

Alternative Asset Management

Quicknews

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Hedge funds operations

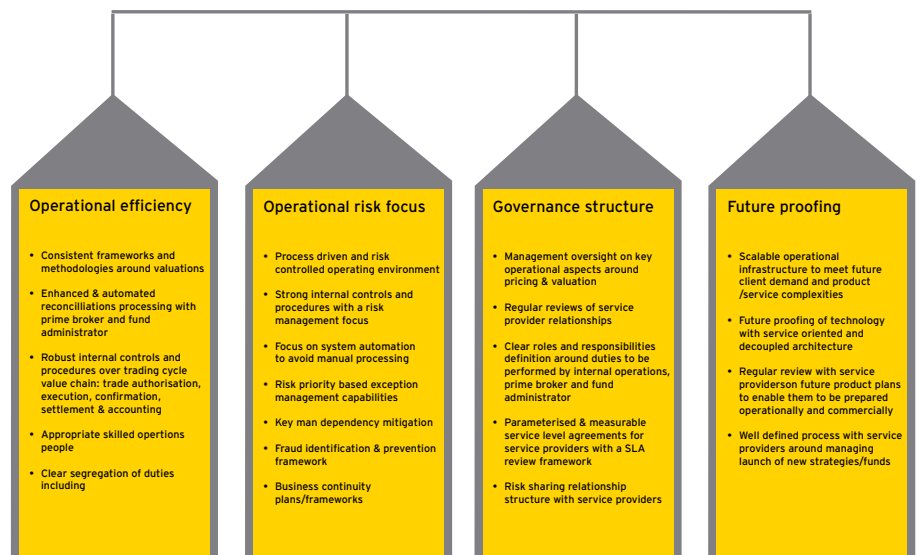
The hedge fund industry, specifically the 'large and aspiring to be large' hedge fund managers, are seeing a marked shift in their investor base from high net worth individuals to institutional investors. The proportion of institutional capital net inflow has significantly increased from 21% to 65% between the first half of 2007 and 2008 respectively (Source: Hedge Fund Research via Pensions & Investments Online).

In our experience, institutional clients are demanding higher levels of service and greater transparency from hedge funds at the level of operational governance over internal operations and from hedge fund service providers. Regulators are also insisting on improved controls infrastructure.

Additionally, we are seeing industry initiatives such as the hedge fund working group and AIMA recommending best practices for hedge funds around their internal operational structure and relationships with their service providers. A sound operational structure helps a hedge fund to adapt to the current environment and to be better placed to take on future opportunities and challenges; the diagram below offers a high level overview of the issues to consider.

We also recognise that future proofing operations from a process and systems perspective shows foresight in this dynamic industry. This will enable hedge funds to adapt to changing client requirements and product complexities as a bolt-on to existing capabilities. Future proofing may include using open systems, layered architecture, decoupled integration, data normalisation and rules-based workflow processing. Hedge funds with robust process and systems are better placed to gain additional investment allocations and are in the position to secure more favourable terms with their investors.

Leadership teams at hedge funds should ask themselves a variety of questions to understand where they stand with respect to the end goal of operational excellence. Operational excellence is rooted in the core operating model components of organisational efficiency and risks, governance structure, future proofing and people as discussed on the next page. Together, these deliver the categories of operational excellence outlined below.



Operational efficiency and risks

Do we have

- ▶ The processes in place to manage client expectations using consistent valuation methodologies at all times and providing mark to market/ model valuations?
- ▶ The processes and documents in place to demonstrate transparency of valuations?
- ▶ An infrastructure in place to meet institutional investors' demand of a daily indicative NAV to meet their internal performance measurement and risk reporting needs?
- ▶ Systems infrastructure and automation in place across the operations value chain?
- ▶ A scalable post trade infrastructure to meet future client demand and product complexities?

Governance structure

Do we have

- ▶ A process driven and risk controlled operational governance framework in place?
- ▶ The right level of management oversight on key operations functions like valuations and pricing?
- ▶ Robust controls and procedures with a risk management focus?
- ▶ Risk priority based exception management capabilities?
- ▶ Processes/ controls to manage reconciliation breaks around positions, transactions and pricing/valuations with the prime broker and third party administrator ?
- ▶ A compliance framework in place for fraud identification & prevention?

Future Proofing

Do we have

- ▶ An appropriate operational relationship management structure in place to manage and review the service provider relationships?
- ▶ The roles and responsibilities clearly defined for internal operations, prime broker and fund administrator?
- ▶ Measurable service level agreements ("SLA") for service providers with well-defined SLA review framework?
- ▶ A risk based relationship structure and a regular review process in place with your service providers?
- ▶ A clear understanding of your planned vs realised objectives of outsourcing to third party providers?

People

Do we have

- ▶ A breadth of senior operational leadership separate from the investment team?
- ▶ A strong operations team to manage the internal operations as well as oversight of service providers?
- ▶ The requisite operational expertise within our teams across all functions?
- ▶ Processes or a back up plan in place to mitigate any key man dependency risk?
- ▶ Roles and responsibilities which are appropriately defined within and across different teams?
- ▶ A clear segregation of duties to avoid any duplication or conflicts of interest issues?

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UK government consultation on investment management

On 28 July 2008, the UK Government published three consultation papers proposing various changes to tax rules in relation to investment funds established in the UK.

Distributors and other service providers should ensure they keep on top of the changes and that their systems can cope with implementing the new rules.

Tax Elected Funds (“TEFs”)

A new, elective tax regime for authorised investment funds (“AIFs”)¹ was proposed.

The key suggestion is that funds electing to be a TEF will be fully exempt from tax on all income and gains within the fund (subject to some exceptions).

To become a TEF, a fund will have to comply with the genuine diversity of ownership conditions and ensure that income remains identifiable as it passes through the fund to its investors. Such income will then be taxable on investors in accordance with the nature of the underlying income and may be subject to tax being withheld by the TEF.

The consultation paper accepts that it is unable to provide certainty with regards to the attitudes of double taxation treaty partners and the new tax status of AIFs.

Major breaches of any of the conditions required will result in loss of TEF status and funds will not be permitted to re-elect for TEF status.

Qualified Investor Schemes (“QISs”)

The current substantial holding rule provides that certain investors owning more than 10% of a QIS will be subject to tax annually on the fair value movement in their holding. Draft legislation to replace the substantial holding rule for QISs with a ‘genuine diversity of ownership’ rule was proposed. The aim is to improve the competitiveness of the UK as a location in which to launch AIFs; remove

tax as a barrier; and reduce compliance obligations for QIS investors.

The new rule will apply to all QISs, irrespective of the type of investor. This will bring pension funds and certain life insurance companies within the new regime. An optional advance clearance procedure will be introduced to help provide certainty.

Investment Trust Companies (“ITCs”)

The ITC industry has long argued that the tax rules applying to them make it inefficient to invest in fixed income assets through an ITC. Adapting the tax rules to enable an optional tax efficient investment in interest bearing assets was proposed. It suggests that ITCs investing in interest bearing assets will be able to treat part (or all) of its dividend distributions as an interest payment to investors. Such interest distributions will be tax deductible in the ITC while UK based investors will be taxed as if they had received a payment of interest.

The proposals are still in the early stages and many details that still need to be worked out.

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¹ Undertakings for collective investments in transferrable securities (“UCITS”), collective investments in transferrable securities, non-UCITS retail schemes or qualified investor schemes vehicles.



Japan Independent Agent reform

The Japanese independent agent exemption introduced with effect from 1 April 2008 is similar to the UK investment manager exemption ("IME"). The guidance, published recently by the Japanese Financial Services Agency, provides four tests which help to determine the independence of a Japanese Discretionary Investment Management ("DIM") entity from the offshore fund being managed and therefore prevent an offshore fund being taxable in Japan.

Detailed instructions test

Local investment managers should ensure that their activities are not subject to detailed instructions or comprehensive control by either an offshore fund or a foreign investment manager. This may be demonstrated by confirming that the local functions are 'high-value' or key entrepreneurial risk taking ("KERT") functions, as seen in transfer pricing.

Shared officers test

No more than 50% of the investment manager's officers should simultaneously serve as officers of either the foreign investment manager or the fund being managed.

Remuneration test

The investment manager should receive remuneration reflective of the value and risks it bears and be based on the volume and performance of the assets under management. This will require the arm's length standard, as seen for transfer pricing, to be applied in the vast majority of cases.

Diversification capacity test

The investment manager should have the ability to diversify its business or acquire new clients without fundamentally altering the way in which it conducts its business. The investment manager should have a sufficient level of specialist skill and knowledge to carry on an autonomous business that

is independent of the offshore fund it represents.

What to do now

The guidance is a positive step forward for investment managers operating in Japan, providing comfort regarding tax exposure. If you are operating as a DIM in Japan, it is recommended that analysis, including that of the transfer pricing policy, is performed to test compliance with the guidance. If you are presently operating as a non-discretionary investment manager in Japan, consideration should be taken with respect to both the tax (including transfer pricing) and non-tax issues which may arise from potentially changing a group's structure and/or functions to be classified as a DIM to meet the tests outlined above.

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Singapore IRAS circular - increased focus on transfer pricing

On 30th July 2008, the Inland Revenue Authority of Singapore ("IRAS") published a circular outlining its intention to enter into a transfer pricing ("TP") consultation with Singapore taxpayers to assess the level of TP compliance and to identify potential areas to further facilitate and promote good TP practices.

Summary of consultation process

- ▶ TP questionnaires to be issued to selected Singapore taxpayers.
- ▶ Field visits may then be conducted by the IRAS to understand the taxpayer's operations and review their TP documentation.
- ▶ IRAS will provide its opinion on the adequacy and timeliness of the TP documentation and suggest improvements and/or make arrangements with the taxpayer to review the issue at a later date.

Implications for fund managers

It will be interesting to see how the TP consultation will impact on the financial services industry, especially on fund managers in Singapore. The last few years have seen an influx of fund managers setting up operations in Singapore due in part to the tax incentives available for the funds and their managers.

TP issues have not been seen as a high-risk area for most fund managers, except where the adopted approach is overly aggressive. One of the key TP questions often faced by a fund manager in Singapore is whether or not the cost-plus method can be used to compensate sales, advisory or management functions. These approaches are expected to remain valid, though the TP consultation process may provide the IRAS with greater levels of market intelligence to challenge current TP practices in the future.

It is expected that the consultation will focus on situations where the taxpayers have had financial losses; is perceived to have applied an inappropriate TP method; or

had transactions with jurisdictions typically identified as 'tax shelters', ie, Cayman Islands, Bermuda, Labuan, BVI and Mauritius.

In view of the impending consultation (and we understand some questionnaires have since been issued), it is advisable for taxpayers to quickly assess the level of their TP risks and take the necessary steps to ensure that their TP policies are robust and that their TP documentation can withstand scrutiny from the IRAS.

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Offshore funds - key points from the current consultation

The partial draft regulations for the revised offshore fund regime attempt to codify the proposals for a new regime of offshore funds. We are broadly supportive of the changes but would like to see simple rules which give more certainty to investors.

Possible areas of concern

- ▶ New funds must make an application at least 42 days before the launch of the fund; this does not allow new funds and share classes to be launched quickly.
- ▶ The computation of reportable income relies on adjustments made in accordance with the IMA Statement of Recommended Practice for Authorised Investment Funds. This retains a number of the existing complexities (eg, accounting for derivatives, returns, and fixed interest securities; and whether the return is income or capital).
- ▶ The regulations for calculating reportable income are unnecessarily complex. In addition, where a reporting fund has an interest in a bond fund, it is proposed that the reportable income would include the fair value movement on the underlying bond fund. This could be subject to challenge as being discriminatory under EU law.
- ▶ Where a non-reporting fund becomes a reporting fund, a UK investor will be able to make a deemed disposal election, triggering an immediate gain on which tax will need to be paid. The participant will not be realising any cash to pay the tax due, so the gain should be held over so that the tax only becomes payable when the participant realises their interest in the fund.

Outstanding issues

- ▶ The issue regarding which participants the reportable income was to be reported to was not covered by the draft

regulations, eg, will it be participants in the fund at the end of the reporting period or on the fund's 'reporting date'?

- ▶ The timing of the introduction of the new reporting fund rules and the new definition of an offshore fund needs to be considered carefully as many funds that are not within the current definition of an offshore fund may be in the new definition.
- ▶ Reporting of income to investors should ensure participants are able to identify the amounts on which they are chargeable to tax.
- ▶ Avoid a participant buying into or selling out of a fund during a reporting period from being taxed on an unfairly large (or small) amount of reported income (as compared to the period or size of their holding) whilst minimising administrative burdens on the industry.

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What's new?

Upcoming Seminar - Global Hedge Fund Symposium 2008

Following on from the huge success of our 2007 programme, Ernst & Young are delighted to announce that they will be hosting a global series of Hedge Fund Symposiums again this year.

These events will bring together senior industry thought leaders and Ernst & Young professionals to discuss the crucial issues facing the global hedge fund industry.

The London Symposium will take place on Wednesday, 22 October 2008 from 3:00-8:00pm at the British Academy of Film and Television Arts.

If you would like to reserve a place or find out more, please email us at londonhfsymposium08@uk.ey.com.

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