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News from:

Across Europe

- IOSCO investigates the role of Independent Oversight Entities
- Possible EC adjustments to the UCITS Directive: getting ready for UCITS IV
- IOSCO sets out the principles for the valuation of hedge fund portfolios
- CESR publishes final guidelines on hedge fund indices

Germany

Luxembourg

UK

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Introduction



Welcome to the second edition of European News & Views. Since March 2007, we have seen considerable developments and initiatives at European and international levels, resulting in some very interesting publications by the European Commission (EC), the Committee of European Securities Regulators (CESR), the Technical Committee of the International Organization of Securities Commissions (IOSCO TC) and the Commission de Surveillance du Secteur Financier (CSSF).

Of particular interest is the EC's Working Document entitled, "Initial Orientations of Possible Adjustments to UCITS Directive (85/611/EEC): Overview of Key Features" (published in March and subject to a public consultation that closed in June 2007), accompanied by a set of "Exposure Drafts", identifying six key areas detailing the anticipated adjustments to the Undertaking for Collective Investment in Transferable Securities (UCITS) Directive, which were urgently required.

After almost two years, CESR published its final Level 3 guidelines on "The Classification of Hedge Fund Indices as Financial Indices" in July 2007. This publication provides a very useful set of guidelines and due diligence to apply to hedge fund indices as well as financial indices in general.

After considerable review over the last two years, IOSCO TC published in February its Part II report entitled, "Independence Criteria, Empowerment Conditions and Functions to be Performed by the 'Independent Oversight Entities' ", aiming at further clarifying the role, powers and functions of the Independent Oversight Entities of Collective Investment Schemes.

IOSCO TC has also addressed another topical subject with the publication in March 2007 of a Consultation Report

called, "Principles for the Valuation of Hedge Fund Portfolios". Comments were submitted for public consultation in June 2007 with responses published in July 2007.

IOSCO TC anticipates publishing a final paper later this year. In this edition we set out those principles along with a brief summary of their anticipated coverage.

In Germany, the German Federal Financial Services Supervisory Authority (BaFin) has reviewed outsourcing guidelines in light of the implementation of the Markets in Financial Instrument Directive (MiFID). While this is being reviewed in Germany, it is interesting to note, from a European perspective, that the Committee of European Banking Supervisors (CEBS) issued proposed "Guidelines on Outsourcing" back in December 2006, to promote, where possible, greater consistency of approach within the national legal frameworks.

In Luxembourg, further to the implementation of The Law of 13 February 2007 on Specialised Investment Funds earlier this year, the CSSF published Circular 07/309, which provides guidelines to further clarify applicable risk-spreading rules.

In the UK, we are glad to publish interesting contributions from Hazell Hallam and Zoë Aylward of Deloitte & Touche LLP on effective yield accounting and the very sensitive issue of claiming back withholding taxes on EU dividends.

I hope you enjoy this newsletter, and we look forward to your continued feedback, which, as always, is very much appreciated.

Sean Quinn
EMEA Head of Fiduciary Services

IOSCO investigates the role of Independent Oversight Entities

The International Organisation of Securities Commissions (IOSCO) has been investigating the corporate governance arrangements for Collective Investment Schemes (CIS) for the past two years. In June 2006, it published a report on the "Examination of Governance for Collective Investment Schemes" (Part I). Following this publication, further work was carried out by the IOSCO Technical Committee (IOSCO TC) to identify principles of independent review and oversight to be applied to CIS. In February 2007, the results of this work culminated in a report being published by IOSCO TC entitled, "Independence Criteria, Empowerment Conditions and Functions to be Performed by the 'Independent Oversight Entities' " (Part II).

Part I, Section II, "Definition and scope of CIS governance", defines CIS governance as "a framework for the organisation and operation of CIS that seeks to ensure that CIS are organised and operated efficiently and exclusively in the interests of CIS investors¹, and not in the interests of CIS insiders".

Part I suggests that despite the diversity of legal and regulatory environments from which a CIS governance model could be developed, the principle of independent oversight applies to, or should be evidenced in, any CIS model.

However, considering that there is no single solution to the implementation aspect of corporate governance for CIS, IOSCO acknowledges that the independent oversight function can be exercised by one or more entities. The purpose of Part II is to further clarify the role, powers and functions of such Independent Oversight Entities.

The concept of independence

In Part II, IOSCO defines independence as "a set of arrangements that provide Independent Entities with appropriate legal conditions and autonomy to

exercise their powers and functions without constraints or interferences from the CIS Operator or its related parties², and allow adequate and objective oversight of the CIS and CIS Operator's activities, with the objective of protecting CIS investors and their assets".

As a consequence, IOSCO considers that a common set of principles and criteria should be adhered to in order to ensure that this independence concept is properly implemented and respected.

As a consequence, IOSCO considers that a common set of principles and criteria should be adhered to in order to ensure that this independence concept is properly implemented and respected. These principles and criteria should be transposed in IOSCO's Member States jurisdictions (where they are not already in place) remaining within the conditions of the local specific fund legal structures.

Part II sets out these principles and criteria as follows:

- II.1. The Independent Oversight Entities should be set up, composed, appointed or dismissed under conditions that prevent the decision-making process from being tainted by any type of conflict of interests with the CIS Operator and its related parties.
- II.2. The organisation and the practical functioning of the Independent Oversight Entities should allow them to be out of the control or undue influence of the

management of the CIS Operator or its related parties.

- II.3. There should not be any confusion between responsibilities of the Independent Oversight Entities when exercising their oversight function on the one side and the CIS Operator in its asset management role over the CIS on the other side.

The powers of Independent Oversight Entities

The issue of how to empower Independent Oversight Entities with sufficient legal capacities to exercise effective oversight is also analysed by IOSCO.

The powers of Independent Oversight Entities may be granted by way of statutory or regulatory rules or contractually. Part II sets out the following generic powers "that Independent Oversight Entities should have regardless of the type or legal structure of CIS in which they operate":

- III.1. The Independent Oversight Entities should be entitled to receive all relevant information enabling them to perform their oversight function in a proper manner.
- III.2. The Independent Oversight Entities should be given the necessary means to carry out their duties without relying exclusively on the CIS Operator assistance.
- III.3. The Independent Oversight Entities should be given the right to review the legal and operational conditions of the CIS management in relation with the CIS in a reasonable way.

Functions to be performed by Independent Oversight Entities

It is important to understand what functions an Independent Oversight Entity should perform. Part II specifies that "in close relation to the exercise

of their powers, Independent Oversight Entities have to perform overall control over the CIS Operator and the way it manages the CIS”.

In exercising this control, the Independent Oversight Entity may have to verify the adequacy of the CIS management, its effectiveness and compliance with existing applicable rules and the CIS Operator’s contractual obligations and fiduciary duties, particularly those cases where a CIS Operator’s decisions may have a significant impact on the CIS’s portfolio or the unit-holders’ interests. In this respect, PART II states “the functions that are more directly related to investors’ protection and may prevent and avoid inappropriate erosion³ or expropriation of the investors’ wealth and interests in the CIS are of particular importance.” The following functions are set out in Part II.

- IV.11. The Independent Oversight Entities, collectively, should have the functions of overseeing the CIS Operator and CIS Operator’s activities.
- IV.2. The Independent Oversight Entities, collectively, should have the function of ensuring that appropriate mechanisms are in place to prevent or avoid the erosion or expropriation of CIS investors’ wealth, and interests in the CIS.
- IV.3. The Independent Oversight Entities should have a duty of reporting to the regulatory authorities or the CIS unit holders.

Final considerations

In Part II, Section 1, “Main conclusions of part one of the governance project: The recommendations in terms of governance structures”, IOSCO TC states that “these principles aim at promoting the establishment and maintenance of

consistently high regulatory standards for the asset management industry in the area of CIS Governance.”

However, we would like you to consider, in particular, IOSCO TC’s reference in Part II, Section II, “The concept of independence: definition and key features”. It states that “in other jurisdictions, particularly those where the contractual model is predominant, independence derives from specific requirements like, for example . . . a regulatory framework requiring that the Depositary or Trustee and the CIS Operator are economically or at least functionally separate entities (if need be, through appropriate ‘Chinese walls’)”.

Notes

- ¹ Including both resident and potential investors.
- ² Entities that belong to the same economic group of the CIS Operator.
- ³ Excluding losses due to the performance of a CIS’s portfolio or the payment of legitimate CIS expenses.

Possible EC adjustments to the UCITS Directive: getting ready for UCITS IV

After much thought and discussion, the European Commission (EC) has published on 22 March 2007 a "Working Document DG Markt" services entitled, "Initial Orientations of Possible Adjustments to UCITS Directive (85/611/EEC)" (Working Document).¹ The Working Document, accompanied by a set of Exposure Drafts, has been subject to: a) a public hearing on 26 April 2007; and b) a public consultation that closed on 15 June 2007.

The Working Document identifies six main areas where amendments to the Undertaking for Collective Investment in Transferable Securities (UCITS) Directive are considered by the EC to be urgently needed, in line with the recommendations detailed in the "White Paper on Enhancing the Single Market Framework for Investment Funds" (referenced in the March 2007 edition of European News & Views). These areas are:

- Fund passport (and notification procedure);
- Fund mergers;
- Asset pooling/master-feeder structures;
- Management company passport;
- Simplified prospectus (and product disclosures); and
- Supervisory cooperation.

For each of these areas, the Working Document provides for a "strategic objective" description, which we will be quoting in the remainder of this article.

Further analysis on each of these areas can be found in the relevant "Exposure Draft" attached to the EC's publication of the Working Document.

The Working Document further states, "DG MARKT services envisage a complete overhaul of the notification procedure. This should significantly reduce delays and transform the procedure into a straightforward regulator-to-regulator filing".

Fund passport and notification procedure

"Strategic objective: ensure the smooth functioning of the product passport by eliminating administrative obstacles, delays and uncertainty to the marketing of UCITS in host Member States."

Much work has been performed in recent years, mainly by the Committee of European Securities Regulators (CESR) (referenced in the September 2006 edition of European News & Views), on streamlining the funds' notification procedure.

However, all work performed so far has been made within the constraints and limitations of a notification process that, due to the way it has been designed and transposed into national laws, is considered by the investment fund industry to be too similar to a "re-approval" process.

Amendments to the UCITS Directive may be required to eliminate those difficulties that – as stated in the Working Document, Section 3, "The Fund Passport (Notification Procedure)" – "undermine the effectiveness and credibility of the fund passport."

The Working Document further states, "DG MARKT services envisage a complete overhaul of the notification procedure. This should significantly reduce delays and transform the procedure into a straightforward regulator-to-regulator filing".

Under this approach, a UCITS willing to passport in another Member State would be required only to submit a set of documents to its home Member State authority. The latter would be responsible for verifying completeness of information and of transmitting it to the host Member State authority. The right of the UCITS to market its units in the host Member State would become effective three working days after transmission of the required documents by the home Member State authority to the host Member State authority.

To ensure a level playing field, the content and form of local (host-state) marketing information required will be subject to Level 2 harmonisation.

Under this new approach, the host-state regulatory authority according to the Working Document, Section 3.2, "Initial orientations for work on cross-border fund notifications," "would be able to invoke emergency powers in the event of clear and demonstrable ground that a UCITS domiciled in another Member State and marketing its units within its territory is in breach of the Directive, and a potential source of investor detriment."

A clear definition of the nature and use of these emergency powers, as well as of the concept of "breach of the Directive", will be required before the new process is in place.

Fund mergers

"Strategic objective: lay down clear and common requirements and procedures for funds wishing to merge, so as to ensure effective protection of the rights of unit-holders in the merging/dissolving

fund(s) and remove any regulatory grounds for competent authorities to object to the proposed merger besides the fulfilment of such requirements and procedures.”

The Working Document identifies the need to create a more harmonised framework for the merger of investment funds; however, despite identifying some areas of improvement, it does not include tax considerations, which may need a more detailed investigation.

The key features of these provisions (initial orientations) can be summarised as follows:

- Any national technique used for funds mergers in principle will be valid at domestic level; however, the EC identifies three typical methods of amalgamation:
 - (i) Merger by way of absorption; or
 - (ii) Merger by creation of a new fund; and
 - (iii) Merger by way of scheme amalgamation.
- The Working Document’s proposed measures will apply both to domestic and to cross-border mergers to ensure adequate investor safeguards are applied.
- Both the merging/dissolving and receiving funds should be authorised as UCITS before the merger can proceed.
- There would be no requirements in terms of comparability or similarity of the investment policies of the merging/dissolving and receiving funds.
- The competent regulatory authorities of the merging/dissolving fund(s) would have to give their approval before the merger can be presented to the unit-holders; however, the refusal of the approval would be admissible only in case of non-compliance with

“the envisaged measures”, and should be given within fifteen working days following the submission of a complete file by the merging/dissolving fund(s).

- The competent authorities of the receiving fund would not be required to approve the merger and may not reject the operation.
- The depositary will be required to give its approval to the merging/dissolving fund (the remit of this approval is not specified) and as stated in the Working Document “ensure that the terms of the merger are in conformity with the law”. It is likely the investment fund industry will request additional clarifications on these provisions.
- Unit-holders of the merging/dissolving fund would have the right to receive all relevant information regarding the proposed merger, to allow them to make an informed decision on the impact of the proposed merger on their individual situation.
- The new regime is aiming to establish a level playing field in terms of unit-holders’ votes required for the approval of the merger. In this respect, a maximum of 75 per cent of the votes cast is proposed.
- Unit-holders will have the right to exit the merging/dissolving fund at no charge (such right would be granted also to the unit-holders in the receiving fund, in certain cases). Legal, regulatory or administrative costs related to the preparation and completion of the merge should not be borne, directly or indirectly, by unit-holders.

A certain degree of consensus exists on the main principles of a UCITS merger framework. Initial studies performed by the International Organisation of Securities Commissions (IOSCO) detailed in a report published in November 2004 entitled, “An examination of the

regulatory issues arising from CIS Mergers”, and the additional suggestions made by the EC’s Expert Group on investment-funds market efficiency, have identified common features that an investment fund merger regime should possess to be flexible and, at the same time, to ensure adequate investors’ protection.

The Exposure Draft on mergers analyses different options with a particular focus on the regulatory supervision to avoid multiple authorisations being required and hence to reduce costs and time to market funds.

Asset pooling/master-feeder structures

“Strategic objective: allow several funds (feeder funds) to pool their assets in a single fund (master fund).”

The Exposure Draft on mergers analyses different options with a particular focus on the regulatory supervision to avoid multiple authorisations being required and hence to reduce costs and time to market funds.

The Working Document, Section 5, “Asset Pooling/Master-Feeder Structure”, states, “the possibility for a feeder to invest into several masters has been examined but rejected for the following reasons. There is limited practical experience with and demand for that approach. Supervision would become more complex and the prevention of operational risks or possible investment policy breaches more difficult. Such a regime would also be hard to distinguish

for legal and supervisory purposes from the existing UCITS 'funds of fund' regime."

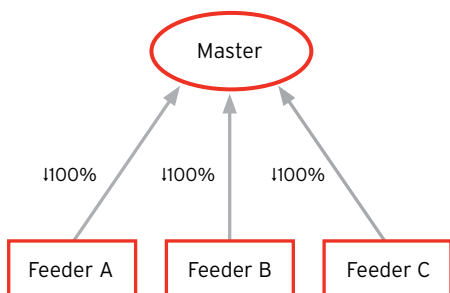
The Working Document goes on to specify, "DG MARKT services have also decided not to pursue further the technique of virtual pooling at this stage. Further research has identified potentially important cross-liability and other investor protection concerns." This does not, however, imply a suggested ban on virtual pooling techniques.

According to the Exposure Draft on pooling, the preferred pooling technique would be a master-feeder structure under which terms the feeder should invest at least 85 per cent of its assets into a single master fund – the investment of a feeder fund into more than one master fund being prohibited. The feeder fund would have no/limited investment policy role of its own; however, both feeder fund and master fund should have the same (identical or very similar) investment policy.

This would require the creation of a special regulatory regime, whereby existing UCITS can be converted into "feeder UCITS", while the master fund would only need to be authorised as a normal UCITS.

Hence, both master fund and feeder fund would remain UCITS funds and need to comply with the UCITS Directive.

Proposed master-feeder structure



Source: EC "Exposure Draft: Initial Orientations for Discussion on Possible Adjustments to the UCITS Directive: Pooling".

In respect to the proposed role of the depositary in master-feeder structures, the Exposure Draft on pooling states that "in the event that the master UCITS and the feeder UCITS have different depositaries, these depositaries shall, prior to the authorisation of the feeder UCITS, enter into an information-sharing arrangement which ensures the accomplishment of their duties." The EC will adopt implementing measures specifying the content of such an agreement, and suggests that the following information should be included:

- Time limits and requirement for submitting annual documents, periodical statements, certified inventories, reports on a merger, demerger, takeover, contribution in kind or liquidations affecting the master UCITS;
- Information about the master UCITS' exposure;
- Information on irregularities of the master UCITS.

Management company passport

"Strategic objective: to allow fund managers to manage funds (of either contractual or corporate type) domiciled in another Member State, without generating fiscal or supervisory uncertainty which might undermine the effective oversight or tax-efficiency of the management company/fund chain."

The EC's proposals on the management company passport may be subject to intense scrutiny, as the investment fund industry has been calling on several occasions, during the past year, for an effective implementation of the management company passport.

The Working Documents states, "In the exposure draft, DG MARKT services seek to provide clear and operational tests to identify the respective domiciles of the management company and of the fund in

cases where the management company passport is employed".

The Working Document further states, "DG MARKT services believe that the envisaged approach would also limit the danger of overlapping tax jurisdictions, i.e. of the fund and its management being both taxed in their respective domiciles."

The proposals detailed in the Working Document, Section 6.2, "Initial orientations for management company passport", can be summarised as follows:

1. The management company should have a right to manage funds of both corporate and contractual type that are domiciled in another Member State. Furthermore, the Working Document states, "The Directive would also provide for the corresponding rights for a UCITS to appoint/designate a management company in another Member State".
2. The domicile of the management company and of the fund would be determined with "clear tests" aiming to prevent uncertainty over relevant tax/regulatory jurisdictions and to ensure that there is "substance in the fund domicile".
3. Fund domicile would be determined on the basis of the laws under which it is constituted, but also by the requirement for the shareholder register to be kept in country, and the reporting of valuations to be "completed" and "filed" in this country.
4. Should a management company manage a fund domiciled in another Member State via the freedom to provide services, the Working Document specifies, "it should ensure that the performance of activities related to maintenance of shareholder register and/or completion/filing of fund valuation reports actually/physically take place in the Member State of the fund and

subject to direct reporting to the local competent authorities. It could not perform these functions on a remote basis. However, it could undertake these activities through branching (i.e. through the exercise of the freedom of establishment under the management company passport) or delegation arrangements”.

5. The depositary would be domiciled in the Member State where the UCITS is located (no changes to the current regime).

Simplified prospectus

“Strategic objective: ensure that product disclosures made by fund managers provide relevant and meaningful information to potential investors; reconfigure these disclosures so that they can be used in the different sales channels through which investors buy funds; remove unnecessary legal or regulatory information which create information overload and excess compliance costs.”

The experience with the simplified prospectus has been negative and frustrating for the fund industry; it will be subject to a kind of “damnatio memoriae” and renamed “key investor information”. According to the Working Document, key investor information will not necessarily be embodied in a specific document. Details on content and format will be decided at Level 2.

The Working Document specifies: “The key investor information disclosures should be fair, clear and not misleading. Key investor information should be consistent with the relevant parts of the relevant (full) prospectus”.

Product information should not be altered when UCITS are marketed in another Member State, so that only translation into the local language of the host Member State should be required.

Supervisory cooperation

No “strategic objective” is stated in this respect, but the Working Document suggests that the envisaged possible adjustments to the UCITS Directive accentuate the need for enhanced cooperation between regulatory authorities. In line with this approach, the Working Document states, “the existing provisions of the UCITS Directive dealing with these issues should be strengthened to”:

1. Ensure equivalence of powers for competent authorities;
2. Develop existing mechanisms relating to the exchange of information; and
3. Create arrangements which allow competent authorities of a Member State to, in the exercise of their responsibilities under the Directive, carry out on the spot verification of information and investigation on the territory of another Member State, or have them carried out by the competent authorities of another Member State/third party.

Final thoughts

The responses to the public consultation have been already published on the EC’s website. A review of the comments submitted allows us to draw some initial conclusions:

- Excellent progress has been made on the fund’s notification procedure, which should allow for reduced time to market and also reduce part of the distribution/marketing costs.
- Facilitating funds merger may improve the efficiency of the market, but some of the burdens placed on the depositaries seem excessive or not necessarily in line with their role.
- As far as virtual pooling is concerned, more investigation would be advantageous, even if proposed master-feeder structures have been positively welcomed by the fund industry.

The Working Document specifies: “The key investor information disclosures should be fair, clear and not misleading. Key investor information should be consistent with the relevant parts of the relevant (full) prospectus”.

- Management company passport proposals have not encountered full support, as most respondents seem to be of the opinion that the need to demonstrate substance in the fund’s domicile conflicts with the concept of a single financial-services market.
- In terms of supervisory cooperation, the establishment of a formal “mediation mechanism” between regulators or of a single UCITS regulator is considered a priority for the future.

Notes

¹ This document is a working document of DG MARKT services, which is published for discussion purposes only. It presents DG MARKT services’ preliminary reflections on possible future adjustments to the UCITS Directive. It does not necessarily reflect the views of the European Commission. The Commission retains full autonomy and discretion as regards the content of any subsequent legislative proposal.

IOSCO sets out the principles for the valuation of hedge fund portfolios

In March this year, the Technical Committee of the International Organization of Securities Commissions (IOSCO TC) published a Consultation Report entitled, "Principles for the Valuation of Hedge Fund Portfolios" (the Report). The Report, written with the close support of a group of industry experts has been subject to a consultation process. The responses received were published by IOSCO in July 2007.

The Report concentrates on the principles for valuing the investment portfolios of hedge funds, as well as those challenges that result from the pricing of illiquid and/or complex financial instruments.

Among the factors that have driven IOSCO TC's analysis are the increasing importance of hedge funds to global capital markets (also in terms of assets under management), the complexity of some hedge-fund portfolio strategies and their underlying instruments and the possible conflicts of interest that can arise when an advisory and/or performance fee is applied.

IOSCO TC sets out nine principles in the Report to meet the challenges arising from the factors above, stating, "The chief aim of the principles is to seek to ensure that the hedge fund's financial instruments are appropriately valued and, particularly, that these values are not distorted to the disadvantage of fund investors".

The nine principles

1. "Comprehensive, documented policies and procedures should be established for the valuation of financial instruments held or employed by a hedge fund."

This principle aims to ensure policies and procedures address the following fundamental points:

- Competence and independence of personnel who are responsible for valuing the assets.
- Investment strategy and the assets held in the hedge fund.
- Controls around the pricing source, methodology and system input.
- Escalation procedures for the resolution of variances in values for assets.
- Valuation adjustments that may relate to the size and liquidity of positions.
- Timing for closing books for valuation purposes.

2. "The policies should identify the methodologies that will be used for valuing all of the financial instruments held or employed by the hedge fund."

Policies should have a clear framework around all financial instruments that can be used in the fund. Furthermore, it should include the methodology to apply to each financial instrument at the following stages: inputs (i.e. from an independent source), valuation models and the selection process for pricing and market data sources.

The procedures should also recognise the process for the valuation of a newly purchased financial instrument that may fall out of the scope of the existing policy for the valuation of a hedge fund. Where the hedge fund can be traded in multiple time zones, the policy should detail the cut-off times when securities can be traded and the applicable regulations on best execution and timely execution.

With the variance in investment strategies applied to hedge funds, the controls that govern pricing sources and model verification are key. The Report states, "In selecting

the methodology to value a financial instrument, account should be taken of the sensitivity of varying methodologies and how specific strategies may determine the relative value of the financial instruments in the portfolio."

The chief aim of the principles is to seek to ensure that the hedge fund's financial instruments are appropriately valued.

3. "The financial instruments held or employed by hedge funds should be consistently valued according to the policies and procedures."

This principle emphasises the importance of policies, procedures and methodologies being applied consistently, which, as set out in the Report, "should generally be:

- To all financial instruments within a fund that share similar economic characteristics;
- Across all hedge funds that have the same Manager, taking time zone and trading strategies into account; and
- Over time unless circumstances arise that suggest that the policy requires updating; in particular, valuation sources and rules should remain consistent over time."

4. "The policies and procedures should be reviewed periodically to seek to ensure their continued appropriateness."

IOSCO TC recognises that, with the various types of hedge-fund structures, the importance of policies and procedures to outline in what

circumstances (i.e. market events, changes in strategy, changes in product) a change to the valuation policy and/or methodology should apply is key.

The process to review any changes to an existing policy should be reviewed and approved by the Governing Body¹ /Manager prior to implementation of any changes that impact the fund.

5. "The Governing Body should seek to ensure that an appropriately high level of independence is brought to bear in the application of the policies and procedures and whenever they are reviewed".

Here the focus is on maintaining the appropriate level of independence involved in the valuation process. This can be achieved by various approaches depending on the management structure of the hedge fund, for example:

- Delegation to a third-party pricing service;
- Independent reporting lines within the Manager for the investment decisions and valuation reporting process; and
- The Governing Body/Manager overseeing a "Valuation Committee".

In all instances, the applicable experience and competence is required.

6. "The policies should seek to ensure that an appropriate level of independent review is undertaken of the individual values that are generated by the policies and procedures and in particular of any valuation that is influenced by the Manager."

This is aimed at ensuring that, for more complex financial instruments (like illiquid securities), securities only priced by one counterparty (or

where the valuation may be influenced by other parties) necessitate that adequate controls verify the reasonability of the prices to be applied.

7. "A hedge fund's policies and procedures should describe the process for handling and documenting price overrides including the review of price overrides by an Independent Party."

Where a price is not accepted to be the best price for a financial instrument and requires overriding, clear procedures and policies should be implemented, which includes reporting to an independent party for the appropriate level of review.

8. "The Governing Body should conduct initial and periodic due diligence on third parties that are appointed to perform valuation services."

In instances where the Governing Body has delegated services to a third-party service provider, the Report states, "suitable due diligence should be conducted to determine that the service provider has and maintains appropriate systems and controls and a sufficient complement of personnel with an appropriate level of knowledge, experience and training commensurate with the hedge fund's valuation needs".

9. "The arrangements in place for the valuation of the hedge fund's investment portfolio should be transparent to investors".

This principle relates to the relevant data that should be made available to investors, if requested. The Report sets out the following list of relevant data but recognises this is not necessarily all inclusive:

- The valuation policies of a hedge fund and material changes to the policies;

- A description of the roles, skills and experience of all of the parties that are involved in the valuation of the financial instruments of the hedge fund;
- A description of the extent to which valuations have been provided by or influenced by the Manager;
- A description of any material conflicts of interest associated with the parties who are valuing the fund's financial instruments;
- The hedge fund's responses to investor questionnaires or any other requests for information about valuation issues; and
- Information about the nature and degree of any contracted pricing services.

Conclusion

These nine principles are applicable to any type of hedge fund regardless of its legal structure. However, IOSCO TC does recognise that hedge funds may vary, in size, structure and operational processes, and will rely on their Governing Body/Manager to review their valuation processes accordingly.

These principles aim to provide a consistent approach to the valuation policies and procedures for the managing, administering and reporting of hedge funds, as well as providing increased regulatory focus. In any instance, it remains best practice for investors to apply due diligence prior to investing in a hedge fund.

IOSCO TC anticipates publishing a final paper later this year.

Notes

¹ According to the Report, "The Governing Body may also be known as the 'Board of Directors' or the 'General Partner', depending on the jurisdiction of the hedge fund. . . . In some jurisdictions . . . the Governing Body may be the Manager."

CESR publishes final guidelines on hedge fund indices

The Committee of European Securities Regulators (CESR) published in July 2007 final Level 3 guidelines on "The Classification of Hedge Fund Indices as Financial Indices" (the Guidelines). In this article, we review the key features of CESR's Guidelines and analyse possible impacts for the Undertaking for Collective Investment in Transferable Securities (UCITS) industry.

In October 2004, the European Commission (EC) mandated CESR to clarify, in its capacity as an independent advisory group, some of the definitions of eligible assets for UCITS investment provided for by the UCITS Directive. In the March 2007 edition of European News & Views, analysis was provided in the article, "CESR Launches a Consultation on Derivatives on Hedge Fund Indices for UCITS Investments".

The Guidelines aim to clarify whether hedge fund indices could be classified as "financial indices" for the purpose of the UCITS Directive.

Definition of a financial index

Article 19(g) of the UCITS Directive 85/611/EEC (obligations concerning the investment policies of UCITS) states that the investment of UCITS may consist of "financial derivative instruments . . . provided that the underlying consists of . . . financial indices" (among other things).

Previously published Level 2 Directive (C(2007) 1178 final) and CESR Level 3 Guidelines (CESR/07-044) clarify the characteristics of eligible financial indices, as follows:

1. **Diversification:** an index must be sufficiently diversified, i.e. it must be constructed in such a way that:
 - Price movements of a single component cannot unduly influence the performance of the whole index; and

- It complies with, or is equivalent to, diversification rules as per Article 22 of the UCITS Directive (which we recommend you review for further guidelines).

2. **Representation:** the index must represent an adequate benchmark of the market to which it refers so that:

- The performance of the underlying index is measured in a relevant and appropriate way;
- The index composition is periodically adjusted to ensure it is representative, on the basis of publicly available criteria; and
- The underlyings are sufficiently liquid to allow for an index replication, if necessary.

3. **Publicity:** the index is published in line with the following criteria:

- The index price production is based on sound procedures, in particular, for difficult to price components; and
- Any material issue relating to index calculation, rebalancing methodologies, index changes or other operational difficulties are made public, timely and widely available.

Hedge fund indices as financial indices

CESR has taken the approach that no additional requirements should be imposed on UCITS willing to employ derivatives on hedge fund indices. The Guidelines Feedback Statement (CESR/07-433), Section 24 Explanation, states, "CESR believes that the objective selection of components using predetermined rules is a key distinction between a hedge fund index and a fund of hedge funds".

The key points of the Guidelines can be summarised as follows:

- A hedge fund index must comply with the conditions laid down by the Level 2 Directive (as identified in the previous section);
- The methodology of the index must provide for the selection and the rebalancing of components on the basis of predetermined rules and objective criteria;
- The index provider cannot accept payments from potential index components for the purpose of being included in the index (objective component selection principle); and
- The index methodology cannot allow for retrospective changes to previously published index values (so-called "backfilling").

The importance of due diligence

A UCITS is supposed to perform due diligence on any investment decision. CESR has identified some guidelines in this respect, but considers due diligence should include all the additional elements that the UCITS may consider relevant.

CESR requires the UCITS to assess, and to keep record of the performed assessment, at least the following elements:

1. Is the index methodology adequate, i.e. does it contain a satisfactory explanation on weighting techniques, the classification of the components and the treatment of defunct components? In other words, does the index represent an adequate benchmark for the kind of hedge funds to which it refers?
2. Is information available and adequate to accurately represent the index and is there an adequate control framework implemented to monitor this process (independent audit)? Furthermore, it is key to determine how frequently the index value is published to enable the investing UCITS to perform regular calculations of its net asset value.

3. Is the index provider treating index components adequately? In particular, does it perform due diligence on the way components calculate their net asset value and are details of the components and their net asset value available (including whether or not the single components are investable and provide sufficient diversification)?

Some considerations on the use of derivatives

When gaining exposure to a hedge fund index by means of an OTC derivative, a UCITS must comply with: counterparty requirements; valuation requirements and ability to close a position; risk-management and valuation process requirements; and risk-exposure requirements.

Counterparty requirements

In terms of counterparties, Article 19(g) of the UCITS Directive states that these should be "institutions subject to prudential supervision, and belonging to the categories approved by the UCITS' competent authorities".

Valuation requirements

In terms of valuation, of liquidity and of valuation process, there are different factors to be considered.

Article 19(g) of the UCITS Directive states that OTC derivatives can be employed if "subject to reliable and verifiable valuation on a daily basis, and can be sold, liquidated or closed by an offsetting transaction at any time at their fair value, at the UCITS' initiative."

One of the key issues is how to ensure that the value of an OTC derivative on hedge fund indices can be independently assessed. Article 21 of the UCITS Directive states that the UCITS management (or the UCITS management company, as applicable) "must employ a process for accurate and independent assessment of the value of OTC derivative instruments."

The Level 2 Directive has already clarified that "reliable and verifiable valuation" shall be understood as a reference to a valuation that complies with the following criteria:

1. The basis for the valuation is either a reliable up-to-date market value of the instrument, or, if such value is not available, a pricing model using an adequate recognised methodology;
2. Verification of the valuation is carried out by either an independent third party (which may not be the OTC derivative counterparty) or a unit within the UCITS independent from the department in charge of managing the assets.

Risk-management process

The UCITS is required to employ a risk-management process that enables it to "monitor and measure at any time" the risk of the positions and their contribution to the overall risk profile of the portfolio.

Risk-exposure requirements

When gaining exposure to a hedge fund index by the use of an OTC derivative, a UCITS must also comply with the risk-exposure requirements of Article 22 of the UCITS Directive.

Conclusions

It has taken almost two years for CESR to issue the final guidelines on hedge fund indices and the terms under which they may be considered as financial indices for the purpose of UCITS. These guidelines also provide a very useful set of criteria and best practices that can be equally applied to financial indices in general.

Modernisation of Germany outsourcing rules

Currently at the European Union (EU) level, there is no harmonisation in the area of outsourcing undertaken by financial institutions, which are subject to regulatory supervision. Following its December 2005 publication, entitled "Minimum Requirements for Risk Management" (MaRisk), the German Federal Financial Services Supervisory Authority (BaFin) sought to simplify its outsourcing rules. Similarly, the BaFin also considered the German Markets in Financial Instrument Directive (MiFID) implementation process, which is currently reviewing outsourcing.

Finally, in December 2006, the Committee of European Banking Supervisors (CEBS) issued proposed "Guidelines on Outsourcing" (the CEBS report), following a Consultation Paper issued in April 2006. It is key to note that CEBS and the Committee of European Securities Regulators (CESR) have ensured that these proposed guidelines are consistent with MiFID.

As specified in the CEBS report, "CEBS has deemed it appropriate to develop these Guidelines in order "to promote greater consistency of approach where possible within the national legal frameworks".

Below we provide summarised details on the definitions and proposed guidelines and rules relative to the outsourcing of a service provider.

The objective behind the CEBS report is "to promote greater consistency of approach where possible within the national legal frameworks."

Definitions

Outsourcing of operational functions as defined by section 25a (2) German Banking Act (KWG) applies if an institution authorises another firm, the "outsourcing service provider" on a continuing basis or for an agreed time frame, to perform principal activities or functions. The one-off and/or occasional

purchasing of goods and services does not constitute outsourcing.

The outsourcing service provider can be defined as any other area, entity or person, which may be an affiliated entity within a corporate group or an entity that is external to the outsourcing institution. The legal form of incorporation of the outsourcing service provider is not material.

The new rules, for the first time, distinguish between "material" and "non-material" activities of outsourcing.

Simultaneously, the outsourcing entity (bank) must establish adequate risk analysis, oversight controls and supervision, to ensure it identifies its responsibilities for all material activities.

Material activities cover:

- Functions and activities that are directly required to execute the conducted business of the outsourcing entity (bank); and
- Functions and activities that impact relevant risks associated with the regulatory responsibilities and supervisory authority – for example, market, credit, default, settlement, liquidation and reputation risks, and operational and legal risks – which may influence the institution.

Simultaneously, the outsourcing entity (bank) must establish adequate risk analysis, oversight controls and supervision to ensure it identifies its responsibilities for all material activities.

Non-material activities:

- These activities have no relevant risks of impacting bank supervision and/or regulatory requirements and, if outsourced, will not effect the compliance of business processes, controls and supervision of business management.

Legitimacy of outsourcing

In principle, all areas of an institution can be subject to outsourcing, provided that outsourcing does not impair the following:

- The orderliness of the conduct of business or the financial service provided by outsourcing institution;
- The senior management's ability to manage and monitor the authorised entity's business and its authorised activities;
- The ability of internal governance bodies, such as the board of directors or the audit committee, to fulfil their oversight tasks; and
- The BaFin's supervision of the outsourcing institution.

The CEBS report specifies: "The ultimate responsibility for proper management of the risks associated with outsourcing or the outsourced activities lies with an outsourcing institution's senior management."

Therefore, adequate core competence at senior operational level must be retained in-house to ensure not only the delegation of senior management's responsibilities around planning, organisational control, risk assessments and regulatory reporting, but also to ensure that the capability is still in-house to resume direct control over outsourced activity should the need arise.

Furthermore, a complete outsourcing of internal audit functions only applies if the financial institution has appointed an audit delegate.

Requirements on admissible outsourcing

Specific standards, notably for the outsourcing agreement, are applicable only to the outsourcing of material activities and processes. The materiality is to be assessed by the institutions themselves on the basis of a risk analysis. If a domestic branch of a foreign corporation outsources functions to the foreign main office or branch of the affiliated institution, appropriate internal agreements have to be established (i.e. internal guidelines, policies and a formal contract).

All outsourcing arrangements should be subject to a formal and comprehensive contract taking into account the following key aspects:

- The operational activity that is to be outsourced should be clearly defined.
- The outsourcing institution has to select the outsourcing service provider by performing adequate due diligence.
- The respective rights and obligations of the outsourcing service provider have to be precisely defined and specified.
- At any time, the outsourcing institution and the BaFin should have access and unrestricted rights to the outsourcing service provider's data, systems and processes to cover its audit, monitoring and regulatory requirements as well as its business contingency arrangements.

Finally, the written statement should contain a mixture of quantity and quality performance targets to manage the outsourcing relationship in a professional manner. Furthermore, confidentiality and banking secrecy should be protected by the inclusion of an appropriate clause into the agreement.

When outsourcing to foreign EU countries, the outsourcing institution is responsible to ensure that arrangements are in place to enable the BaFin to uphold its control and regulatory supervision. If these rights cannot be granted in favour of the BaFin, the outsourcing arrangement has to be revoked.

When outsourcing to foreign EU countries, the outsourcing institution is responsible to ensure that arrangements are in place to enable the BaFin to uphold its control and regulatory supervision.

Obligation of notification

The former obligation to notify the BaFin and the German Central Bank prior to any outsourcing will no longer apply.

Intra-group outsourcing

As the proposed rules are still subject to discussion, and feedback to the Consulting Papers from the regulatory bodies was requested by 7 May 2007, the BaFin has explicitly asked for proposals with regards to "if and how intra-group outsourcing could be subject to reduced requirements".

In the second Consultation Paper, published on 13 August 2007, the BaFin suggests that the group-wide audit must act as an additional component of the risk management within the group subject to the subordinated company and can rely on the internal audit results and reports of the subordinated company.

Conclusion

Given the increased use of outsourcing by institutions, including on a cross-border basis, we anticipate that the modernisation of German outsourcing rules will promote greater flexibility and legal security for domestic financial institutions outsourcing their functions to other EU jurisdictions whose focus is mainly on low-cost centres or streamlined processes.

CSSF publishes risk-spreading guidelines for SIFs

The Law of 13 February 2007 on Specialised Investment Funds (the SIF Law) has provided Luxembourg with a revamped legal and regulatory environment for alternative investments. Recent guidelines from the Commission de Surveillance du Secteur Financier (CSSF) now clarify applicable risk-spreading rules.

According to the SIF Law, a SIF may invest into assets (any category thereof) in compliance with risk-spreading rules and may not hold assets “passively” since the law refers to “management” of assets as opposed to the “holding” of assets.

One of the key aspects of the SIF Law is that the extent of risk-spreading rules is not clarified. CSSF Circular 07/309, published on 3 August 2007, provides guidelines in this respect.

Extreme flexibility

The SIF has immediately attracted the interest of promoters and asset managers because of its extreme flexibility in terms of eligible assets. Even if some of its features may be considered restrictive in comparison with “classic” offshore locations (the requirement for a depositary to be appointed, for example), the SIF is becoming a very popular vehicle for investment into any asset class.

The CSSF has decided to preserve this perceived flexibility by stating in Circular 07/309 that despite the suggested risk-spreading rules (which we analyse below), the regulators will approve derogations if adequately justified (“*il est entendu que la CSSF peut accorder des dérogations sur base d'une justification adéquate*”).

Well-informed investors

Investment into SIFs is restricted by law to “well-informed investors” only. A well-informed investor is defined as an institutional investor, a professional

investor or any other investor (“*tout autre investisseur*”) meeting the following criteria:

1. He/she has confirmed in writing to adhere to the status of “well-informed investor”;
2. He/she invests a minimum of EUR125k; or
3. Has been the subject of an assessment made by a credit institution, investment firm or management company certifying his/her expertise and knowledge of the product.

The CSSF considers, in Circular 07/309, that in consideration of the above it is assumed that investors are informed enough to understand the risk-spreading concept and are capable to obtain the information they require to assess the characteristics of the investment.

However, to facilitate this assessment, a SIF’s offering documentation must include quantifiable limits documenting compliance with risk-spreading principles.

The new SIF Law provides Luxembourg with a modern pragmatic legal and regulatory environment for alternative investments.

Risk-spreading rules

The CSSF defines three risk-spreading rules, for long, short and derivative positions, respectively, applying to all of them a 30 per cent limit as follows:

- **Long positions** A SIF cannot, in line of principle, invest more than 30 per cent of its assets in securities of the same nature, and of the same issuer. This rule is not applicable in the case of securities issued by an OECD Member

State or, interestingly, securities issued by a collective investment undertaking subject to risk-spreading rules at least comparable to those of a SIF.

- **Short positions** Short sales on securities of the same nature and the same issuer cannot, in line of principle, represent more than 30 per cent of the SIF’s assets.
- **Derivative positions** The underlying positions in case of investment in derivative instruments must comply with risk-spreading rules comparable to those identified above in the case of long or short positions. The same applies, in the case of over-the-counter derivative positions, to counterparty limits.

Conclusions

The new SIF Law provides Luxembourg with a modern and pragmatic legal and regulatory environment for alternative investments. The light-touch approach to risk-spreading rules taken by the CSSF strengthens Luxembourg’s role as the leading centre for onshore hedge fund business.

The CSSF’s risk-spreading rules may be equally applied to private equity or venture capital funds; however, the question may arise as to whether or not they would fit in with other asset classes (properties, fine arts, wines, etc.).

As the CSSF retains the right to agree alternative risk-spreading rules, this may prove to be a non-issue from a practical point of view.

Effective yield accounting – tax issues

For accounting periods beginning on or after 1 January 2007, the methodology used for calculating income from bonds held in authorised funds in the UK, changed to an effective yield basis. Managers may now be forced to make a decision between having volatile income, or dealing with potentially horrendous daily net asset pricing systems issues. The adoption of effective yield accounting presents a very real problem for managers that have marketed and sold bond funds offering guaranteed income returns to investors.

Income volatility is now an issue because effective yield accounting requires that calculations of income must reflect the amortisation of premiums or discounts to the maturity of bonds. Consequently, it can bring what were previously acknowledged to be capital movements to income.

As competing jurisdictions such as Luxembourg and Dublin¹ have not yet adopted effective yield accounting, the competitiveness of UK authorised funds could be impacted, although not all offshore funds will remain untouched, since the UK's adoption of effective yield accounting could be significant for offshore funds seeking to achieve UK distributor status by reference to UK General Accepted Accounting Principles (GAAP) and the Statement of Recommended Accounting Practice (SORP).

The proposed solution to the issue of income volatility is to allow funds to opt to distribute on a coupon as opposed to on an accounts income basis. From 23 March 2007, the rules will allow managers of authorised funds to distribute income from bonds on the newly introduced effective yield basis or the coupon basis. Coupon distributions will be permitted only where these are at least equal to the amount of income calculated on an effective yield basis.

As interest rates move, funds could have to switch between effective yield and coupon distribution basis. Tax deductions are given for distributions, so if managers opt to avoid volatility of income, then there is a potential tax consequence, since the basis on which tax deductions in relation to distribution will be calculated will change.

Income volatility is now an issue because effective yield accounting requires that calculations of income must reflect the amortisation of premiums or discounts to the maturity of bonds.

No tax solution has to date been found for what is known as "AG8 adjustments". Some capital gains that have historically not been subject to tax, will now be subject to tax as income.

The remainder of this article considers in more detail what effective yield is, the potential impacts of its adoption and the tax consequences.

What is effective yield?

Effective yield is a method of calculating bond income. Instead of just accepting the coupon yield to be the income on bonds, where there is a premium or discount to the purchase price this is amortised to the maturity value of the bond over the bond's remaining life. The simple way of performing this amortisation calculation is on a straight-line basis; however, the method required by effective yield, International Financial Reporting Standards (IFRS) and the SORP uses discounted cash flows, thus taking into consideration the time value of money.

In practice, effective yield income from bonds includes the amortisation of the premium (or discount) when purchased as well as the coupon yield and contains adjustments to income when there are changes to expected cash flows. It is certain changes, typically changed expectations on maturity dates that result in adjustments to income that result in income/capital distortions, commonly known as AG8 adjustments.

Until now, except where the premium or discount at issue was significant, only the coupon yield has been considered to be income.

Why the move to effective yield?

The move to amortisation of purchase price to maturity value for all bonds as a fairer way of accounting for income from bonds was unavoidable. The previous SORP for authorised funds required a simple amortisation only where the discount or premium to the issue price was "significant"; this was a defined term and meant 15 per cent. The new SORP therefore introduced amortisation on an effective yield basis for accounting periods beginning on or after 1 January 2007. Thus, fund accounting would move to best practice, be consistent with IFRS, and should give investors and fund providers certainty of how income is calculated. In response to feedback during the public consultation on the new SORP the decision was taken to move to adopt effective yield in one step rather than moving to amortisation on a straight line basis then to effective yield when IFRS became a requirement, as an earlier IFRS convergence was expected.

How does effective yield work and what does it mean in practice?

The effective yield basis requires calculation of income by estimating future cash flows and identifying the discount rate (Internal Rate of Return or IRR) that would discount those cash flows back to the carrying value.

Year	Amortised cost at start of year	Expected receipts	Investment Income	Amortised cost at end of year	Amortisation in the year
1	990,000	80,000	81,696	991,696	1,696
2	991,696	80,000	81,836	993,532	1,836
3	993,532	80,000	81,987	995,519	1,987
4	995,519	80,000	82,151	997,670	2,151
5	997,670	1,080,000	82,330	0	2,330
Total		1,400,000	410,000		10,000

This discount rate (IRR) is the effective interest rate at which income is earned and this "effective interest rate" (EIR) is used to calculate the annual interest income. All premiums/discounts arising on the purchase of debt securities are spread over the remaining estimated life of the instrument. The key differences to the previous practice of amortising significant discounts or premiums are that the spreading of a premium or discount is not on a straight-line or compounding basis but makes allowance for the time value of money, and that all bonds are now subject to amortisation not just the ones issued at a significant discount or premium.

It is perhaps helpful to provide a simple numerical example for known cash flows.

A five-year bond purchased for GBP990,000 with a principal of GBP1 million and a fixed 8 per cent annual coupon.

Under the 2003 SORP, the 8 per cent coupon would have been recognised as GBP80,000 interest income annually and a capital gain of GBP10,000 at the end of year five. Under the effective yield method, the cash flows on this asset generate an IRR of 8.25212 per cent that spreads the total investment income over the life of the asset (see table above).

In summary and by comparison, where previously the fund would have recognised GBP80,000 of interest income per annum, the EIR income will be GBP81,696 in year one rising

to GBP82,330 in year five and the total income (if the security were held to maturity) would be GBP410,000 compared to GBP400,000 on the old coupon basis.

In a different set of circumstances it is of course possible for coupon income to be higher than coupon income plus amortisation. It is also possible for amortised income to be more volatile under different circumstances.

What's the problem with effective yield?

The FSA has permitted funds to opt to make distributions based on coupon receipts as opposed to solely on accounts income recognised, as it identified the following issues with effective yield accounting:

- The way effective yield works in practice could mean that when the market value of bonds are falling, the movements in market value are treated as a reduction in income through the AG8 adjustments. In these instances the effective yield will be lower than the coupon rates.
- The old FSA rules restricted distributions to the level of income in the accounts. When combined with effective yield accounting this could reduce income for investment grade funds below rates offered by banks despite the coupon rate for the fund being higher. This would have conflicted with the basis on which the fund was marketed to investors.

- It could have a serious detrimental effect on the UK bond fund market. For example, Luxembourg has not implemented IFRS and although Ireland has implemented the relevant IFRS, distributions made by Irish funds do not depend on the income figure shown in their accounts.

AG8 adjustments – the "sting in the tail"

AG8 adjustments are adjustments to the amortised cost of a bond arising where there has been a change in future cash flow estimates. They are a concern because they make income recognition considerably more volatile. Where AG8 is applied the amortised cost of an instrument is adjusted by the present value of the changes in cash flow estimates, and the movement in amortised cost is required to be recognised in the income statement as interest income. In the case of authorised funds, this requires recognition in the Statement of Total Return.

In its Circular 233/06 the Investment Management Association (IMA) suggested that AG8 adjustments are capital in nature and therefore should be identified in the notes to the accounts and should not be included in distributable income. One point not dealt with in the IMA circular is the question of how to treat any tax that is assumed to be charged on AG8 adjustments that might arise, particularly if AG8 adjustments are treated as capital and excluded from the distribution; paragraph 2.50 of the SORP,

sets out the principle that tax treatment should follow the principal amount.

According to FSA regulations, "property income" must be distributed. This is a defined term in the FSA regulations. In short, it means that the amount should be determined by the Manager in consultation with the fund's auditor.

The concept of distributing income based on something other than accounts income is in fact nothing new. It is already the case that some funds make distributions of income which are not the same as the income shown in the audited accounts (departures are most commonly seen in the context of distributions of special dividends on mergers, etc). In addition, there are already a number of tax cases where the decision was that "income" for the purposes of "income property" in the FSA handbook in fact means income from a legal point of view and that what constitutes distributable income from an accounts perspective is in fact irrelevant.

AG8 adjustments – how frequent will they be?

Whilst there will of course be some AG8 adjustments, they are not expected to occur frequently and may in fact be rare. Nonetheless, managers will need to implement procedures which ensure that where changes to the cash flows expected at acquisition have arisen, these are communicated to the fund accountants on a timely basis, in order that they may be dealt with appropriately.

There perhaps at least three reasons for AG8 adjustments being kept to a minimum:

1. Changes to cash-flow expectation should be considered to be "reliable" to trigger an AG8 adjustment. Market expectation of call date is subject to several factors including: future interest rate expectations, expectation of an issuers' future credit standing

and the expectations for corporate bond credit quality of the overall market. Although a change to market expectations may become apparent, whether that revised expectation is "reliable" or not will likely depend on a number of factors being predictable over the longer-term with some degree of certainty.

2. Investment managers rarely hold bonds until call or maturity, as the risk premium on the bond falls as the call/maturity date approaches. Instead managers typically sell bonds and buy new bonds with longer durations. Therefore managers' cash flow expectations are not necessarily governed directly by the anticipated call dates, but could be said to more depend upon anticipated disposal dates. Therefore, it may not be logical for a manager to make an AG8 adjustment reflecting the latest market view on a future call date when the manager may have no intention of holding the bond to such a date in any event.
3. In practice managers are likely to operate within "tram lines" (upper and lower limits) as set out in the IMA's published SORP guidance. Only material changes to the market value of the underlying securities, e.g. + or - 5 per cent, should require an AG8 adjustment to income. Equally, the contractual terms should be used where estimates cannot be made reliably.

Accounting and distribution

Since the adoption of effective yield accounting can clearly produce results inconsistent with funds' objectives and can result in distortions between income and capital, the FSA consulted in CPO6/18 on a proposal to change the definition of "income property" so as to enable distributions to be made on a coupon basis.

It was recognised some time ago that if distributions were to differ from accounting income that there would be consequences and the decision on how to distribute should also consider these issues:

- In pricing, the analysis between income and capital would have to follow the distribution basis rather than accounting income.
- There would potentially be additional administration costs as a result of having to maintain records for accounting and separate records for pricing.
- There could be a tax charge to the fund if the distribution is lower than accounting income. Where the distribution is higher than accounting income there could be tax losses carried forward (discussed further below).

As a result of CPO6118, as of 23 March 2007, the FSA will permit funds to make distributions of coupon income as opposed to accounts income but only where coupon distributions are in excess or equal to accounts income. The acceptability of coupon distribution only in one scenario (i.e. coupon > accounts income as opposed to accounts income > coupon income) was apparently put into place at the request of the UK tax authorities.

Tax implications – UK funds

One suggestion put to HM Revenue and Customs (HMRC) to prevent tax sticking at the level of the fund was for both taxable profits and distributions to be based on coupon receipts, i.e. so that the link with the accounts would be broken entirely. However, HMRC were quick to advise that they would not consider this to be an acceptable basis, since the existence of zero coupon and deep discounted bonds would have enabled the postponement of the payment of tax. A break of the link with the accounts

would of course additionally have the risk of making the whole capital/revenue debate much more arduous, especially where derivative policies were concerned!

Discussions have also been taking place with HMRC over whether they would seek to tax so-called AG8 adjustments. However, HMRC are not yet persuaded that such adjustments are capital rather than revenue in nature and as a result there is currently uncertainty over whether AG8 adjustments are taxable. In light of this uncertainty, the IMA has recommended that for pricing purposes, for funds with accounting periods beginning on or after 1 January 2007, fund pricing should assume that AG8 adjustments within accounting income are taxable.

Bond funds are entitled to take a tax deduction for distributions made. If a fund switches between effective yield and coupon bases for making distributions, then this will undoubtedly introduce a tax complexity into daily net asset pricing models.

Tax implications – distributing funds

Effective yield accounting will become significant for offshore funds seeking to achieve UK distributor status by reference to UK GAAP and the SORP. An offshore fund cannot be certified as a distributing fund in respect of any account period unless, with respect to that period, it pursues a full distribution policy. The amount of the distribution to be made for the account period should be at least 85 per cent of "income" of the fund. In this context "income" is as shown in the fund accounts; but this cannot be less than 85 per cent of the United Kingdom Equivalent Profit of the fund. Given the potential implications of AG8 adjustments on distributable income and the fact that a number of funds have undertaken to provide their investors with a constant stream of income (likely based on coupon receipts), it remains to

be seen whether this situation will cause fund managers to reconsider seeking UK distributor status, although it would seem likely that this change might prove to be a further disincentive, particularly for funds that are based in Dublin.

Tax implications – investors

If it becomes possible to make distributions on a coupon basis, then managers will need to take care so that investors pay tax on income that they actually receive and not on accounts income, if the two differ. This may not be as simple as it seems and should managers get this wrong, issued tax vouchers and amounts of tax paid by investors could be incorrect. In addition, if investors pay tax on income that they do not actually receive, there could also presumably be some reputational risk. It is imperative therefore that "amounts available for distribution" as so described by the tax legislation are clearly defined.

Conclusion

Whether fund providers will opt to make coupon distributions in practice remains to be seen. What is clear is that the change in accounting practice combined with the FSA's proposed solution – as curtailed by the UK tax authorities – will not only generate income volatility, but will also create some significant systems issues. Going forward, fund providers may have to make some difficult decisions.

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Notes

¹ Unlisted funds only.

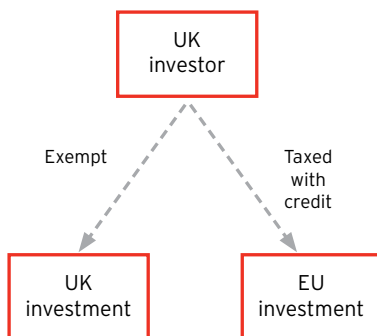
Claiming back withholding taxes on EU dividends

In the last year there have been a number of important judgments delivered by the European Court of Justice (ECJ), which have had a significant impact on direct tax in the UK. Two of these judgments are of particular importance to the European funds industry: the Franked Investment Income (FII) Group Litigation Order¹ and the Denkavit² case. Many Investment Managers have already made claims in respect of these cases; however, recent statistics show that there are still a number of funds which have not addressed the issue. This article will be of interest to those Investment Managers who have not yet made EU based claims in respect of dividends, and would like further information on how to do so.

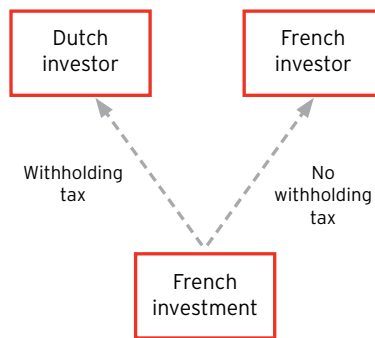
The issue

These cases both concern the taxation of foreign dividends; however, there is an important distinction between the two. The FII Group Litigation Order decision concerns a challenge to a "home state" system of taxation of foreign dividends whereas the Denkavit decision concerns a challenge to source state taxation of dividends. In particular, the FII Group Litigation Order decision concerns the UK, and the Denkavit decision concerns France.

FII GLO



Denkavit



FII Group Litigation Order (GLO)

The FII Group Litigation Order covers two issues: firstly, whether the UK's Double Tax Relief system conflicts with the EC Treaty and secondly, whether claims for Advance Corporation Tax can be made by companies with foreign income.

The ECJ's decision is long and complicated, and in answering the questions asked it appears to raise more questions. On the key question of whether the UK's Double Tax Relief system is contrary to the EC Treaty, the ECJ decided the following:

- Portfolio holdings of less than 10 per cent – the UK legislation, which taxes foreign dividend receipts without allowing credit for tax paid on profits by the overseas company (underlying tax), is not acceptable.
- Non-portfolio holdings of at least 10 per cent – the UK corporation tax rules, which tax foreign dividend receipts but do allow credit for underlying tax paid by the overseas company, are broadly acceptable. However, the ECJ has left it to the national courts to consider each situation on a case-by-case basis to see whether the UK system has discriminated against the overseas dividends. Discrimination could occur in exceptional cases where the foreign company would have benefited from a lower tax base had it been UK resident, due to a special relief (e.g. substantial

shareholding exemption, R&D tax credit, tonnage tax regime).

It is now left to the High Court in the UK to decide on the FII Group Litigation Order claims in light of the ECJ decision. The High Court decision could be subject to further appeal within the UK court system.

The decision is good news for the majority of funds who are likely to have many portfolio holdings. It would appear that these companies should be able to treat the receipt of EU dividends as exempt from UK corporation tax or be entitled to relief for underlying tax.

However, the Government has made it fairly clear that it intends to defend the tax system robustly against legal challenges under EU law. Therefore, we would expect that companies will have to litigate any such claims on an individual basis, even if they were part of the FII GLO. The Government's recent consultation on the taxation of foreign profits is likely to address these issues and we are expecting the result of this to be announced at the next Budget.

In relation to the Advance Corporation Tax claims, the ECJ decided broadly in favour of the taxpayer. It is likely that most companies with ACT compensation claims will have already taken the necessary steps to make the claims.

Denkavit

The Denkavit case concerns a Dutch company with two French subsidiaries. In accordance with the France-Netherlands Double Tax Convention, 5 per cent withholding tax was levied on dividend payments. A French parent would not have been subject to French withholding tax. The Dutch company argued that it was being discriminated against, as it had to pay additional tax compared to a French parent company. Whilst the France-Netherlands Double Tax Convention provided for relief by way

of credit for the French withholding tax, in fact the Netherlands operated an exemption for such dividends, so the French withholding tax was in fact an extra cost which a French parent would not have suffered.

The ECJ ruled that the differential treatment was discriminatory and contrary to the EC Treaty. The fact that the Double Tax Convention provided relief for the withholding tax in the Netherlands was not relevant; as for the reason noted above, the combined effect of French legislation, the France-Netherlands Double Tax Convention and Netherlands legislation was to leave the Netherlands parent company in a worse position than a French parent.

The facts of the Denkavit case have similarities with those in the Fokus Bank³ case, which also concerns withholding tax levied on dividends by the source state. In the Fokus Bank case the EFTA court decided that the Norwegian taxation system was contrary to the EFTA Treaty as it resulted in an increased Norwegian tax burden on the non-resident recipient. It did not matter that the Double Tax Convention with, say, the UK, allowed this extra Norwegian tax to be credited against UK tax. However, the ECJ decision in Denkavit differs to the extent that it adopts an “overall” approach whereby the court looked at the combined effect of the French and Netherlands domestic legislation, and the Double Tax Convention. In contrast the EFTA court in Fokus Bank appears to adopt a narrower approach and focuses on the source country in question.

What are the next steps?

These ECJ decisions have provided funds with the opportunity to make claims both in the UK (based on the FII GLO) and in other EU Member States (based on Denkavit). The majority of funds are likely to be in a situation where foreign withholding tax is recoverable to the extent that it has not been offset against

a UK corporation tax liability. However, the following situations may also apply:

- Both foreign withholding tax and UK corporation tax is recoverable.
- UK corporation tax paid is recoverable.
- No tax is recoverable.

As a first step, fund managers and fund boards should calculate the amount of withholding tax suffered on EU dividends in order to quantify the magnitude of any possible claims. The number of years that can be taken into account is clearly relevant in quantifying the possible claims; however, for the purpose of an initial estimate it would be advisable to go back three to five years. The potential benefit should be calculated for each EU Member State in order to identify appropriate countries in which to make claims.

The decision is good news for the majority of funds who are likely to have many portfolio holdings. It would appear that these companies should be able to treat the receipt of EU dividends as exempt from UK corporation tax or be entitled to relief for underlying tax.

Fund managers and fund boards should then take a close look at where the responsibility for making the claim lies and the extent of this duty. This is likely to raise a number of additional problems such as whether the cost of making the claims should be charged to the fund

and when the potential benefit should be recognised. Again, this will depend on the terms and conditions on which the fund can be charged and legal advice may be required.

Once the potential benefit of making a claim has been estimated the next step is to quantify the cost. This will be harder to quantify, particularly in respect of “Denkavit” claims as the process in each EU jurisdiction will vary, as will the cost of legal fees. As well as substantial pecuniary costs it is also important to consider the costs in terms of the administrative burden of putting together all the relevant information. In addition, there are likely to be costs involved in obtaining the dividend vouchers from the custodians.

Whilst performing the cost benefit analysis fund managers and fund boards should also consider their fiduciary duties, including their responsibility to the regulators. For example, it may not be possible to make claims for Collective Investment Funds without also considering discretionary clients.

Claims for UK corporation tax paid, based on the FII Group Litigation Order should be made with HM Revenue & Customs as soon as possible. As discussed above, the UK Government has indicated that any such claims will involve litigation.

Making a “Denkavit” claim

The actual process of making “Denkavit” claims will vary significantly, depending on the country in question. There is no direct equivalent to the UK Group Litigation Order in other EU Member States, although some countries do have a form of class action.

As a first step UK funds investing in EU equities may wish to file a “Denkavit” claim with the tax authorities of the Member State to reclaim the withholding tax suffered. Generally, this will involve

writing to the tax authority setting out the details of the claim and the arguments for making such a claim based on the ECJ decision. It may also be necessary to provide a formal legal opinion at this stage if the tax authority questions the basis for the claim. Time limits apply to making the application for a reclaim and these vary according to each Member State; broadly the range is from three months to five years from the date of the payment of the dividend.

The information that will need to be included in making the claim will vary depending on the Member State; however, the list below provides an indication of the detail that is likely to be required:

- Dividend vouchers (usually provided by the custodians).
- Bank statements.
- The amount of dividend income.
- The amount of withholding tax on the dividends.
- The date the dividends were paid.
- Details of the company paying the dividends.
- Details of the underlying shares and bonds.
- Details of the paying agent (the paying agent may also be required to confirm and provide details of the payments).
- The amount of withholding tax already recovered.

The tax authority will then have a certain period in which to accept or reject to reclaim, before the claimant can appeal. If claims are rejected it is likely that the claimant will have to appeal through judicial proceedings in the Member State in question.

It is likely that the success of making a “Denkavit” claim will vary depending

on the relevant Member State and their ultimate response to the ongoing tax cases. In addition, it may be easier to make the claim in certain Member States, although at this early stage it is difficult to give a definitive overview. Significantly, last year the EU Commission sent formal requests to Belgium, Spain, Italy, Luxembourg, the Netherlands and Portugal to amend their tax legislation concerning outbound dividend payments to companies. The Commission believes that these countries are in breach of Article 56 (Free Movement of Capital) and Article 43 (Freedom of Establishment) as they tax dividend payments to foreign companies more heavily than dividend payments to domestic companies. On 12 July 2007, the French tax authorities published guidelines clarifying the conditions that have to be satisfied for an EU/EEA parent company to benefit from an exemption from French dividend withholding tax. It will be interesting to see whether other Member States will follow suit.

Conclusion

The Denkavit decision is likely to have a bigger impact on the funds industry and many fund managers will be in a dilemma as to what to do following the ECJ decision. Of course, the right action to take will depend on a number of factors and it is important that a cost benefit analysis is carried out for each potential claim. In addition, fund managers should examine their contracts and agreements to see what contractual and fiduciary duties they have in relation to the ECJ decisions.

The FII Group Litigation Order interacts with the Denkavit case to the extent that relief may have already been received by the company from the UK Revenue, for the withholding tax suffered. Therefore if a reclaim is made for the withholding tax from the overseas authority, it may be necessary to pay back the original relief received from the UK Revenue.

This should also be taken into account when deciding whether or not to make a claim.

Following an initial analysis, a UK fund investing in EU equities may wish to file a “Denkavit” claim with the tax authority of the relevant overseas Member State. This should be done as soon as possible in order to comply with the time limits relevant to the various countries. In most cases the tax authority will not reply or will reject the claim; at this stage, the claimant can appeal. It is likely that any such claim will result in judicial proceedings and the cost and time involved in this should be considered.

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Notes

- ¹ Test Claimants in the FII Group Litigation (C-446/04). The ECJ decision was delivered on 12 December 2006.
- ² Denkavit Internationaal BV, Denkavit France SARL v Ministre de l'Économie, des Finances et de l'Industrie (C-170/05). The ECJ decision was delivered on 14 December 2006.
- ³ Fokus Bank ASA v Norwegian State (E-1/04).

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