Investment Management and Real Estate

IMRE News

Asset management insights & views*

March 2009

Section A:
Managing through a downturn

Section B:
General stories

Introduction

We focus in this issue on ‘Managing through a downturn’.

John Forbes presents our Emerging Trends in Europe research, exploring the real estate industry’s deteriorating circumstances. Roger Turner outlines the impact of upcoming regulation on hedge funds. And, Adrian Keller explains the importance of controls reporting as a response to calls for greater transparency.

In the second section of this issue, we provide insights into developments such as the approval of UCITS IV, described by Odile Renner. Tim Sowter reports how pension clients are receiving substantial Dutch withholding tax refunds. And Victor Meyer outlines the effect of proposed changes to the European Savings Taxation Directive.

Please don’t hesitate to contact me or any one of the authors listed in this edition if we can be of further assistance.

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Emerging Trends in Real Estate

Availability of credit is at the lowest level ever recorded during the six years the Emerging Trends in Real Estate® Europe survey has been conducted.

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As Europe slides into recession, the focus for the real estate industry for 2009 will be managing through the continuing downturn.

European investors, developers, bankers, and brokers confirm that 2009 will be "a very difficult" year according to the report Emerging Trends in Real Estate® Europe, 2009. Capital for real estate will continue to be in short supply during 2009, in both equity and debt markets and there is real uncertainty as to when this trend will reverse. It is not yet clear whether it is holding off for pricing to improve or whether the reason is more fundamental. Indeed, the ratings for overall availability, on a scale of one to nine, are the lowest ever recorded by Emerging Trends in Real Estate® Europe.

In its sixth year, the report published by the Urban Land Institute (ULI) and PricewaterhouseCoopers[1] is based on surveys and interviews with nearly 500 of the industry's leading authorities.

Overwhelmingly, respondents report that it is virtually impossible to get new debt and it will continue to be tough to obtain in 2009. As a result, buyers are adopting alternative strategies to keep them in a deal, such as looking for seller financing or talking to the existing lender.

The report also reveals that the current real estate capital markets crisis could turn into an occupier crisis as Europe slides deeper into recession. Economic growth continued to decline across Europe in 2008 and this trend will persist in 2009 as European economies continue to struggle in current market conditions. Even the fastest growing countries will face production declines through the year ahead and expectations are that these will feed through into tenant demand and a corresponding increase in vacancies, with rents stalling or facing a correction.

For those investors who bought at the top of the market it could be a struggle for survival, particularly if banks become more aggressive in dealing with covenant breaches. On the other hand for those with equity to invest, there will be opportunities as the banks start to take action. Although new debt will remain in very short supply, banks may have little alternative to remaining as lenders during the restructuring of defaulting borrowers. For all, there will need to be a clear focus on real estate fundamentals – managing costs and maximising cash flows. Comments from interviewees included: "Asset management takes precedence over new deals." "Try to decrease vacancies and improve tenant quality." "Stabilise debt." The report ranks sentiment regarding the investment and development prospects for 27 cities across Europe. For the first time ever prospects fell for all of the cities ranked in the report,

1 "PricewaterhouseCoopers" refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

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with overall investment prospects dropping from a rating of 5.6 (modestly good) in 2008 to 4.7 (fair) in 2009. Development prospects fell even further, from 5.6 to 4.3 (modestly poor). Risk ratings have also worsened. The league tables are, therefore, more of a measure of the cities that are expected to fall least rather those that are expected to do well.

Germany ranked highly for investment prospects

Munich has emerged as the lead real estate investment market in Europe moving up three places from its 2008 rank. It is important to remember, however, that although Munich has come out on top this year its investment prospects, along with each of the other cities in the survey, have fallen in comparison with the previous year. Germany is considered 'less volatile with more long-term investors' helping Hamburg to second place with Frankfurt and Berlin also ranking among the top ten for investment prospects in 2009.

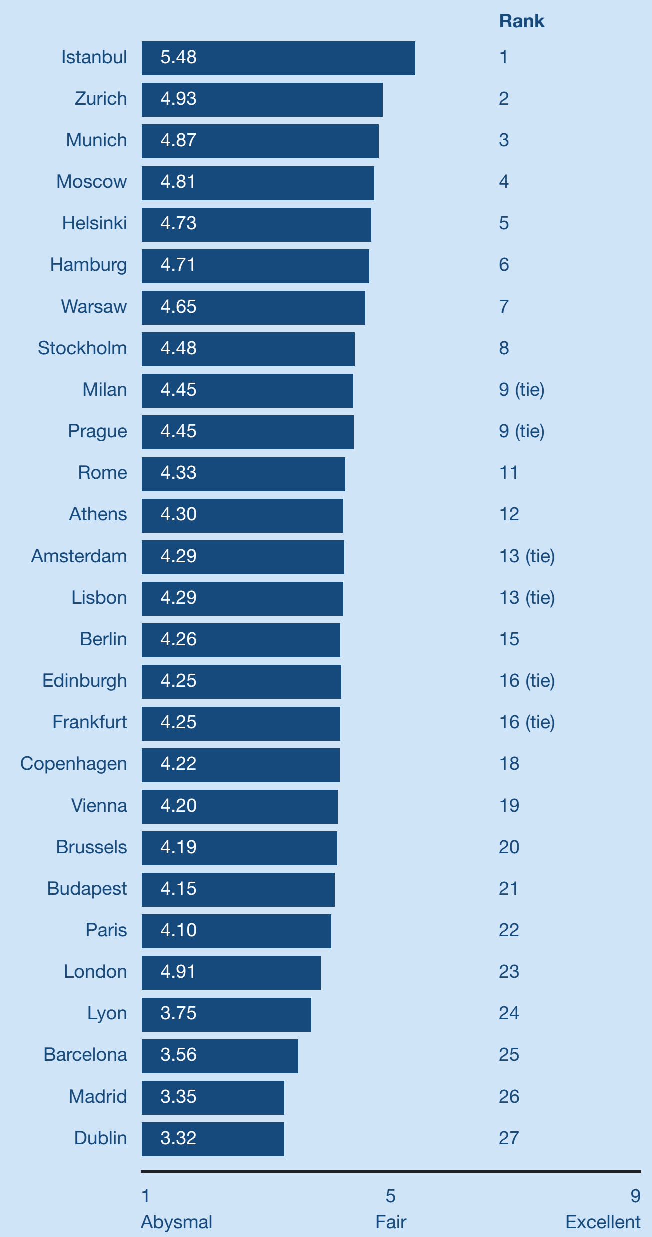
Survey respondents ranked Istanbul third for investment prospects, falling from first place last year as investors continue to seek opportunities in the city. Istanbul secured the top place for development prospects although investors are still concerned with the risk Istanbul brings, viewing it as the eighth riskiest city in which to invest.

At the other end of the spectrum, Spain and Ireland are at the foot of the table. The countries that boomed most in the good times are expected to struggle most as things become tougher. As one investor put it: "Ireland is a real struggle – a bubble that's popped."

Exhibit 3-2 European Investment Market Prospects

Source: Emerging Trends in Real Estate Europe 2009 Survey

Exhibit 3-3 European Development Market Prospects



Source: Emerging Trends in Real Estate Europe 2009 Survey

Divining real estate valuation signals

Establishing a set of valuation signals to support valuations in today's volatile markets requires intensive research.

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Commercial real estate market participants' search for 'true' value of a property or portfolios given the challenges of the current economic and financial environment is similar to Juan Ponce de León's valiant search for the legendary Fountain of Youth in the early 1500s.[2] Is it possible to find, estimate, and support the fair market value of commercial real estate properties? If so, what rational methodologies exist to support market valuations for office, hotel, retail, warehouse, development and other property types? Where are today's valuation signals, internal and external to the real estate industries, that shine a light into a global capital market best described as volatile?

Direct vs. indirect signals

International economic and financial trends are having a profound effect, direct and indirect, on commercial real estate valuation. The direct effects include the obvious facts and trends such as number and volume of market transactions, albeit limited as they are, on the reasonable valuation of commercial real estate properties. The valuation of a property is much easier when there is sufficient number and volume of transactions and more difficult under other conditions. For example, total global commercial real estate transaction volume in 2008 declined approximately 60% from 2007 levels according to Real Capital Analytics[3]; U.S. volume alone declined 74% in 2008. Thus, using the industry standard sales approach to commercial real estate valuation is taxing when sales are essentially minimal, especially in smaller geographic areas. There are also challenges to the valuation of commercial real estate mortgages as total international volume for commercial mortgage backed securities (CMBS) has fallen from $303.5 billion in 2007 to a miniscule $29.3 billion in 2008. At the same time spreads over US Treasury bills have increased from 200 to more than 1,000 basis points.[4]

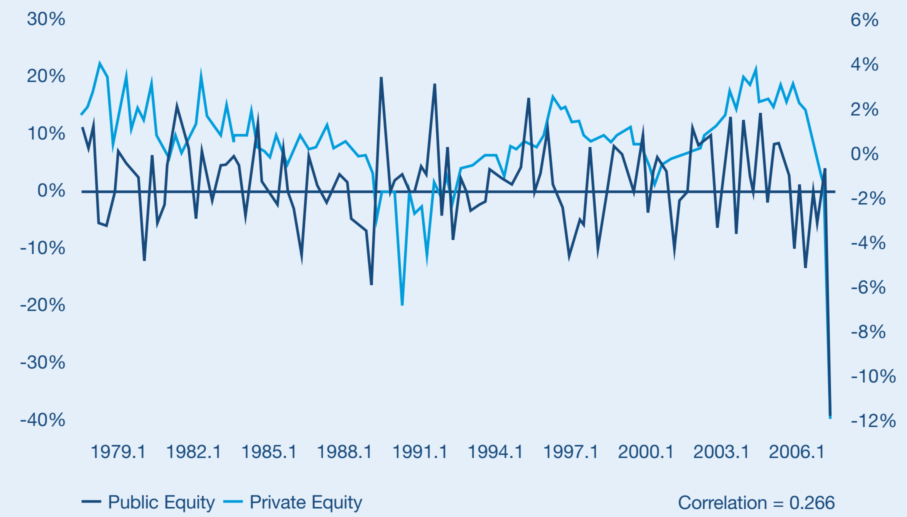
The indirect factors affecting commercial real estate include a multitude of assumptions, expectations, and biases supporting investment and valuation decisions of principal market or most advantageous participants. Perhaps market participants expect private real estate valuations to follow the public real estate valuations. Although history shows there is a significant correlation between the two quadrants, the correlation is still low at 0.266 (see exhibit). The estimation of fair value today implies assumptions regarding occupancy rates, rent growth and cap rates over the next few years.

2 The Spanish conquistador who, according to legend, discovered Florida in 1513 while searching for the Fountain of Youth.

3 Real Capital Analytics, Global Capital Trends, December 2008 (see http://www.rcanalytics.com [31 January 2009])

4 Ibid.

Private equity vs. Public Equity Real Estate Quarterly Appreciation Returns 1979Q1 through 2008Q4



Source: National Association of Real Estate Investment Trusts, National Council of Real Estate Invest Fiduciaries, PricewaterhouseCoopers

The industry recognises that cap rate compression is over. Are cap rates, the inverse of a price-earnings ratio, increasing, and if so, how much? The absolute average of the year-over-year change in cap rates from January 2002 to November 2008 is 44 basis points. Is it therefore reasonable to assume an increase of 100 or 200 basis points for cap rates in 2010 when valuing a property today?

Market participants are acutely aware of employment trends such as the announcement on 26 January 2009 by major employers of layoffs totalling over 70,000 in one day. Are rents going to decline as occupancy rates decrease due to lower demand, and if so, by how much? For example, over 700,000 jobs in the financial activities and professional business service sectors have vanished in the U.S. from August 2007 to December 2008, according to the U.S. Bureau of Labor Statistics.[5] What is the rational probability of office tenants renewing leases, and what is the effect of retailers becoming bankrupt and closing stores?

Finding and challenging signals

Psychologists understand how fear affects humans and behavioural finance researchers are pushing the body of knowledge trying to explain investors' behaviour under varying scenarios. Real estate cycle research indicates that collective mania means buyers and sellers are most diverse in valuation assumptions at the peak and bottom of the cycle. Thus, a herd mentality will exist in the marketplace until participants confirm a sustainable recovery has started.

As FAS[6] 157 and other future regulations (including updates to IFRS[7]) impact the valuation process and reporting standards of commercial real estate properties, it is imperative to: (1) apply healthy scepticism to overly pessimistic and optimistic valuation assumptions, (2) seek out the details behind any industry benchmarks, e.g., the use of smaller geographies vs. national returns, or property type returns vs. all property types, (3) research, read, and review capital market activity reports and investor surveys and, finally, (4) enlarge your sample size for peer group analysis[8] that determine market participant assumptions.

The valuation of a property is much easier when there is sufficient number and volume of transactions and more difficult under other conditions.

5 See U.S. Bureau of Labor Statistics, http://www.bls.gov [31 January 2009]

6 Financial Accounting Standard (FAS)

7 International Financial Reporting Standards (IFRS)

8 PricewaterhouseCoopers' Real Estate Business Advisory Service's appraisal management services provide a proprietary and confidential database of over $70 billion in institutional real estate investments.

Building scale through acquisition

The changing landscape for participants in Europe's investment management sector is forcing businesses to adapt and this may result in a drive for scale.

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The short-term outlook for the asset management sector remains uncertain and asset managers are confronted with pressure from market volatility, withdrawals from retail investment funds and institutional business becoming less profitable as clients reallocate funds from equities and alternatives into lower margin cash and fixed income. Furthermore, the sector generally and the hedge fund industry in particular are suffering from reputational damage, capital scarcity and the threat of increased regulatory intervention. These pressures have been reflected in the share prices of listed fund managers. For example, the weighted average share price decrease of the largest 10 UK asset managers (by market capitalisation at 1st January 2008) was 50% during the 2008 calendar year, compared to a 30% fall in the FTSE All-Share Index.

The response of many asset managers has been, and is likely to continue to be, a reduction in costs. Several have announced headcount reductions and others have announced mergers at the fund level. Research from Morningstar highlights that there was a sharp increase in share class closures/mergers from 1,482 in 2006 to 4,538 in 2008.[9]

A further option for businesses will be to search for scale at the house level which may benefit organisations from both a cost reduction and a capital perspective. Larger asset managers may, therefore, think this is a good time to acquire smaller counterparts.

Emerging opportunities

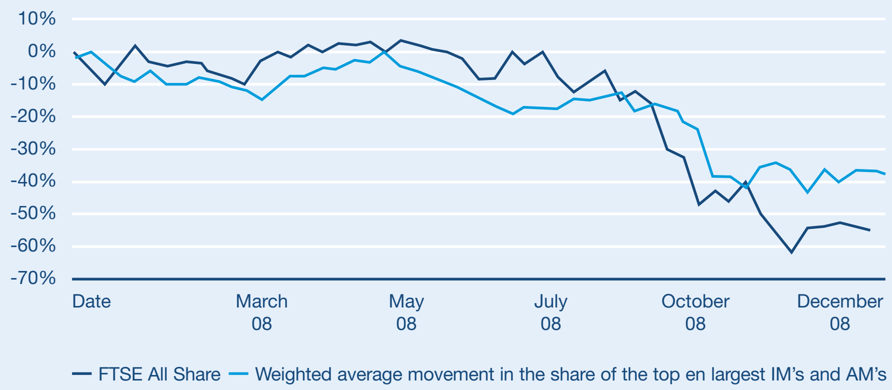
With prices for asset managers at low levels, opportunistic financial buyers with capital to invest may view this as the right time to buy and there has been some evidence of this trend developing. For example, GLG Partners acquired SocGen's UK asset management business in December 2008 for an undisclosed sum. A number of questions remain for private equity houses interested in the sector including the critical question of talent management which deterred some buyers in the past.

The year 2008 was punctuated by two events which may be indicative of further emerging trends in the sector:

Distressed sales – New Star, the UK listed fund manager, announced a capital restructuring on 3rd December 2008 "that will result in £240 million of its £260 million of gross debt being converted into equity".[10] The restructuring resulted in the banking consortium of HBOS, Lloyds TSB, HSBC, RBS and National Australia Bank effectively

9 Source: Morningstar research 12 January 2009
10 Source: New Star press release 3 December 2008

Weighted average movement of the largest 10 listed UK investment and asset managers (by market cap as at 1 January 2008)



Source: PricewaterhouseCoopers analysis

owning a 75% stake of New Star's enlarged fully diluted ordinary share capital. The banking consortium is rumoured to be searching for a new buyer for the business. It is possible that other asset managers, particularly those with a high degree of leverage, may also be required to renegotiate or restructure the terms of their debt and this could give rise to distressed sales.

Sale of captive investment businesses representing attractive capital-raising options for large financial services groups – Aberdeen Asset Management announced on 31st December 2008 that it had acquired parts of Credit Suisse's Global Investors business for £250 million (subject to shareholder and regulatory approvals). Credit Suisse's exit continued a trend seen in the United States where large financial services groups have sold fund management units to raise capital. US examples have included Citigroup swapping its asset management unit for Legg Mason's brokerage operations (2005); Northwestern Mutual selling its Mason Street Funds to American Century and Federated Investors (2006); and AmSouth Bancorp selling its fund unit to Pioneer Investments (2005). Other large financial services groups are likely to be considering doing the same as they look to focus on their core businesses.

In the medium to long term the outlook for the sector remains strong as the demographic of an increasing proportion of elderly people in Western Europe and a large under-developed market in Eastern Europe will create growth. Therefore, with asset prices at historical lows many will view this as an exciting time to acquire an asset management business for the longer term.

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Regulation likely to segment the hedge fund industry

A series of regulatory initiatives is likely to have the effect of allowing different hedge fund strategies varying degrees of access to investors.

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In response to the crisis in financial markets, several international organisations are proposing a series of amendments to investment management's regulatory framework. In particular, these will have an impact on the activities of some hedge funds.

Broadly speaking, these measures are designed to improve investor protection and financial stability. In the current political climate, there is no doubt that some of the measures proposed will become law.

The practical effect of this is likely to be that the least leveraged strategies such as equity long-short continue to become more widely accepted, but the most highly leveraged hedge funds can only market to a far smaller group of potential investors. Consequently, arbitrage-style funds that typically deploy considerable leverage to profit from small anomalies in securities prices may find they have a far more restricted investor base.

Two main initiatives

There are two main regulatory initiatives. In its November 2008 declaration, the G-20 set out its proposals to stabilise financial markets. As a result of this, the International Organisation of Securities Commissions (IOSCO) formed three task forces to review short selling; unregulated financial entities; unregulated markets and products.

At the same time, the European Commission has released a consultation paper, with a view to amending European hedge fund regulation.

IOSCO's recommendations will be discussed at the next G-20 summit, which will be held in London on 2 April, 2009. Meanwhile, the European Commission has received comments on its consultation paper and is likely to pass new legislation by June 2009.

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The likely impact

While these regulatory initiatives vary in scope, their practical effect is likely to be to create a three-tiered industry structure – within Europe, at least.

- Regulated hedge funds, governed by UCITS III legislation, have weathered the financial crisis well. They are likely to be allowed to continue to be marketed to a wide range of investors.
- Unregulated hedge funds that accept certain limits on their activities will be allowed to market to investors falling into specific definitions of sophistication and net wealth. However, they will have to provide more transparency in their investment strategies, accept a capped level of leverage and comply with a capital requirement in the form of a liquidity buffer.
- Hedge funds that do not comply with these requirements will form the third tier. They will only be able to market to specific groups of people.

Looking forward, this will cause the hedge fund industry to fragment. The less leveraged strategies such as equity long-short will become increasingly accepted by not only the institutional market but also retail investors. More specialist strategies such as macro or distressed debt may remain unregulated and able to market to a similar group of investors as is currently the case. Finally, the highly leveraged arbitrage funds will find the size of their potential market curtailed.

European Commission moves towards regulating hedge funds

In response to a Parliamentary report in September 2008, and against the backdrop of the ongoing crisis, the European Commission consulted on hedge funds activities with a view to potential regulatory action before June 2009. It identified five key areas for stakeholder comment: definition of hedge funds, hedge funds contribution to systemic risk, short-selling, transparency and disclosure to investors and supervisors.

PricewaterhouseCoopers, in responding to the consultation, highlighted, inter alia:

- Hedge funds cannot be defined by unique and distinctive criteria, and yet a clear definition would be necessary for direct regulation of hedge funds. From an EU perspective, prudential requirements for prime brokers which use leverage may provide an alternative, particularly as most hedge funds are not domiciled in the EU.
- The extent and the nature of hedge funds' contributions to the current financial crisis is difficult to determine in the absence of adequate empirical data.
- Tailored but sound risk management practices need to be implemented by all actors in the industry, including fund managers, fund administrators, custodians, etc. Where these practices rely on industry codes, effective enforcement mechanisms need to be in place.
- Regulators would benefit from enhanced disclosure on hedge fund trading strategies, amount of leverage used with the portfolio, types of financial instruments used and exposure concentrations.
- Retail investors should be allowed access to hedge funds provided they are sufficiently informed of the risks they are undertaking.

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Hedge fund restructuring – navigating treacherous waters

When restructuring, hedge funds need a detailed and realistic plan that addresses the needs of both creditors and investors.

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Pre-crunch, as investors became comfortable with the concept of absolute returns and increased their exposure to hedge funds, the pressures for transparency, liquidity and lower costs were growing. The credit crunch has accelerated this but it has also brought some big new challenges of its own.

The downward spiral of liquidity needs, forced selling, negative returns and heightened risk has caused managers, investors and counterparties alike to question who they trust. They are revisiting the fine print of the complex agreements which govern their relationships.

Today, even some of the most successful hedge fund managers are faced with a set of challenges they have not experienced before, with few advisors to which to turn.

New challenges

Four of these challenges appear to drive hedge funds' response to the credit crunch: the extent of liquidity mismatches (and investor reaction); insolvency and liability risks; the need to treat parties equitably; and, the need to live within reduced incomes.

In most cases, hedge fund managers are still run by their founders. Talented money-makers, they are typically not experienced in crisis management. With the help of competent COOs and good legal advice, some have come up with feasible restructuring plans. Yet for others 'denial' seems to be the order of the day and many are failing to seek the commercial advice and support needed to navigate the challenges – strange for a sector which focuses on its strengths (i.e. investing) and outsources much of the rest.

Understanding investors' needs

For those that need to restructure, the first step is to design a plan that works for individual investors. Historically, the relationship that hedge funds had with investors was somewhat one-sided with investors generally accepting 'standard' terms unsuited to a worst case scenario. Now, with hedge funds weaker, investors with money not only have the power to negotiate better deals but also need to be convinced of the merits of restructuring plans. Investors who don't (or can't) support a restructuring need another solution, such as the opportunity to partially redeem their interests in a fund. Either way, knowing the investors' approach is vital.

A restructuring plan should encompass detailed cash flow modelling, consider all the options (including good fund/bad fund splits), contingency planning, liability management and investor communication.

Funds' managers and directors have to become involved in a way that they have never had to before, acknowledging their duties to both creditors and investors. But while good legal advice is essential, many lack the commercial expertise to navigate the challenges of liquidity, solvency and liability whilst also doing their day jobs.

Realistically, many hedge fund managers, directors, investors and counterparties will need early advice and support to achieve an ordered restructuring. Leaving it late may mean the only realistic option is insolvency.

The need for talent in a downturn

For investment management firms that can offer long-term job security, today's market turmoil presents an opportunity to hire talented investors

There is no doubting that the investment management sector has been one of the hardest hit in the current market turmoil, with some tales of investment performance and redemptions making the horror stories faced by other sectors seem tame in comparison. For well-run businesses capable of surviving the downturn, however, there are some exciting and potentially lucrative opportunities for the brave and deserving.

In order to navigate these difficult times, management teams will be looking harder than ever for talented fund managers to deliver outperformance and to maximise profitability in a sustainable manner. On the fund manager's side, no longer is the best employer the one offering the greatest rewards. Investment professionals are looking for job security, the ability to operate business as usual and a robust employer likely to remain a going concern for the long run.

Where is the value?

In due course certain sectors will provide some great investment opportunities, including both equities and property. Many of these assets are undervalued at present but the trick is in separating the wheat from the chaff with the consequences of bad investment decisions being disastrous in the current climate. This emphasises the point that genuine talent is in more demand now than in the recent bull market where the price of poor decision making was not nearly as severe.

Cash-rich, stable businesses are already sizing up opportunities for acquisitions with many competitors being valued at knock-down prices, either as a result of poor performance or a desire for cash-strapped shareholders to realise value. Fund teams and entire businesses are both under the microscope but, one of the biggest questions to be asked is does the value lie in the assets or the people?

If the answer is the people i.e. the talent, then culture comes into play. In this sector many firms take the stance of either supporting or suppressing the star fund manager culture and for two organisations at either end of the culture spectrum, integration may prove too difficult a challenge to even attempt.

Following from that argument, businesses that stress process over management capability may be less likely to see value in people with the real gold being in the asset books and contracts. While star fund managers are actively discouraged in this environment a different type of talent is valued, that of managing processes, delivering results and defining and delivering the business ethos.

The retention conundrum

With collapses in the value of many share prices and business values, the retention value for many fund managers represented by the amount of money at risk or forfeitable (often linked to fund or business performance) is at a low point. This may mean that there is less potential to lock key talent in place and presents acquisitive businesses with a golden opportunity to poach the best in the market.

On the flip side, those fund managers secure in their jobs look to be less likely to risk moving to another employer. As a result the employment proposition can no longer be exclusively financial. Today, the best are likely to value the ability to operate as they choose, combined with the opportunity to make a good but stable living.

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Breaking up the value chain

Recent market events, as well as competitive pressure, are making institutional investors more likely to outsource non-core activities across the value chain.

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With the proliferation of investment products, tremendously shrinking asset bases and increasing regulatory requirements, institutional asset managers currently face major challenges in fulfilling their given duties. In the context of today's difficult markets and tough competitive environment, this is forcing many to reconsider what their core competencies are.

Typically, these asset managers perform three main functions in the fiduciary management of investor assets. Viewed collectively, these comprise the investment management 'value chain'. The first and foremost function is the duty of governance, which is key to the asset manager's core value proposition and cannot be outsourced. More suitable for outsourcing 'make or buy' decisions are, secondly, the investment function and, thirdly, the underlying operations. For these functions, market trends differ depending on how critical the activities are, and the appetite for alternative sourcing options in certain countries. Consequently, outsourcing models range from the traditional, encompassing middle- and back-office functions only, to comprehensive outsourcing of both these functions and front-office portfolio management (e.g. full fiduciary management outsourcing).

Traditional outsourcing

The traditional outsourcing model covers all non-core and non-critical activities. This comprises mainly typical operations functions, but should be evaluated (and challenged) for comprehensiveness in virtually every instance. Surprisingly, this questioning and structured break-up of the value chain (as well as fair judgment on core and non-core functions) has rarely been observed in the past. Currently, the Swiss market – which trails the more mature European (e.g. UK or Luxemburg) and US markets – is taking some initial and very careful steps. However, recent market and competitive trends have put pressure on Swiss institutional asset managers to focus not only on value-generating tasks surrounding the investment process but also on ensuring cost-efficient and flexible operations. Given these circumstances and the large number of specialist providers in this field, Swiss asset managers have begun to challenge parts of their operational value chains and are, increasingly, considering alternative sourcing options.

Fiduciary management outsourcing

More progressively, there is increasing pressure to outsource the investment function – again, a form of outsourcing that is already seen in more mature markets. For example, in the past insurers have been judged on their broad ability to manage liability-driven investment strategies effectively. Yet, more recently they have been asked to tackle heightened competition and decreasing margins by seeking greater investment returns. Consequently, they are now seeking to incorporate sector specialists firms' best ideas into their investment portfolios. This is driving them to review whether their investment management function is a core competency. If not, it could also become a candidate for outsourcing, with sector specialist managers performing the money management while the insurance company focuses on the functions it naturally performs best, such as marketing, sales, customer service and liability forecasting. In this more progressive model, both investment management and platform processing can be provided as an integrated solution – full fiduciary outsourcing.

Given the strength of these trends and the continued focus on core competencies, it is fair to ask if there are any natural limitations as to the scope and granularity of the de-construction of value chains. Right now, the answer appears to be that the trend is increasingly spanning the front, middle and back-offices, as well as becoming increasingly granular in its treatment of the front-office investment process.

Summary

In conclusion, investment management is rapidly becoming a mature industry. As evidence, specialist service providers have emerged across the full value chain, from front to back office, and including areas previously thought "off limits" for outsourcing, such as the investment process itself. Service providers are offering their specific competencies at cost and quality levels that benefit both the investment management firms themselves and their clients – and the market is growing to accept this.

The growing supply of non-performing loans

The European market for non-performing loans (NPLs) is expected to increase over the next two to three years, as lenders try to clear up their balance sheets.

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Investors expect a significant number of portfolios to be marketed in Europe within the next 12-24 months – which suggests a 'buyers' market', both in terms of pricing and 'Sale & Purchase Agreement' terms. The UK is expected to be particularly active. We estimate the UK NPL market's size to be between £50bn and £100bn, making it one of the most significant markets globally. Looking at the rest of Europe, Spain is currently attracting a lot of investor attention, with portfolios being offered for sale exceeding €10bn.

Key issues in the European NPL market

Pricing

Scarcity of debt financing: Lack of debt financing increases the amount of equity required in order to complete a purchase. This reduction in leverage means that investors are paying lower prices in order to achieve their internal rate of return targets.

Historical collections: the past is not necessarily a good guide for the future: Historical collection data currently available reflects the more benign credit conditions of the last decade. In the UK, collection agencies are already reporting an increasing number of borrowers that are unable to sign full and final settlements due to the lack of available financing/refinancing.

Opportunity cost: Due to limited resources and the larger number of portfolios being offered for sale across Europe, investors are being more selective about which portfolio sales they participate in and may discount their pricing as a result. Furthermore, availability and experience of existing local due diligence teams, ranging from local lawyers to accountants, is key in determining whether investors are willing to participate in a sale process.

Impact of the real estate market decline

Investors are uncertain regarding the extend of property market falls in certain markets (namely the UK and Spain) and are currently discounting prices for secured portfolios more than in the past.

Due diligence

Legislation: European governments are currently under pressure to ensure that foreclosure is the solution of last resort and some of them (for example in the UK) have introduced measures to extend the mortgage repayment periods for certain borrowers. This creates significant uncertainty over the enforceability of loans and the representations and warranties provided by the seller.

Quality of information: Investors are requiring more detailed information and larger sampled data as part of their due diligence process because of market uncertainty and the risk-averse nature of their Investment Committees. This means that the seller's preparation and ability to address the investor's concerns will be key in maximising value from the sale.

Tax

Withholding taxes: Withholding tax leakage may arise on certain proceeds from the debt collection. In particular the interest withholding tax position needs to be secured as part of the repayment of the loans may be considered interest for tax purposes. In practice, treaty-based structures may mitigate the withholding tax risk, provided sufficient substance is maintained and beneficial ownership issues are properly addressed.

VAT: The VAT upon the sale/acquisition of the portfolio needs to be considered. VAT upon transfer of a NPL portfolio needs to be taken into account on a country-by-country basis as some countries may consider the sale/acquisition of NPL portfolios as factoring, which may make VAT irrecoverable. Furthermore, VAT may be due on debt collection services; however, proper structuring may mitigate this.

Servicing

Domestic special loan servicing capacity and capabilities, and future deal flow in each region, will determine whether investors seek to partner with local servicers or build/acquire their own platforms. In the UK, servicers are facing significant challenges adjusting to the current credit conditions with special servicing capabilities at scarce supply.

Current deal activity

We have recently seen sales of NPL portfolios (corporate, consumer, secured and unsecured) in Poland and Greece and currently anticipate further sales in Spain, Greece and the Czech Republic – in addition to the various Lehman Brothers European portfolios. This indicates that despite the current market conditions, there remain willing buyers and sellers of distressed debt.

Controls reporting as a response to demand for greater transparency

In light of the current market turmoil, the recent failures and fraud cases, the pressure on alternative investment providers to disclose their internal risk management and internal controls systems has increased.

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In view of the recent turbulence in the financial markets, fraud cases and the resulting lack of confidence, the need for better transparency and controls has become more vital than ever.

Investors consider strong risk management, compliance and transparency to be as important as a good performance track record. While most alternative investment providers report on the investment performance and risk results, only a minority volunteer to inform on further key metrics, such as operational risks and the internal control system around the investment process and back office.

Even before the recent fall in asset values, a 2008 research project from PricewaterhouseCoopers in cooperation with the Economist Intelligence Unit (EIU) concluded that as investments in alternatives had become more deeply embedded in the mainstream asset class mix, so investors increasingly expected higher levels of transparency, disclosure and risk management.

Just before, in January 2008, the UK Hedge Fund Working Group's Hedge Fund Standards, stated that hedge fund managers should explain their approaches to managing risk and their risk frameworks in funds' offering documents, including the risk of breakdowns in internal controls or systems. The US President's Working Group on Financial Markets stated in its report on best practices for the hedge fund industry issued in April 2008, that hedge fund managers should implement and maintain strong internal controls to minimise the risk of loss as a result of operational risk.

Current internal controls reporting initiatives

Controls reporting can provide the desired standardised framework to provide investors with the information required to understand the internal controls environment.

Currently, the most popular globally accepted standard for reporting on controls at a service provider is the Statement on Auditing Standards No. 70 (SAS 70) established by the American Institute of Certified Public Accountants. In November 2008, the US Accounting Standards Board proposed a new Statement on Standards for Attestation Engagements (SSAE) "Reporting on Controls at a Service Organization", which will supersede the current SAS 70 standard.

In addition, the International Auditing and Assurance Standards Board (IAASB) has proposed the new International Standard on Assurance Engagements (ISAE) 3402 “Assurance Reports on Controls at a Third Party Service Organization”, which covers the requirements and principles on an audit of internal controls at a service provider. ISAE 3402 reports can be used for investor communication, as well as in relation to reporting requirements from third-party auditors.

Enhanced transparency in risk management

The above standards are closely related to each other. Both represent initiatives to work towards convergence of the controls reporting standards and to enhance the scope from pure financial reporting objectives to reporting on operational and compliance related matters. The final release of ISAE 3402, as well as the new SSAE, is expected in June 2009.

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UCITS IV, at last

Approval of UCITS IV proposals will, among other measures, introduce an EU management company passport aimed at enabling more specialisation and efficiency savings for asset managers.

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On January 13, 2009, the European Parliament voted massively in favour of the proposed reform of the UCITS directives. This paves the way for the cross-border 'remote' management of funds (the 'management company passport' or 'MCP'), cross-border reorganisations of fund ranges through mergers and master-feeder structures, a streamlined procedure for cross-border distribution and a standardised information document for investors (key investor information).

The end of a long process, this will increase efficiency in Europe's fund market. Expert groups set up by the EU Commission first recommended major changes to the 2001 UCITS III directives in 2004. In March 2007, the MCP, the most controversial of these measures, was first presented by the Commission in its 'partial' version, where certain 'core' administrative services had to remain in the fund's domicile. Yet come the Commission's July 2008 official proposal for a recast directive, the passport had vanished, and The Committee of European Securities Regulators was tasked with defining what it should look like.

Management company passport

Well, now we know what it looks like. A management company (MC) based in one country will be able to set up and run a fund, even in contractual form, in another country. The fund's nationality is no longer determined by the location of its MC's registered office – it will, instead, simply be that of the country where it is authorised.

The issue of which laws and competent supervisory authority have jurisdiction over funds are as below.

- Rules governing a fund's establishment and functioning will be those of its domicile, and the local supervisory authority will enforce the rules. This includes, notably: accounting and net asset value calculations, investment compliance, issuance of units, unit-holders' rights.
- Meanwhile, the MC will be subject to the rules and supervisory authority where it is based. This includes: operations and organisation, fund risk management procedures, delegation of all tasks included in collective portfolio management functions and the rules of conduct applicable to its business.

In practice, this can get complex. A MC in country A could establish a fund in country B and delegate, for example, the administration of that fund to a service provider in country C. In which case, the service provider would have to follow country B's rules. But the Commission is confident that close cooperation and collaboration among supervisory authorities will overcome these potential difficulties.

Other measures

Close collaboration will also be necessary to permit UCITS IV's other measures to deliver their promises. The simplified notification procedure for cross-border distribution of UCITS will depend on the host Member State's confidence in the review of the file by the MC's regulator – a review which has to be performed within 10 working days. Cross-border mergers and master-feeder structures will require that the authorities collaborate and respect relatively stringent deadlines – which means that their readings of the 'interest of investors' are basically the same. Finally, one can hope that the key investor information document, the content of which should be fully harmonised, will end the ridiculous situation where simplified prospectuses were as big as complete ones.

The EU Parliament's vote still needs to be followed by a Council vote, probably in March, a formality given the large consensus. It will take over two years, until July 1, 2011, for UCITS IV to be fully implemented in the 27 Member States' legislation. Only then will it become real…and show that things are perhaps not as difficult as everyone thought!

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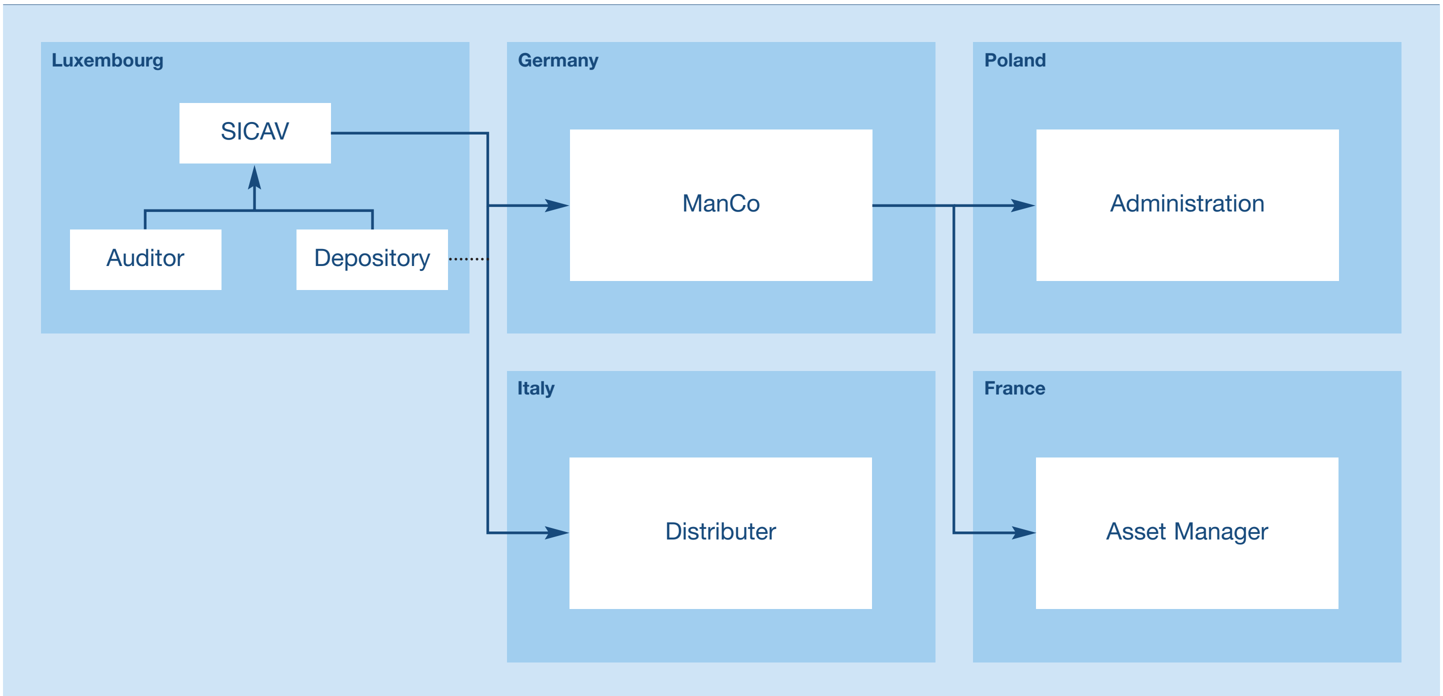
UCITS IV may open the way to...



OECD releases funds tax reports

The Organisation for Economic Co-operation and Development (OECD) finds investment funds are entitled to treaty benefits.

Previous issues have commented on the OECD's joint Government and Industry group examining the problems of granting treaty benefits to funds and streamlining international procedures. The OECD has now issued the reports of the group and is calling for public comment before 6th March 2009.

The issues addressed have major implications for promoters, service providers and paying agents. The timing of the release is particularly relevant in light of governments' renewed focus on tax compliance, reporting and the exchange of tax information.

Key conclusions of the reports are:

- Investment funds are entitled to treaty benefits;
- A fund is entitled to claim in its own right or on behalf of investors;
- New treaties should contain provisions covering funds;
- Best practice is to grant treaty benefits at source;
- Governments and industry need electronic systems that minimise cost;
- Governments need systems that ensure proper compliance and reporting;
- Authorised intermediaries should be able to claim benefits on a pooled basis.

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New markets for UCITS

Global distribution is creating new opportunities for UCITS, as are new products.

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As worldwide UCITS sales have grown over the past five years, an unexpectedly large volume of sales has been to markets outside Europe. For sure, the leading domiciles in terms of assets have been within Europe. Yet UCITS funds are also being distributed across Africa, Asia, the Middle East and South America.

According to the European Fund and Asset Management Association (EFAMA), the top five investment fund domiciles in terms of assets are Luxembourg, France, Germany, Ireland and the UK. Other key European markets are Austria, Italy and Spain.

But the rapidly growing emerging markets provide great potential for sales. In Asia, the main countries targeted are Singapore, Hong Kong, Taiwan and Macau. In South America, Chile and Peru are two emerging markets for the distribution of UCITS funds. South Africa is the main country targeted in Africa. As expected, the Middle East is emerging as a significant growth area.

Furthermore, China is also emerging as a key market, especially due to the new Memorandums of Understandings (MOUs) it has signed with Luxembourg and Ireland. These approvals will allow Chinese investors to invest in foreign-domiciled UCITS - funds as well as non-UCITS investment products. This welcome development opens up one of the world's fastest-growing pools of private capital.

Fast-growing product opportunities

Islamic funds are especially appealing in some of these markets. Consequently, there has been significant growth in Shariah-compliant UCITS funds. Luxembourg and Ireland lead the way in this area, with significant regulatory and administration support in both jurisdictions. In Ireland, the Financial Regulator has established a dedicated regulatory team for the authorisation of Shariah products.

Looking to the future, we expect to see more Islamic UCITS funds in years ahead as global asset management firms enter this growing market. Additionally, given the present financial crisis, the Islamic finance industry's resilience highlights it as a major player in the global investment arena.

Following substantial falls in asset values, distressed asset funds are also likely to be in demand – both in Europe and across the globe. There are opportunities to purchase assets at deep discounts from troubled organisations – i.e. portfolios of loans from failing financial institutions, discounted bonds from cash-strapped corporates and prime properties from struggling mortgage holders.

Another area of interest is Socially Responsible Investment (SRI). Total sales for the SRI sector for November 2008 were €784.2m ($1bn) to take the overall value of the sector to €35.3bn. Sales of mainstream equity funds totalled €588.7m over the same period. This suggests that SRI funds are becoming a mainstream asset class.

For UCITS funds, there are clearly both new growth markets and products.
The UCITS brand is well-established and trusted. Even at a time when the European investment industry's assets under management have contracted, there are new areas of opportunity.

UK pensions to receive £ millions in Dutch withholding tax refunds

Following claims filed on their behalf, UK pension funds are about to receive substantial Dutch tax refunds. Other territories, in particular France, may have to follow.

UK pension schemes have begun to receive notices from the Dutch tax authorities that they will receive withholding tax refunds worth in excess of €35 million, following protective claims filed by them under EC treaty principles.

These claims have been made on the basis that UK schemes investing in the Netherlands suffered withholding taxes on Dutch dividends that local Dutch schemes did not. Similar claims have been filed on behalf of UK pension schemes in other European territories. The total value of claims is in excess of €100 million (more than £85 million).[11]

Although refunds of withholding taxes for UCITS funds and non-UK pension scheme clients in Europe have been successfully obtained during 2008, this is the first time that UK pension schemes will receive refunds in respect of the EU protective claims they have filed.

Similar refunds may follow in other Member States. In France, for example, the Supreme Court ruled in February that French withholding taxes are also in breach of treaty principles.

Moving towards equality of tax treatment

In the UK, pension scheme clients have been working on such claims since 2004. And, in the Netherlands, the European Federation for Retirement Provision filed a ground-breaking complaint with the European Commission in 2005 against 18 Member States that operated discriminatory withholding taxes. The EC are now well advanced with infringement proceedings against Member States named in the complaint that, to date, have refused to change their laws.

The Dutch have never officially conceded that their withholding tax laws were in breach of EC treaty principles, in spite of this latest development. Furthermore, many other territories named in the complaint have yet to follow the Dutch example or bow to EC pressure to change their laws. For this reason, this very positive development appears likely to be the first victory in a series of protracted discussions in other territories.

We believe these are the first welcome steps on the road to seeing the principle of the freedom of movement of capital driving the equality of tax treatment for investors across the European Union. We expect that more and more countries will have to follow suit over time.

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11 Relates to claims made by PricewaterhouseCoopers only.

Proposed amendments to the European Savings Taxation Directive

The proposed amendments are likely to affect certain products sold by wealth managers.

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The European Commission adopted an amending proposal to the European Savings Taxation Directive (EUSD) on 13 November 2008. The Commission noted that the proposal seeks to ensure the taxation of interest payments which are channelled through intermediate tax-exempted structures. It is also proposing to extend the scope of the Directive to include income equivalent to interest obtained through investments in some innovative financial products, as well as in certain life insurance products.

This article summarises the scope of the existing EUSD, as well as considering the impact of the proposed changes for the wealth management industry.

What does the existing EUSD do?

The Directive was introduced as an anti-tax evasion measure to stop individuals resident in one member state from putting savings into investments in other member states, collecting the interest and not declaring this as taxable income in their home state. The European Union (EU) also concluded bilateral agreements, equivalent to the regulations of the Directive, with third-party states (e.g. Andorra, Liechtenstein, Monaco and Switzerland).

The existing Directive and the bilateral agreements with third-party states cover 'interest payments' made to individuals. The term 'interest payment' is defined in the Directive and the agreements and is fairly widely drawn to include income from bank savings accounts, as well as bonds, debentures producing an interest-like return and also collective investments that produce an interest-like return.

What are the proposed changes and how would they affect the wealth management industry?

The European Commission noted that based on an analysis of the functioning of the Directive, the regulations have proven effective within the limits set by its scope. The evaluation nevertheless reveals the need for certain amendments to close possible loopholes, especially in relation to:

1. Beneficial ownership: The Directive deals only with interest payments made for the immediate profit of individuals resident in the EU. These individuals have opportunities to circumvent the Directive by using an interposed legal person or arrangement situated in a non-EU country, which does not tax the payments. The Commission, therefore, proposes asking paying agents to use, in selected cases,

the information already available to them under the anti-money laundering provisions about the actual beneficial owner(s) of a payment made to a legal person or an arrangement (look-through approach).

2. Definition of paying agent: Under the Directive, as an anti-avoidance measure, some entities are obliged to apply the Directive when they receive an interest payment, by acting as paying agent. This concept of ‘paying agent upon receipt’ seems to have generated uncertainty. The Commission, therefore, proposes to move to an approach based on a ‘positive’ definition of the intermediate structures (including trusts, transparent entities …) to be charged with obligations to act as a “paying agent upon receipt”. This ‘positive’ definition would be based on substantial elements rather than on their legal form.

3. Treatment of financial instruments equivalent to those explicitly covered: At present, the Directive can be circumvented by rearranging one’s financial affairs in such a way that income which is equivalent to interest from debt-claims remains outside the formal definition of interest payment. The Commission, therefore, proposes to include structured products in the scope of the Directive if the capital is protected and the return is predominated. Also included are non-UCITS funds with domicile in an EU member state, further collective investment schemes with domicile outside the EU and life insurance policies with minimal insurance elements and liquidity features. When might these changes take effect?

The European Commission has voted to adopt the proposals, but they are some way from becoming law. The earliest possible start date, assuming a smooth running of the process to implement the revised Directive, would be 1 January 2011. The process can be summarised as follows:

1. ECOFIN (European Council of Finance Ministers) met in December 2008 to commence discussions on the proposals;
2. Unanimous agreement needed by all member states to adopt the revised Directive;
3. Once the revised Directive is in force, each member state would have to enact this in their domestic legislation;

When the initial Directive was introduced, certain countries made their agreement conditional on other non-EU countries (such as Andorra, Liechtenstein, Monaco and Switzerland) also adopting the Directive. The European Commission, furthermore, seeks bilateral agreements (equivalent to the regulations of the Directive) with other third-party states (e.g. Singapore and Hong Kong).

It is anticipated that some countries will put forward similar conditional agreements this time, in which case there could be further delay while agreement is sought from these non-EU countries.

What should the wealth management industry do now?

The EU has specifically identified certain types of structured products, non-UCITS funds with domiciles in an EU member state and further collective investments with domiciles outside the EU schemes, which produce an interest-like return and believes that these fall within the intentions of the original Directive. Given this, it is probably unlikely that such financial products will be left out of scope entirely in any revised Directive.

Wealth managers should review their products (structured products and collective investment schemes) and structures (interposing legal entities) provided to wealthy clients to identify those which might fall within the scope of the revised Directive, and consider the impact of this in terms of the associated data and reporting requirements.

Infrastructure investing: global trends and tax considerations

With infrastructure one of the few asset classes that is growing in the current environment, and the Obama stimulus package likely to provide significant infrastructure in the US, tax-efficient fund formation and deal structures are important.

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Global trends

Infrastructure is a rapidly growing investment class. Despite tougher capital-raising conditions brought on by the credit crisis fund raising continues, with various new infrastructure funds launched in 2008. Meanwhile, global demand for infrastructure is soaring; the need is particularly acute in emerging economies such as India and China. The Organisation for Economic Co-operation and Development (OECD) estimates that more than US$71 trillion in infrastructure investment will be required globally by 2030.[13]

The worldwide economic slowdown is likely to increase the impetus for infrastructure investment. China, for example, has recently announced a stimulus package including US$586 billion of infrastructure investment over the next two years.[14] In the US, the Obama administration has indicated that its first priority is boosting the economy and creating jobs. It is expected that the US$775 billion stimulus package being developed will involve significant infrastructure investment and that the Obama administration will develop a detailed long term strategy for infrastructure.[15]

The key players in the infrastructure market are infrastructure funds, pension funds, construction funds and sovereign wealth funds. Funds and institutional investors will seek high yields and equity-like returns from the debt facilities and look for cross-border opportunities.

Tax and structuring considerations

With the increased focus and cross-border investment in infrastructure, it is important to understand the international tax framework for structuring infrastructure funds and investments in infrastructure assets.

Fund formation and investment structuring

Infrastructure fund formation and deal structuring is complex. Infrastructure consortiums' distinct funding and yield requirements, as well as applicable tax and regulatory considerations, often necessitate complex structures which, at times, may need to meet conflicting objectives. The optimal fund structure will depend on the investor profile and should also accommodate efficient structuring of carried interest for key portfolio managers.

12 The authors wish to thank Emily Fett, associate in the International Tax Financial Services Practice for her contributions to the article.

13 OECD, "Infrastructure to 2030" report, 2007. This estimate includes investments in road, rail, telecoms, electricity and water infrastructure; it does not include seaports, airports or social infrastructure.

14 "Beijing Unveils $568bn Stimulus Plan," The Washington Times, November 10, 2008; "China Unveils Sweeping Plan for Economy," The New York Times, November 10, 2008.

15 "Obama Weighs Government Spending and Tax Cuts," Financial Times, December 28, 2008. See also, for example, "Obama Vows Swift Action on Vast Economic Stimulus Plan," The New York Times, November 23, 2008.

In determining the location and structure of the acquisition vehicles, the location of the asset will be a key consideration. The acquisition structure must take into account relevant aspects of the investee jurisdiction's tax environment, including corporate taxes, withholding taxes, transfer taxes and other indirect taxes, as well as its regulatory regime. Exposure to source country income and withholding taxes can be mitigated by establishing a treaty-protected special purpose holding company (Hold Co) below the level of the fund. The Hold Co would invest into the local entity acquiring the asset, usually by way of debt, and rely on treaty benefits to reduce the source country income and withholding taxes. The Hold Co must be a qualifying resident under the relevant treaty and it is critical that the Hold Co has sufficient substance in the jurisdiction where it is formed.

US tax considerations

Many US infrastructure investments utilize a flow-through structure and the US tax considerations of such investments will largely depend on the profile of investors. Although they are typically long-term passive investments from the investors' perspective, infrastructure investments usually give rise to operating income such as tolls or user fees, rather than to passive-type income such as dividends or interest. This type of income can subject non-US investors and US tax-exempt investors to US federal income tax in the form of Effectively Connected Income (ECI) for non-US investors and Unrelated Business Taxable Income (UBTI) for US tax exempt investors. Non-US investors could also be subject to tax on the gains from the disposal of their investments under the Foreign Investment In Real Property Tax Act (FIRPTA) rules which apply to investments in US real property. Currently there are rules being proposed that would expand the application of the FIRPTA rules to include government licenses.[16] Sovereign Wealth Fund investors are typically exempt from US federal income tax under Section 892, however this exemption may not apply to operating income earned from infrastructure investments.

Many of these tax issues can be resolved by investing through a corporate structure, and although the corporation would be subject to US income tax, this can be minimised by funding the corporation with debt. For non-US investors, interest payments are typically subject to a 30% withholding tax, however this can be reduced by planning.

As an alternative to forming the fund in a tax-free jurisdiction, the investors may want to take advantage of one of the fund regimes which have been introduced in various jurisdictions. In Ireland, for example, a Qualifying Investor Fund (QIF) is a tax-exempt vehicle which in many cases is eligible to take advantage of the Irish treaty network and EU Directives. Luxembourg may also be an attractive jurisdiction for establishing the fund.[17]

Management company structuring

When setting up a management company which may be involved in sourcing the deal as well as managing the investment, care should be taken to limit the fund's taxable presence in the management company jurisdiction. Certain countries have special regimes in place that exempt the fund from taxation of income generated by the activities of the management companies. For example, funds established in the Cayman Islands should carefully review whether the activities of their US based management company fall within the 864(b) trading safe harbour rules.[18] Similarly, a management company presence in India or China, for example, or extensive travel to such countries, could potentially subject the fund to corporate income tax in these jurisdictions.

16 Advanced Notice of Proposed Rulemaking on Infrastructure Improvements Under Section 897 (Federal Register: October 31, 2008 (Volume 73, Number 212)).

17 The fund may be established as a Société d'investissement à capital variable ("SICAV"), a Société d'investissement à capital fixe ("SICAF"), or a Fonds Commun de Placement ("FCP"). These vehicles can be used to make investments across various jurisdictions with a low level of tax in Luxembourg, and the potential to access Luxembourg's treaty network at the fund level.

18 IRC Section 864(b)(2)

Sustainable investing brings specific tax risks

Governments are developing their tax strategies towards this emerging asset class, yet investing in sustainable assets already brings some specific tax risks.

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Investments in renewable energy, carbon and sustainability have grown rapidly in the last few years. The main drivers behind this growth are regulatory and other policy initiatives, introduction of tax incentives, expansion of carbon markets, energy security concerns and an increased interest in preventing climate change. Even with the credit crisis, investments in this area have shown significant growth in 2008 and, although the credit crisis will impact growth in 2009, further growth is anticipated.

However, this is still a relatively new asset class and governments worldwide are developing their tax strategies and introducing new taxes or incentives in response to the challenges posed by this sector. It is, therefore, essential that ownership structures are as flexible as possible, particularly given the long-term nature of many of the investments, and that investors keep up to date with global tax developments – a few of which are highlighted below.

An important issue for renewable energy and sustainability assets such as water infrastructure is the tax status in the country where the assets are located. Depending on whether the assets are considered movable or immovable, income from these assets may be taxable in the local jurisdiction, even where the assets are held by a foreign entity. Investing from a tax treaty jurisdiction does not always solve this issue as taxation of income from immovable property is generally reserved to the state where the property is located. However, there are a wide variety of debt financing and leasing structures which may reduce taxation in the local jurisdiction. In certain jurisdictions there are also various 'green' tax incentives or tax holidays which may reduce local taxation.

Where, as a result of the above, the holder of the renewable assets does not have sufficient tax capacity, 'green' tax incentives may not be beneficial to the holder of the assets. In these circumstances, the holder of these assets could explore ways of transferring these 'green' tax credits to, for instance, the leverage financier in order to reduce finance costs.

Investing in the carbon markets

Cap-and-trade schemes and project-based credit mechanisms form the two key building blocks of the carbon markets.

A project-based credit is an emission reduction below a hypothetical business-as-usual baseline. The two project-based credit mechanisms under the Kyoto Protocol are the Clean Development Mechanism (CDM) and Joint Implementation (JI). The CDM is an arrangement allowing countries with greenhouse gas reduction commitments to invest in projects that reduce emissions in developing countries that have no commitments such as China, India and Mexico. The CDM may result in Certified Emission Rights (CER) which can be traded. The JI is a similar sort of arrangement for investments in countries with binding greenhouse emission targets. The JI may result in Emission Reduction Units (ERU) which can be traded.

Investors investing in CDM and JI projects should be aware of the tax issues. Although these are generally long-term investments, offshore funds investing in CDM and JI projects should carefully consider the permanent establishment risks in countries such as China. Failure to do so can lead to unexpected tax costs.

Although the payment of CERs and ERUs generally do not trigger any local withholding tax, certain countries, such as China, claim part of the profits from the cross-border sale of these credits and certain jurisdictions are considering a direct withholding tax on carbon credits. Furthermore, the management of these projects may trigger withholding tax on the project management fees. Where licences and patents are used, licence fees and royalties may result in withholding taxes. VAT, and other indirect taxes, should be carefully considered to avoid irrecoverable VAT for the fund.

SWFs move to increase transparency

The Santiago Principles are being implemented and likely to make Sovereign Wealth Funds more acceptable to third-party governments.

In recent years, Sovereign Wealth Funds (SWFs) have become subject to an ongoing debate about the benefits they present to the global capital markets and whether they outweigh their perceived risks, as is often argued by the protectionists.

The apprehension surrounding SWFs emerges largely due to the perceived lack of transparency and disclosure by these state-owned investment vehicles. Protectionist governments believe their investment activities are politically motivated and driven by the desire to acquire strategic assets resulting in an imbalance in power in the economy of the recipient country i.e. intervention in recipient country fiscal policy.

Understanding the ultimate objectives and motives of these funds is fundamental. SWFs investment strategies vary widely; some are used as shields to protect local economies against market volatility, currency fluctuations and inflation. These are usually referred to as stabilisation funds while others are used as a means to diversify natural wealth, and to reduce concentration risk. Irrespective of the nature and form of these funds, however, they all share a common interest – to maximise profit returns.

Improving understanding

The International Working Group (IWG) of Sovereign Wealth Funds has recognised the need for transparency and disclosure by SWFs, through a set of principles and practices known as the Santiago Principles, which aim to ease market concerns. Finalised in September 2008, the framework will improve understanding of the investments' objectives, practices and governance. It will also provide a certain degree of comfort over the SWF investment process, from both an economic and financial perspective.

Implementation begins

While the principles are voluntary, SWFs are starting to implement them. As these principles become more refined and publicised, protectionist governments are likely to demand full compliance before SWFs are allowed to make investments. This should serve to reduce scepticism among the protectionists, help stabilise the global financial system and allow for the free inflow and outflow of capital between economies.

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Pressure for alternatives firms to adopt GIPS grows

Following the recent lacklustre performance across much of the alternatives industry, there is more reason than ever to increase transparency through the highest standards of performance measurement.

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After the recent turmoil in financial markets, the need to improve transparency and corporate governance has become more urgent. Confidence in performance data is at the core of this, making it likely that pressure will grow for alternative investment managers to adopt the Global Investment Performance Standards (“GIPS®” or the “Standards), a code of ethics governing the measurement and presentation of investment performance.

Regulators have been discussing the wider use of GIPS by private equity and hedge funds for some time. In the UK, a Financial Services Authority discussion paper has noted the need for private equity to reduce opacity, and the body has referred to the role GIPS could play in raising standards. In the US, the Investors Committee of the President’s Working of Financial Markets recommended that, where practicable and applicable, investors should require hedge fund and fund of hedge fund performance to conform to GIPS.

While large traditional investment firms have increasingly complied with GIPS, alternatives firms’ interest remains tepid. Yet these ethical standards confer a badge of transparency and integrity. They provide a global passport for presentations, and enable a firm to establish effective internal controls for measuring performance. By choosing to comply with GIPS, investment managers assure clients that historical performance track records are both complete and fairly presented.

Originally introduced in the United States in 1991 as the AIMR Performance Presentation Standards (AIMR-PPS®), the global version of the Standards was formally endorsed in 1999. The latest version, effective since 1 January 2006, results from close co-operation between professional bodies and sponsors around the world. As many as 30 countries in Europe, Africa and the Asia Pacific have now adopted GIPS.

Adapting to alternatives

It is anticipated that the forthcoming redraft of GIPS, due for release in 2010, will specifically address the characteristics of alternative asset classes, with drafting committees developing the existing Standards to encourage take up.

As interest in, and pressure for, GIPS compliance grows, so might investment managers seek to cut corners in their haste to comply and incorrectly claim compliance. One check against this is the involvement of the independent verifier in the process.

In order to ensure GIPS is correctly applied, its Executive Committee strongly encourages independent verification, although this is not mandatory.
As Jonathan Boersma, Executive Director of the GIPS Standards, notes, "the Executive Committee's decision not to require mandatory verification reflects the view that verification should be a market-driven decision – if it is important to investors, they will demand that their investment managers be verified."

Verification involves a comprehensive assessment by an independent third party of a firm's performance measurement processes and procedures. It covers the whole firm's performance, rather than its individual portfolios, and the whole period over which the firm claims to have been in compliance. Typically, each subsequent year is annually verified.

The quality of performance data has been a grey area for decades, presenting a multiplicity of methodologies, styles and standards, but the issue has become more pressing as the industry has grown and, more recently, as market conditions become more turbulent. Perhaps compliance with GIPS is the answer.

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IMRE News is produced by experts in their particular field at PricewaterhouseCoopers, to address important issues affecting the investment management industry. If you would like to discuss any aspect of this document, please speak to your usual contact at PricewaterhouseCoopers or one of those listed on these pages.

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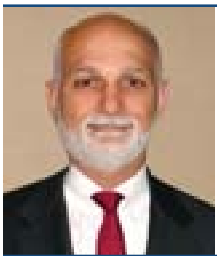

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