4-factor model with the 3 industry factors from Pastor and Stambaugh (2002) added. The factor related return is then estimated from the average mean return stemming from those factors over the last months. The author then estimates the CAPM based alpha and by construction the latter can be decomposed into two components. It is the sum of the factor related average return and the residual alpha from the 7-factor model. Fund flows indicate that higher past factor related returns lead to large fund flows, indicating that investors seem to confuse factor related performance with active management skill. As for a given skill level the performance of funds decreases with assets under management due to scale effects, funds that benefit from excessive inflows have worse expected future performance. Econometric evidence indicates that this is the case across different levels of AUM. Pastor, Stambaugh and Taylor (2017) suggest that trading costs such as price impacts and execution costs are the main cause of negative returns to scale. This implies that the scale effect should be stronger for funds with higher trading costs and this result is confirmed by empirical analysis.

a fraction of funds that had high factor related inflows over the last years and are thus above optimal scale, leading to negative after fee alpha. The majority of funds, however, do not seem to be above optimal scale and thus generate positive after fee alphas. As the net after fee alpha is typically used to measure skill, this is good news for the fund industry as academic research typically indicates that the asset management industry generates little value added to society.

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First, economies of scale might lead to lower operating costs for larger funds and performance persistence might lead to better performing funds becoming larger. Also, better management skills might lead to better investment decisions and efficient management of fund operations. Second, fund investors might differ in their performance sensitivity. Funds with bad performance history face outflows and mainly stay with performance insensitive investors. In order to compensate for losses, they might increase fees which would lead to a negative relationship between risk-adjusted performance and fees. Finally, low-performing funds might face higher marketing and distribution costs. Insensitive inTypically, it is assumed that an active fund's performance is declining with size. Well-informed investors can also invest in purely passive funds that still would cost a few basis points per year. In a rational equilibrium with well-informed investors, the return after fees on an active investment fund should be equal to the return after fees on a passive investment fund. This implies that the analytical determinants alluded to above, condition the size of the funds and thus the industrial organization of the fund industry in equilibrium. The typical industry parameters are such that active funds have a higher amount earned from skills but the decline in performance is faster with size. It has been argued that this leads to an equilibrium size for active funds that is smaller than for passive funds.

A recent paper by Song (2020), however, sheds new light on the relationship between skills, performance and size. According to Berk and Binsbergen (2016) fund investors are less rational and sophisticated than postulated by the Berk and Green (2004) models. Many mutual fund investors misevaluate exposure to

The author also analyzes the implication of this factor related inflows and scale effect for the aggregate relationship between fees and performance. Interestingly, the empirical results indicate that negative aggregate performance of the fund industry is mainly driven by

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