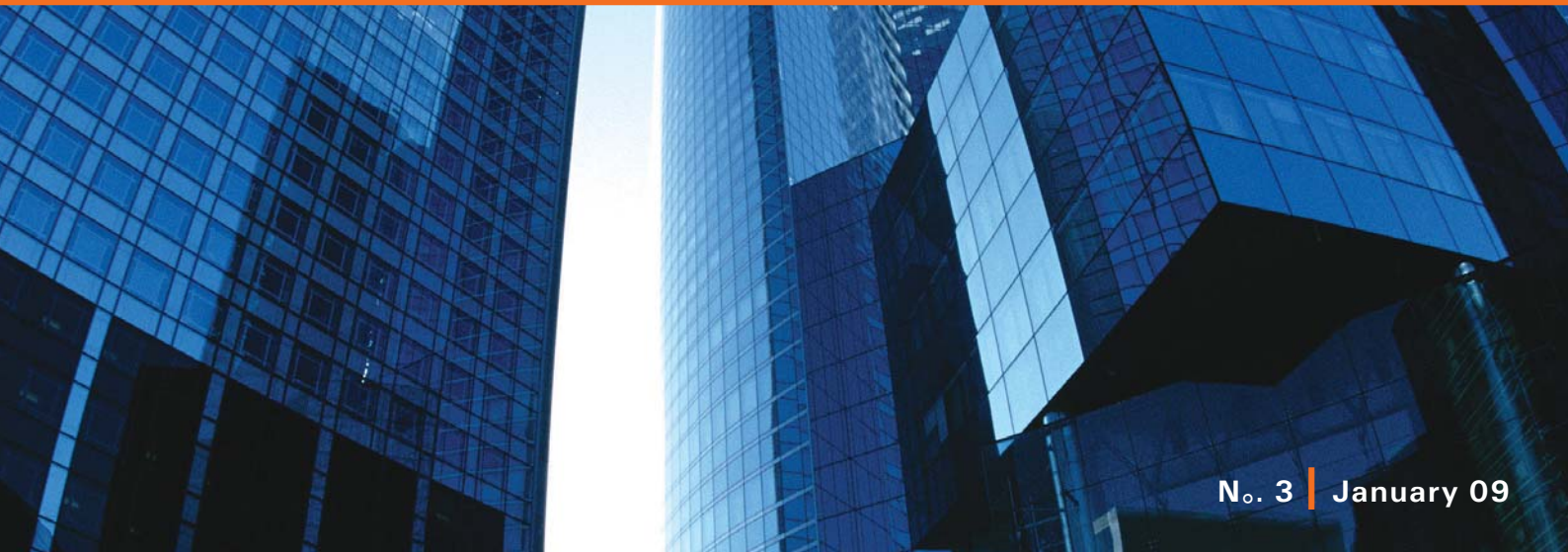


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LUXEMBOURG
FUND
REVIEW



No. 3 | January 09

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Luxembourg opportunities for Middle
East investors**

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regulations update

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Update on UCITS – The Management Company passport

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**Calls for more regulation of hedge funds – The Rasmussen
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Cross-border Distribution

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The beginning of 2009 has unfortunately suffered from the heavy heritage of the financial crisis of the last months of 2008, which seems to be far from over and is now impacting the so-called "real economy". From a geopolitical point of view, it has also witnessed increasing tensions in the Middle East and in Asia and the commercial conflict between Russia and Ukraine, which has considerably disrupted the European gas market.

Whilst 2009 seems to be a very challenging year, an increased effort from all of us to find solutions and bring those crises to an end will be extremely valuable.

Exploring new market opportunities, for instance, would be one of the ways to move ahead for the Luxembourg Fund Industry.

Middle Eastern countries and in particular the member countries of the Gulf Cooperation Council (GCC), while affected by the current financial crisis, have however seen a remarkable growth in the last year; in particular the new financial centers in Dubai (DIFC) and Qatar (QFC).

According to the figures of the Central Bank of Bahrain - Bahrain is the traditional fund jurisdiction of the region - the Bahraini fund industry has registered a surge of nearly 115 % in assets under management during the period from June 2007 to June 2008. Other sources, such as the recently published McKinsey World Islamic Banking Competitiveness Report, suggest that liquidity in the region is still very high and that Middle Eastern financial institutions have seen a strong growth in assets of both conventional and Islamic banks over the last year.

Such high liquidity coupled with the increasing sophistication of the Islamic finance industry is the reason for the growing demand in Luxembourg for the creation of investment funds for the Middle East and in particular of Islamic fund structures, given the specificities of the region.

Thus, in the special topic of this issue, our editorial board invites you to explore what Luxembourg has to offer to Middle East investors and, more specifically, what a Shariah-compliant fund is, to which constraints it is specifically submitted and how it can be structured in Luxembourg.

Wishing you all the best for 2009, I hope you find this issue both informative and enjoyable. ■

Isabelle Lebbe

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SHARIAH COMPLIANT INVESTMENT FUNDS – OPPORTUNITIES FOR LUXEMBOURG

There has been a recent surge in demand for Shariah compliant investment instruments including institutional funds, not only from Islamic investors but also from conventional investors. This has accelerated the growth of Shariah compliant investment funds that invest in a wide range of sectors such as equity, real estate, private equity, infrastructure and are increasingly seeking to invest on a pan-European basis.

1. INTRODUCTION

Worldwide, there are more than 500 Shariah compliant investment funds active and their number is growing. There are currently only about 10 (regulated) Shariah compliant investment funds around in Luxembourg, out of which about half have UCITS status. It is more difficult to determine how many unregulated Shariah compliant funds were established in Luxembourg, but it is anyway clear that Luxembourg (which is still relatively unknown as a fund location in the Middle East) could play a much more important role in this sector.

2. STRUCTURING SHARIAH COMPLIANT INVESTMENT FUNDS

To understand the requirements of such funds, and to identify possible opportunities for Luxembourg in this sector, we will first summarize the most common agreements used for structuring Shariah compliant investment funds, and provide an overview of relevant points to be taken into account as to their investment strategies.

Common basis: Mudaraba

Mudaraba agreements are the most widespread and successfully implemented agreements for structuring Shariah compliant funds. This type of partnership agreement indeed fits the usual needs of investors who solely provide capital to an investment fund (with-

out being involved as an active partner of the operating business), and a *mudarib* in the role of fund manager. The two main parties in a Mudaraba are the *mudarib* (general partner) and the *rabb al-maal* (the investors; literally: "owners of the capital"). The *rabb al-maal* will provide capital to the *mudarib* who will use his knowledge and expertise to define the most suitable investment strategy. Additional parties may be involved, such as *wakil* (agents), *amin* (trustees) and *kafil* (guarantors). As the Mudaraba agreements akin to a joint venture enterprise, any profits or losses generated by this venture must be shared between the investors and the *mudarib*. The formula to determine the sharing arrangements is defined *ab initio*. For sharing profits, the *Mudarib* is allowed to receive management and performance fees under a Mudaraba agreement; the investors being entitled to the remaining return. Losses are borne by the investors up to the capital invested in the fund, and by the *Mudarib*, limited to his time spent, and efforts undertaken. The *Mudarib* will thus in principle not be liable for losses on the investments (which are borne by the investors only), except in cases of negligence or dishonesty.

Investment strategies

Restrictions: Riba, Gharar, Haram

Shariah refers to the Islamic body of law, based on the Qur'an, the Sunnah (the sayings and actions of the Prophet Mohammed (PBOH)), and Ijtihad (the result of individual or collective effort or

collective juridical analysis; a powerful source for reinterpretation of authentic texts). Ijtihad comprises, amongst others, Qiyas (analogical reasoning), Istislah (public welfare reasoning), and Urf (custom). In this context, it is very important to understand that Shariah does not have a uniform set of interpretations, as different Islamic schools exist and Islamic scholars will have differing opinions on a number of subjects. Though there are initiatives to harmonize certain interpretations (through, e.g. the Bahrain based AAOIFI), Shariah compliance with respect to investment funds will still largely depend on the Shariah board's or Shariah advisers' position. Generally, the approach may be stricter in countries such as Saudi-Arabia, and more liberal in e.g. Malaysia, meaning products may have to be shaped differently depending on the countries of distribution.

Within the context of structuring Shariah investment funds, the following main restrictions can be derived from Shariah:

- **Riba**: this concept refers to the general prohibition of delay¹ or interest on a loan, and the prohibition of excess when monetary commodities are traded. The reasoning behind this prohibition is that money is only a value measuring tool but does not have an integral value. The notion of money includes receivables and guarantees, which are thus subject to the rules of Riba as well. Investments in companies involved in lending and borrowing (such as conventional banking) are prohibited, as are investments in highly geared companies (though a growing number of scholars consider such investments as acceptable if certain criteria as to debt/equity and interest income are met). A Shariah compliant investment fund cannot offer a fixed or guaranteed return on capital but should link the return to the actual performance of underlying assets. Nevertheless, leveraged investments can be structured through suitable agreements (such as e.g. diminishing Musharaka agreements²).
- **Gharar**: the prohibition of preventable ambiguity or uncertainty. One of the main aspects to be dealt with in an investment fund context is the prohibition of derivatives, including futures and options under certain circumstances. It

must be said that this is an area currently under review by Shariah scholars.

- **Haram**: the prohibition on investment in certain products and industries: gambling, casinos, alcohol, pork products, entertainment such as gossip or pornography, defence industry and weapons, and any other immoral or unethical activities identified by the Shariah scholars or Shariah board.

Commodity Funds

This type of Shariah funds has been in existence since the early 1990's. The income of such funds is derived from the purchase and resale of permissible commodities. The Shariah restriction on short sales and forwards (a commodity can indeed not be sold before it is actually owned, and the price of the commodity must be known) can be overcome through Salam and Istisna'a contracts (two notable exceptions on the Shariah conditions that at the time of contracting, the object needs to exist and the seller must have valid possession of the object).

Salam is a sales agreement for the purchase of goods which will be delivered in the future, at a specified date and place. The full price for the goods must be paid in advance, otherwise the agreement may be assimilated to the sale of a debt (considered as a violation of Riba by a majority of scholars). The goods are commodities, the quality and quantity of which is clearly specified. In a financial markets context, such an agreement does provide a means of finance. Banks or investors can realize a return by paying the funds to a trader under Salam regarding the future delivery of goods, which are pre-sold to a third party buyer.

Istisna'a is a cash sales contract allowing the future delivery of goods at a specified date. Payments may be deferred but to be valid, all specifications, delivery options, payment conditions and pricing must be agreed in advance. Again, there is no traditional loan receivable involved as the obligation is in the form of manufactured goods. In a financial markets context, a bank or investor would not enter into such agreement unless a purchaser for the goods being manufactured on behalf of the bank/investor has been identified (through a contractor or agent). Istisna'a agreements are also used successfully in the

context of the construction of aircraft and ships, infrastructure, plant and machinery, etc.

Equity Funds

Based upon a strict interpretation of Shariah, the investment possibilities for Shariah compliant equity funds would be very limited, and basically restricted to pure halal business as most companies do have a certain level of debt financing, realize interest income on cash deposited, etc. Technically, according to the traditional interpretation, every investor in a fund is a partner, consenting to and responsible for every transaction by the fund manager, whether permissible or not from a Shariah perspective. However a majority of contemporary scholars disagree with the traditional position, stating that investors are not partners in the fund but merely investors, incapable of vetoing impermissible actions. This has opened a broader investment perspective for companies which have incidental non-halal features, but also have an obligation of purification, namely the interest element of a dividend earned (and capital gains, according to some scholars) must be given to charity. For screening suitable equities, there seems to be growing consensus among scholars that the total interest bearing debt should be lower than 33% of market capitalization, and non operating interest income should not exceed 5% of total revenue. Islamic indices (such as Dow Jones' Shariah index) are increasingly used in this context.

Real estate funds – Ijara

Ijara agreements are close to conventional lease agreements, incorporating a fixed or periodically re-fixed term and an income stream or rental from underlying physical assets. This type of agreement is often used for structuring Shariah compliant real estate funds.

Sukuk

Sukuk are often referred to as Islamic Bonds, but in fact are not bonds. Legally speaking, Sukuk are Shariah compliant investment certificates, as the Sukuk holders hold undivided beneficial ownership rights in the underlying assets (and consequently share in the recurring and non recurring revenue generated by these

assets). Though Sukuk can be a stand-alone investment (they can be quoted; some of them are actually listed on the Luxembourg stock exchange), and can be used within securitization deals, they could also be suitable portfolio assets for certain (generally, non-UCITS) investment funds.

Service providers and Islamic calendar

One of the practical but important elements in accommodating or serving Shariah compliant investment funds is the fact that the main day of rest in the Islamic calendar is Friday. European service providers should aim for flexibility and adaptability in this context.

3. CONCLUSIONS AND LUXEMBOURG OPPORTUNITIES

As an important gateway to Europe for inbound investments, and as one of the primary fund locations in the world, Luxembourg does have a lot to offer in the Shariah investment fund sector.

For instance Luxembourg based UCITS have a high quality image and are already

distributed cross-border on a large scale. The extensive Luxembourg fund servicing industry is familiar with cross-border distribution, meaning there should be possibilities for distribution of these types of funds (Shariah compliant or not) in the Middle East.

An even more important potential opportunity may exist for structuring pan-European investments of Shariah compliant investment funds through lightly regulated Specialised Investment Funds, non-UCITS funds and SICAR. It goes without saying that these types of funds would be able to accommodate a broad range of investments structured in a Shariah compliant manner, including Ijara funds, Murabaha funds and private equity funds. Not only Middle Eastern institutional and high net worth investors could be targeted with these products, but also conventional institutional investors.

For investors not requiring any regulatory supervision, unregulated Luxembourg vehicles such as SCA may be tailored to accommodate e.g. Ijara funds for investing in pan-European real estate.

Finally, Middle Eastern based Shariah compliant funds and sovereign funds, which are

increasingly seeking to invest on a pan-European basis, may successfully use Luxembourg as an intermediate holding country for appropriately structuring the investments in a tax efficient way. ■

Raymond Krawczykowski
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¹ Delay within the meaning of an unjustified excess in time artificially added to the transaction. The concept refers to the "usury of waiting", involving a non-simultaneous exchange of equal qualities and quantities of the same commodity (such as cash).

² An agreement whereby a financier and his client participate in a joint ownership of an asset, or in a joint commercial enterprise, and whereby the share of the financier is divided into units. The client will acquire the units of the share of the financier periodically, increasing his own share until he has acquired all units of the financier, and thus finally obtains full ownership.

³ Halal means "lawful"; i.e. refers to things or actions permitted by Shariah.

THE GROWING TREND FOR SHARIAH COMPLIANT FUNDS – CAN UCITS TAP THIS BURGEONING MARKET?

The Islamic funds industry is growing rapidly with an estimated \$59bn in assets as of June 2008, and the number of funds has more than doubled in the last three years¹. The investment policies of these funds are equity (52%), *sukuk* (fixed income) (6%), private equity and real estate (18%), *murabahah* deposits (money market) (13%), balanced funds (8%) and the remainder in leasing based instruments (4%), with a high concentration of investments in Gulf Cooperation Council («GCC») based assets. In Luxembourg there has been increased interest over recent months in the establishment of investment funds with investment policies that comply with Islamic Shariah laws. This surge in interest in structuring Islamic investment funds emanates from both international asset management groups as well as groups based in Muslim countries, attracted to Luxembourg by the opportunities of the UCITS passport, the sound regulatory and supervisory environment and the multi-product fund administration platform.

This article looks at the existing and potentially new Shariah compliant fund structures that would fit within the UCITS framework, but does not set out to explore the structuring possibilities either under part II of the Luxembourg law of 20th December 2002 or under the law on Specialised Investment Funds of 13th February 2007.

1. NON-EXHAUSTIVE SUMMARY OF SHARIAH PRINCIPLES OF IMPORTANCE WITHIN THE UCITS FRAMEWORK

Shariah outlines all forms of practical actions by a Muslim in practicing his faith and belief². While covering all areas of life a number of guidelines and prohibitions apply specifically in the area of Islamic banking and finance. The main (non-exhaustive) guidelines are as follows:

1. the prohibition of interest for the mere use of money;
2. any contract based on the occurrence or non-occurrence of a future uncertain event is in principle not allowable;
3. speculation is not permitted;
4. Shariah does not allow the financing of a certain number of commodities or activities such as conventional insurance and financial services, pork-related products, gambling, alcohol..., etc. (hereafter «prohibited activities»).

For an investor wishing to invest in accordance with Shariah principles, only certain selected financial products are permissible. It is certainly worth exploring the positioning of the Luxembourg UCITS brand in this market to target the growing demand from investors for Shariah funds in the petrodollar rich GCC countries, in South-East Asia and the Muslim communities in Europe.

A number of such structures have already been set up in Luxembourg and Shariah compliant equity funds clearly dominate the scene. According to the latest statistics available, there are currently 32 funds and sub-funds (including non-UCITS funds) which declare themselves Shariah-compliant and are inscribed on the official list of collective investment undertakings.

2. SPECIFIC CHARACTERISTICS OF SHARIAH COMPLIANT UCITS

Shariah compliant UCITS have, as a matter of principle, to be set up as any other

Luxembourg UCITS in compliance with the provisions of the law of 20th December, 2002 and the promoter can choose either the form of a SICAV or an FCP (with or without multiple compartments). In addition, the documentation of Shariah compliant UCITS needs to provide for the removal of any reference to or notion of interest payment, the exclusion of exposure to non-permitted activities from the investment policy and the screening of financial instruments for Shariah compliance. The board of directors of the self-managed SICAV or the management company, the conducting officers and the appointed investment manager are supported in their respective roles by a Shariah advisory committee / Shariah advisory board.

The advisory committee is generally composed of independent Shariah scholars and their role, which should be described in the Prospectus, is to advise on the compliance of the investments and operations of the UCITS with Shariah principles. In general the advisory committee puts in place an approval process to screen the investment universe of the fund (ex-ante) and provides a list of eligible issuers/instruments to the investment manager. The screening process is based on business sector activity as well as an examination of the issuer's financing. The Shariah advisors would usually also continue to screen the portfolio of investments on a periodic basis as the business activities of an issuer may change over time, e.g., arising out of mergers and acquisitions.

It is worth noting that some regional differences in how stock-screening is performed exist and may impact the requirement for the UCITS to have its own Shariah advisory board. In Malaysia, for example, the screening of listed stocks for Shariah compliance is undertaken by a centralised body, the Shariah Advisory Council of the Securities Commission which publishes a list of Shariah compliant stocks twice a year. Another approach to stock screening is

reliance on an external Shariah compliant index as a proxy for the fund's own assessment of the compliance of a particular instrument. Some firms including Standard and Poor's, Dow Jones and FTSE have developed Islamic indices that track the performance of securities approved by their own Shariah advisory boards.

Upon set-up of a Shariah compliant UCITS the split of roles and responsibilities between the board and the SICAV / management company and the Shariah advisory board will need to be clearly defined with UCITS eligibility checked by the management company / investment manager and Shariah compliance checked by the Shariah adviser. This is particularly important if the Shariah advisory board is supported by a contractually appointed Shariah adviser who is advising the investment manager on a day-to-day basis.

It is important to note that there is a lack of convergence among Shariah advisors and scholars from different jurisdictions or geographical regions in the interpretation of certain Shariah principles, due in part to the complexity and fast changing nature of the Islamic financial markets. As an illustration, there has been major uncertainty recently in the Sukuk market following a position taken by a prominent scholar that certain types of Sukuks based on *Mudaraba* and *Musharaka* contracts were not Shariah compliant.

Even though a UCITS fund is not allowed to «exercise significant influence» over an issuer, Shariah funds tend to make known their views to the issuers in which they invest and may be considered as a particular type of activist investor.

In fact, Shariah compliant funds are in a way comparable to socially responsible investment funds, implementing a more restrictively defined investment policy within the same investment sector or geographical area as «conventional funds».

Another characteristic (for equity funds) is the existence of a *purification* of the dividends received from the target issuers.

Securities of certain issuers would *per se* be eligible following the initial Shariah screening but the issuer could nevertheless be considered, up to a limited percentage, to perform prohibited activities or have part of its income generated by interest payments. The dividend purification procedure would normally result in the Fund being credited with the dividends paid by the

issuer, minus the purification ratio (to be determined in view of the level of prohibited activities and interest based income) applied to those dividends. Any identified impure income is not due to the UCITS and would be donated to a charity. In general the Shariah advisors propose the name of a charity but the final choice remains with the board of directors.

3. SHARIAH COMPLIANT EQUITY FUNDS

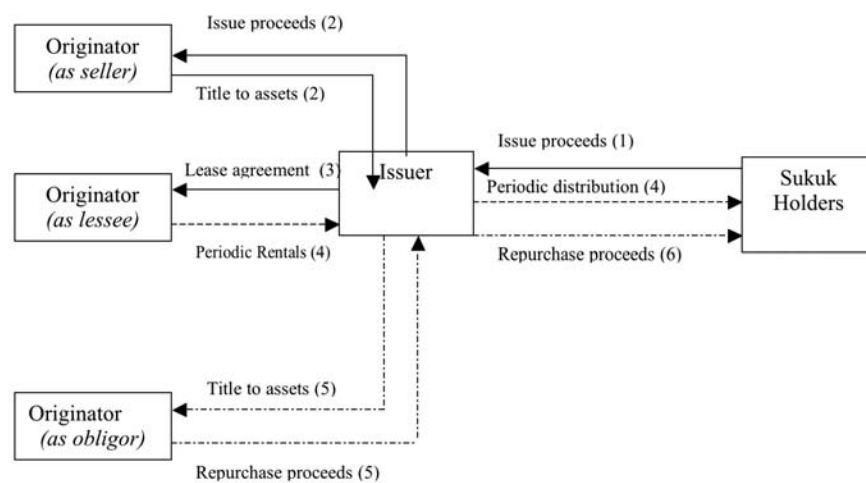
It is predominantly Shariah compliant equity funds which have been approved by the CSSF under the UCITS regulations (although at least one fixed income fund has been approved to date). By and large the current cluster of Shariah compliant UCITS equity funds take advantage of existing Shariah compliant indices provided by the major index providers and only on an ancillary basis would they invest in issuers outside the index universe. This type of organisation clearly smoothes any discussions on Shariah eligibility and also, to an extent, can simplify UCITS III eligibility appraisal for criteria such as liquidity, pricing and valuation.

4. FIXED INCOME SHARIAH COMPLIANT UCITS

Given the ban on charging interest, most conventional fixed income instruments are not eligible investments for a Shariah compliant fund.

The securities/instruments which could be used by managers of Shariah compliant UCITS funds include Sukuks, *Murabahah* deposits and other types of Shariah compliant money market instruments. The Sukuk market is one of the most important growth segments in Islamic finance and is projected to grow by 30-35% per annum³. Sukuk, also generally known as "Islamic bond", is a generic term to encompass a broad range of Shariah compliant instruments. The Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI), based in Bahrain, has identified 14 different types of Sukuk although in practice a much smaller number are regularly issued on the market. It is common in naming a Sukuk to refer to the main underlying contract, for example *Ijara* (lease) or *Musharaka* (a partnership structure), but simply naming the contract may not be sufficient to describe all the economic activities and effects involved, given the new generation of innovative and increasingly complicated Sukuk. The majority of Sukuk that have been issued to date have been structured as asset-based rather than asset-backed securities, with the credit risk linked to the originator similar to a conventional bond. However it is important to take into account that there are Shariah limitations on the trading of debt which may impact the tradability of certain Sukuk on the secondary market although there is no unanimity among Shariah scholars about the precise boundaries.

To follow is an illustration a typical Sukuk-al-ijara⁴:



- (1) The Issuer – usually an SPV – issues sukuk to sukuk holders in exchange for proceeds.
- (2) The Issuer purchases title to the assets from the Originator.
- (3) The Originator enters into a lease agreement with the Issuer to lease the assets.
- (4) The Originator makes periodic rental payments on the lease to the Issuer which the Issuer passes on to the sukuk holders.
- (5) At maturity (or upon a *dissolution event*) the Issuer sells the assets back to the Originator (*purchase undertaking*).
- (6) The Issuer passes the proceeds on to the sukuk holders and the SPV is dissolved.

5. OPERATIONAL ISSUES

It is generally accepted that the custodian of a Shariah compliant UCITS does not itself need to operate along the lines of an Islamic bank but needs to be in a position to service the Shariah compliant fund without violating any Shariah principles.

The prohibition of interest will prevent a fund lending or borrowing on interest and arrangements will need to be put in place with the Custodian to deal with overdrafts in particular, in a Shariah compliant manner. Some of the concerns applicable to any UCITS are magnified for Shariah compliant funds due to the small market size of eligible instruments, the lack of an active secondary market for the trading of Shariah compliant instruments and the non-standardised documentation and set-up. The secondary market for Islamic products tends to be shallow and illiquid due to the insufficient supply of tradable Islamic products as well as the typical buy-and-hold approach of investors, and this may lead to difficulties in determining the fair value of the investments.

6. ACCOUNTING STANDARDS AND ACCOUNTING AND AUDITING REQUIREMENTS

Certain Shariah compliant transactions may not have parallels in conventional financing and this may lead to certain accounting difficulties. The AAOIFI develops accounting, auditing, governance and ethical standards relating to the activities of Islamic banks and by mid 2008 the AAOIFI had issued 30 Shariah standards. In addition the Malaysia based Islamic Financial Services Board (IFSB) is a standard-setting board that covers banking, insurance and securities regulation. The work of the AAOIFI and the IFSB has helped to harmonise the application of standards among the different Shariah boards in different jurisdictions although their adoption has been mixed. These accounting standards can act as a useful reference aid in determining the accounting treatment for Islamic products that do not have a clear parallel under Luxembourg GAAP or IFRS.

It is likely that investors in Shariah UCITS will look for assurance that the portfolio is Shariah compliant as there is currently no

common view on the Shariah compliance of instruments among Shariah scholars, and this has led to a certain level of uncertainty and concern among investors. As part of their audit the external auditor of a UCITS will tend to look at the Shariah screening process put in place by the UCITS. The auditors will seek to gain an understanding of how the process and procedures actually operate to ensure that the investments comply with Shariah principles. The auditor may request disclosure of material information to investors, which may include details on Shariah compliance. For some UCITS this Shariah related disclosure in the annual report currently takes the form of a certification by the Shariah Advisory Board of the compliance of the portfolio of investments with Shariah principles during the period. A Shariah audit may be requested by the UCITS and in this case the external audit firms, if they do not have the expertise locally, may request Islamic finance specialists in other offices to perform the Shariah audit.

In terms of the accounting of an Islamic UCITS the external auditor may be requested to provide assurance services on some of the Shariah specific aspects of the UCITS. One example is the cleansing mechanism to purify investments that are tainted by prohibited activities, as described earlier, which is generally carried out by an Islamic fund on behalf of its investors. The Board of Directors may request the external auditor to provide assurance on the figures calculated prior to making a donation to a charity.

7. TAXATION OF SHARIAH COMPLIANT FUNDS

As already mentioned some Shariah financial instruments may not have parallels in conventional financing. For example, the Sukuk is considered an equity based investment under Shariah, but many of the Sukuk issues have very strong similarities in terms of cash-flows and risk to a conventional bond. There is currently no Luxembourg Tax Circular dealing with the classification of Islamic financial instruments and it would be essential to approach the Luxembourg Tax Authorities to clarify if the Sukuk investments that the UCITS intends to hold would fall under the classification of debt instruments and therefore within the scope

of the EU Savings Directive. The same may also be necessary for other types of Shariah instruments as there is currently limited tax jurisprudence on Islamic instruments in Luxembourg.

In the same manner as innovative financial instruments and techniques have been successfully structured to qualify for investment by UCITS funds since 2002, the flexible Luxembourg regulatory framework will within the limits of the UCITS directive offer satisfactory solutions for Shariah compliant funds.

The know-how acquired on the smooth operation of existing Shariah compliant structures and the initiatives of the Luxembourg government, ALFI and ABBL to position Luxembourg as a credible location for Islamic Finance in general, and Shariah compliant investment funds in particular, will help to boost the position of Luxembourg as a credible platform for asset management groups seeking a global hub for their Shariah compliant products. ■

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¹ IOSCO Report on Analysis of the Application of IOSCO's Objectives and Principles of Securities Regulation for Islamic Securities Products - September 2008.

² Islamic Banking and Finance – Bahrain Monetary Agency 2002

³ Moody's « Special Report on Sukuk » 2008

⁴ Introduction to Sukuk Deutsche Bank AG August 2007.

THE INTERNATIONAL GROWTH OF SHARIAH COMPLIANT FUNDS

In the wake of the current global crisis, Shariah compliant funds have emerged as a viable alternative to the conventional range of investments. The demand for Socially Responsible Investing (SRI) and Sustainable and Ethical, including Shariah compliant, investments has resulted in the evolution of these investment strategies into a truly global business. Within Europe, Luxembourg has emerged as the pre-eminent center for this fast growing investment market segment.

1. GLOBAL OVERVIEW

According to a 2008 Ernst & Young report, 'Outlining Opportunities in the Asset Management Landscape', the Islamic fund universe continues to expand and is beginning to provide improved coverage across asset classes and geographical mandates. At the end of the first quarter of 2008 there were more than 500 Shariah compliant funds in the world and it is forecasted the number will reach 1,000 funds by 2010, with a compound annual growth rate of 24 per cent for the period between 2007 and 2010. New funds issuance has increased significantly with 153 funds launched in 2007 alone, a 50 per cent improvement on 2006. When compared to the composite Dow Jones Islamic Market Index (DIJM), the regional Shariah compliant equity indices have performed consistently: only the Middle East equity index showed strong growth between September 2000 and December 2002. The asset allocation of the Islamic funds universe is increasingly diversified, but Islamic equity funds remain dominant with 40 per cent of the share of total assets in 2006, compared to 27 per cent in 2002. Money market and commodity funds experienced strong

growth, rising from 14 per cent in 2002 to 20 per cent of total assets in 2006.

Compared to the conventional mutual fund universe, equity remains a core asset class, and where conventional fund managers have scaled back their equity exposure, the asset allocation that Islamic fund managers are making to equity remains strong. There is an allocation of 52 per cent to equity for the Islamic fund managers, against 42 per cent asset allocation to equity for the conventional universe. The fixed income exposure that Islamic fund managers have is, on the contrary, underdeveloped. The average asset allocation that Islamic fund managers have to fixed income is 7 per cent of total assets, compared to a 22 per cent allocation to this asset class by conventional fund managers. This allocation reflects the lack of depth in Sukuk and other fixed income product offerings in the Islamic financial system.

Murabaha placements as an asset class is popular among Islamic fund managers. There is a 13 per cent exposure to the money market asset class against only a 6 per cent allocation to money markets by conventional fund managers. This reflects the increased demand in the Middle East for less risky investments, following stock market corrections. Furthermore, allocation to real estate and private equity are higher at 18 per cent, than the 10 per cent average for conventional funds.

The mandates for Islamic funds are widening and becoming more global. In 2002, 45 per cent of Islamic funds were mandated to Asian securities, whilst 32 per cent more were focused on Middle East regional securities. However, five years later, the proportion has shifted, and in 2007, 33 per cent of Islamic funds ran Asian mandates of which only 24 per cent were Middle East funds. As research and analysis has widened and the index providers have started to create new series and subsets of Shariah compliant indices, so other markets come into play,

and in 2007, 2 per cent of Islamic funds were Emerging Market funds.

2. PRODUCT INNOVATION

As the Islamic fund universe continues to expand, providers have to keep ahead of investors by offering improved coverage across asset classes and geographical mandates.

Product innovation has also transformed the investment landscape and includes multi-manager funds like NCB's Al Manarah; exchange traded funds like BNP Paribas's Easy ETF DJ Islamic Market Titan 100, the first Islamic ETF on a global index; equity-linked structured products like Deutsche Bank's listed Islamic Equity Builder certificates; and equity long/short hedge funds from Permal and Old Mutual. International providers active in the business include Deutsche Bank, BNP Paribas, Crédit Agricole, SocGen, UBS, Credit Suisse, HSBC Amanah, and RBS Bank. Several of these players have established a regional hub in the Dubai International Financial Centre (DIFC). Major regional Shariah-compliant investment providers include NCB, Al Rajhi, Kuwait Finance House, Shuaa Capital and CIMB in Malaysia.

Recently, RBS announced that it plans to establish a global hub for Islamic banking in Dubai and to launch retail Islamic banking services in the Middle East region by the second quarter of 2009, in order to meet the surging demand for Islamic products. The bank plans to accelerate the introduction of Islamic products, introducing between five and 10 new products every month. RBS expects to launch at least 30 new Islamic products during the second half of 2008. The bank's wholesaling strategy is to carry out research studies investigating where there are gaps in the supply of investment product in the Middle East markets, and then creating structured products that suit different investment trends and risk appetites among high-net-worth individu-

als in the region. It distributes the Islamic products through intermediaries, including Islamic banks, investment companies and fund managers in the region.

For example, an important recent trend has been the growth in the number of Shariah compliant Exchange Traded Funds (ETFs) listed on the world's leading stock exchanges. ETFs are open-ended index funds that are listed and traded on stock exchanges in the same way as individual companies' shares are. According to a recent guide published by Barclays Global Investors (BGI), ETFs "allow investors to gain broad exposure to entire stock markets of different countries, emerging markets, sectors and styles as well as fixed income and commodity indices with relative ease on a real-time basis and at a lower cost than many other forms of investing. ETFs, unlike traditional funds, are transparent as the managers provide the ETF portfolio composition to the market on a daily basis!"

This combination of low costs, transparency and rules-based adherence to clearly established benchmarks has already shown itself to be highly attractive to investors. According to BGI, at the end of the third quarter of 2008, there were just fewer than 1500 ETFs worldwide with total assets of US\$ 764.08 bn. BGI expects this total to grow to \$1 trillion in 2009 and to reach \$2 trillion in 2011.

The expansion of ETFs into new areas such as Shariah-compliant products has been made possible by the launch in recent years of a range of new indices tracking the performance of companies that are not in violation of Islamic law. These indices, the main providers of which are Dow Jones and Standard & Poor's, screen out all shares in companies involved in proscribed sectors such as gambling, alcohol and pornography. BGI itself has been a pioneer in the development of these products for Islamic investors through its specialist ETF arm, iShares, listing the first ever Shariah compliant ETFs on the main market of the London Stock Exchange. The iShares launch has since been followed by a similar initiative from Deutsche Bank, which has been a leader in the development of Islamic products. In 2007, its global mutual funds arm, DWS Investments, launched a series of Islamic funds, and in July 2008, it announced that its ETF platform, db x-trackers, had listed the first ever regional

Shariah compliant ETFs on the London Stock Exchange.

In the market for multimanager products (funds of funds), for example, which are aimed at strengthening fund holders' protection by increasing the diversification of their exposure, players such as HSBC's Islamic division (Amanah) have been active for a number of years. HSBC Amanah unveiled its first three Shariah compliant multimanager products – equity funds covering the Americas, Europe, and the Asia-Pacific region – in 2005.

Elsewhere, products such as the family of Al Manarah multi-manager funds offered by Saudi Arabia's National Commercial Bank (NCB), are designed to minimise risk by more actively varying their exposure to low-risk Murabaha trades relative to the proportion held in higher-risk, higher-return equity investments.

Another manager to have recently added multi-manager funds to its stable of Shariah compliant funds is Jadwa (Frank Russell teamed up with Jadwa investments), which at the end of March launched a series of multi-manager funds designed to appeal to investors with varying risk-return objectives. These are the Aggressive Allocation Fund, the Balanced Allocation Fund and the Conservative Allocation Fund, complementing Jadwa's existing range of Shariah compliant funds, which include the Saudi Equity Fund, the GCC Equity Fund, the Arab Market Equity Fund and a Murabaha Fund.

Another important recent trend in the global market for Islamic funds – which is expected to gather momentum in the wake of the financial crisis – is the increased diversification of the products available to Muslim investors. While the early growth of the market was driven almost exclusively by equity-based funds, a range of products based on other asset classes, including bonds, real estate, commodities, trade finance receivables and leasing is now coming on-stream in the market for Shariah compliant funds.

3. STRATEGIC ALLIANCES AND JOINT VENTURES

Goldman Sachs recently signed a memorandum of understanding with NCB Capital to set up a strategic alliance, and the Abu Dhabi Government took a 7.5 per cent stake in The Carlyle Group in September

2007. Retail, mass affluent, HNWI and institutional investors are interested in achieving a more stable and less volatile pattern of returns, especially for lifecycle products like insurance unit-linked investments and family Takaful plans, individual retirement plans, annuity and other tax-advantaged long-term savings products. Investors are becoming increasingly receptive to paying for quality investment advice, to help underpin their long-term saving and capital accumulation needs, and find effective solutions to match their individual financial planning goals.

Dubai Multi Commodities Centre Authority, an agency of the Dubai government, and Barclays Capital, the investment banking division of Barclays Bank PLC, have committed to a joint venture to seed five commodity hedge fund managers on Al Safi with \$50 million each, for a Shariah compliant fund-of-funds product to be offered under the Dubai Shariah Asset Management (DSAM) brand in June 2008.

4. SUSTAINABLE INVESTMENTS

According to the Oliver Wyman Report, the pace of growth will remain high in Asia Pacific and the Middle East at 9% and 12% p.a., respectively, whilst the US is likely to experience a slowdown to 8% CAGR. This implies that even more than they currently do, wealth management firms will increasingly compete for the same HNWI customers, and the customers themselves have become more demanding especially in the Middle East and the Far East regions with an increasing propensity towards "Socially Responsible Investments" (SRI) and ethical products. Investors are attracted to shariah compliant investments due to more corporate governance, transparency, accountability and the economic risk/reward characteristics. Shariah compliant investments are now available across a wide range of asset classes which include equities, sukuk, murabaha, real estate, commodities, leasing, trade finance, private equity and hedge funds.

According to the McKinsey "World Islamic Competitiveness Report 2007-2008", Islamic asset management shares many principles with Socially Responsible Investing (SRI). The ethical category will focus on contribution to public good rather than only profit maximization avoiding businesses

involved in alcohol, gambling or weapons. These social investments will combine good corporate governance, the support of workplace diversity as well as fair interaction with business partners and employees. The environmental label supports green responsible as well as sustainable business practices. According to the World Wealth Report 2008¹, more HNWI individuals are attracted towards green investments: holding more than 70% of the USD 2.71 trillion SRI (Socially Responsible Investments) assets under management in 2007, representing an increasingly attractive target for financial institutions and advisors. It is estimated that 12% of HNWIs and 14% of Ultra-HNWIs around the world allocate part of their investment portfolio to green technologies and alternative energy sources.

5. LUXEMBOURG: AN ATTRACTIVE FUND CENTER

In Europe, the Luxembourg Stock Exchange was the first European stock exchange to enter the sukuk market, having listed sukuk since 2002. In September 2008, 14 sukuk with a combined value of USD 5.5 billion were listed and traded on the Luxembourg Stock Exchange. In September 2008 there were 31 shariah compliant investment funds held in 17 Luxembourg domiciled investment vehicles. Major fund managers and custodian include Pictet, BNP Paribas, Citi, JP Morgan, and UBS.

Several large funds are in the process of being launched. Islamic finance has the support of the Luxembourg financial establishment. In 2005, the Central Bank of Luxembourg hosted an Islamic Financial Services Forum together with the Islamic Financial Services Board. The Luxembourg legal framework is largely compatible with Islamic finance and suitable for the creation of shariah compliant products; many institutional investors, including sovereign funds,

are using Luxembourg investment vehicles to structure their real estate portfolios; legal structures tailor made for institutional and HNWI investors include the Specialized Investment Fund (SIF), the venture capital investment company (SICAR), the family wealth management company (SPF), securitization vehicles and the SOPARFI, a corporate participations (holding) structure; Luxembourg domiciled investment funds compliant with EU law can be sold to retail investors throughout the EU and are widely accepted around the world; Luxembourg is the world centre for the cross-border distribution of retail funds, with 75% of the market; UCITS regulation can be applied to both equity and fixed income equivalent Islamic investment funds. Luxembourg is the second largest investment fund centre in the world after the United States, with almost EUR 2 billion under management² and with approximately EUR 2 trillion of net assets under administration.

CONCLUSION

The advent of powerful fund supermarkets and the use of technology for customer risk profiling, sales fulfillment and effective customer servicing, timely reporting and delivering customer convenience has provided the sell side with a competitive advantage. The main criteria that differentiates one multi-manager provider from another is the manager's proven global reach and expertise in manager selection, portfolio construction and the use of strategic and tactical asset allocation techniques, disciplined risk management, timely portfolio rebalancing and proactive manager changes. Enlightened providers offer the distribution partner the benefit of white labeling or co-branding the investment offering, defining its own universe of target funds and combining strong-performing own brand mutual funds with top quartile third party mutual funds.

Future opportunities and challenges for multi-managers include satisfying the expectations of global distributors and financial intermediaries in terms of producing and delivering gains across the different investment market cycles; realizing economies of scale and improving cost efficiency; eliminating perceived conflicts of interest, and enhancing product packaging and customer convenience. Islamic wealth management players are starting to offer diversified investment opportunities across specific asset classes, especially direct investment in equities, private equity and real estate. Co-branding funds and other investment products is increasingly proving to be attractive. There is also an increasing proliferation of Shariah compliant structured equity linked products, multi-manager offerings and alternative investments, and several of these form an integral part of the wealth management platforms of major international, regional and local banks. Luxembourg is well positioned to increase its share of this fast growing market segment. ■

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¹ Barclays Global Investors, ETF Landscape Industry Review, October 2008

² *The Future of Private Banking 2008.*

³ *Cap Gemini and Merrill Lynch.*

⁴ Source: CSSF.

MONEY-MARKET FUNDS

Luxembourg is the second largest domicile in Europe for money-market funds after France and offers an attractive domicile for the entire range of money-market funds.

Money Market Funds can range from the standard fund structured to invest primarily in money-market instruments with some offering a degree of stability though to the high quality “2a-7” or IMMFA style funds which focus on maintaining an extremely high credit quality within the underlying portfolio and which will generally maintain a AAA rating at fund level. Funds will obviously vary depending on the nature of the investors targeted and one can broadly classify funds into three types – high-quality money-market funds targeting corporate and institutions; those targeting retail and high-net worth investors as part of an asset allocation program; and finally money market funds offering an enhanced yield feature (through an increased risk profile). Luxembourg is the second largest domicile in Europe for money-market funds after France with assets standing at around EUR 350 billion at the end of October and offers an attractive domicile for the entire range of money-market funds.

AN OVERVIEW OF THE DIFFERENT TYPES OF MONEY MARKET FUNDS

IMMFA style funds primarily target corporates and offer treasurers a simple, safe and efficient means of parking cash for short periods of time. As mentioned, the funds are highly rated themselves and provide stability either as to price or yield through daily distributing or accumulating share-classes. Also known as “422 funds” from the CESR recommendation on eligible assets, such funds are based largely on the US money-market funds which were established under rule 2a-7 of the Investment Company Act of 1940.

IMMFA style funds will look to invest in high-quality, short-term corporate debt whilst retaining a weighted average maturity of the portfolio of 60 days or less – allowing some extra yield to be sought through limited positions in longer dated paper. The funds are valued on an amortised cost basis but maintain a rigorous process for comparing amortised cost-to-market. Such process would often be dictated within their constitutional documents and would be a requirement of the rating agency to which the funds are subject. Maintenance of both the fund rating and a stable price/yield for such funds is critical for their continued success as they are viewed by treasurers as exceedingly safe and equivalent to overnight cash deposits. Failure to do so – also known as “breaking the buck” - is tantamount to business failure for both the fund and its promoter. Most such funds offer same day liquidity for investors and are characterised by significant capital flows on a daily basis as would be expected by bank deposits.

Other high-quality money-market funds will also maintain their NAV at amortised cost but do not have the same degree of oversight as required by the rating agencies for those targeting corporate investors. Business risks are similarly high in the event of “breaking the buck” and such funds are largely targeting retail or high-net worth investors whose investment aim differs from those of the corporate treasurers in terms of the ongoing need for same-day liquidity.

Finally, in recent years, there has been a growth in so-called “Enhanced Yield” money market funds which seek both to retain a high-quality short-term portfolio but to overlay this with longer-dated higher-yielding instruments to provide a combination both of security and yield. Such funds would generally not offer stability of price or yield and would mark at least part of their portfolio to market as a result.

One of the challenges within the European market place is the lack of a distinction between those funds whose primary

aim is security and those who also offer an enhanced yield feature and thus, bring with them, an enhanced risk profile. Such a challenge has been brought into stark focus in recent months as the effects of firstly the sub-prime and then the broader financial crisis have impacted the money-market fund community.

INDUSTRY EVOLUTION

The money-market fund industry in Europe is most developed in the domestic territories of France and – to a lesser extent – Germany as well as in Luxembourg and Ireland. France’s industry has grown as such funds offered an income earning alternative to bank deposits whilst Ireland has enjoyed growth over the past decade in the institutional or IMMFA style money-market funds. Luxembourg has seen growth in all segments with both the more retail-oriented money funds of French, German and Swiss players as well as some of the largest IMMFA style funds flourishing as the markets have developed. The commencement of the sub-prime crisis in August 2007 saw a number of pure money funds struggle – most notably in France – as well as the near collapse of the enhanced yield funds. It was quickly seen that the promise of both high yield and a secure investment was untenable in the market environment witnessed at the end of 2007 and start of 2008 and many of the enhanced funds faced massive redemption flows and were soon struggling to stay afloat. The IMMFA style funds also saw some degree of brand contamination as the market turned away from “money funds” owing to the lack of clarity within the European market as well as some high-profile issues within the “2a-7” environment in the US. In response IMMFA launched a campaign to clarify what such funds stood for and to seek to brand them differently. In addition, certain of the most prominent players started to launch “ultra-safe” money mar-

ket funds investing solely into short-dated government paper:

As the crisis spread, LIBOR began to rise to historical highs and this caused some IMMFA and other high-quality money funds to struggle with maintaining a stable NAV. Certain non-IMMFA funds which offered stability have since reverted to a floating NAV (ie have “broken the buck”) or have been suspended as retail targeted funds have been further harmed by certain government measures to guarantee banks. This has led many retail investors to divest from the diversified high-quality but low yielding funds and move to higher yielding, effectively state-guaranteed bank deposits. To stem such flows, Germany and then Luxembourg have issued assurances around their money-market funds. In addition, measures have been taken in the US, Ireland and Luxembourg to address some of the challenges money funds were facing in their mark-to-market comparison owing to the liquidity crisis – specifically on short-dated (60-90 days) high-quality

paper. Similarly, the “treasury funds” referred to previously witnessed significant inflows as even corporate investors chose quality over any level of yield. In recent weeks, we have seen a stabilisation of the industry with investors now returning to the more traditional high-quality money-market funds as well as an easing of the strains players faced in their assessment of amortised cost over market. Looking back, it is clear that those funds which kept to their credos of security and quality over yield have been the winners and are now seeing their assets boom in the current environment.

THE FUTURE OF MONEY-MARKET FUNDS

Presuming the continued fall in interest rates does not jeopardise the underlying business model, it is clear that money-market funds play and will continue to play a vital role within the European fund industry. The recent crisis has, however,

made it similarly clear of the need for clarity around the different types of money market fund in today’s market place. Investors need clarity around both the core objectives of the fund and the rigour which is maintained around ensuring the security and/or yield components of its objectives. There is room in the market for both the higher-quality, generally lower yielding funds, as well as those adding a degree of security with a higher level of yield – what is needed is some distinction between the two that is both recognised and enforced throughout the European arena. It is critical within the money-market fund industry even more so than in the mainstream that investors are able to understand that certain so-called money-market funds are not akin to leaving your money in the bank, whilst others are arguably – at least in today’s uncertain times – even safer. ■

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UPDATE ON UCITS – THE MANAGEMENT COMPANY PASSPORT

On 16 July 2008, following a lengthy consultation period, the EU Commission issued its proposals for introducing new rules to modernise the framework applicable to UCITS. These proposals are commonly referred to as UCITS IV. The Commission's proposal provided for (i) a simplified notification procedure, (ii) merger of UCITS Funds on a cross border basis, (iii) UCITS master/feeder structures, (iv) a key investor information document replacing the simplified prospectus in addition to (v) measures to enhance cooperation between competent authorities. The Management Company passport was not included in the proposal because, during the consultation process, concerns were raised by a number of Member States and industry participants as to how responsibilities for supervision could be allocated between the competent authority of the Management Company and the competent authority of the UCITS. Some felt that the proposals for a Management Company passport would leave major legal, regulatory and tax issues unsolved, which could harm the UCITS brand. Since July 2008, the EU Council's Presidency has actively worked on and finally published a compromise to nevertheless include the Management Company passport in the UCITS IV proposals. The purpose of this contribution is to describe the main elements of the Management Company passport as proposed by the Council.

INTRODUCTION

1. The inclusion or not of the *Management Company passport* in the reform of the legislative framework for UCITS (commonly referred to as "UCITS IV") has been the subject of discussions at investment management industry level and EU governing bodies' level and has also been the subject of the publication on 31 October 2008 by the Committee of European Securities Regulators ("CESR") of its *Advice to the European Commission on the UCITS Management Company Passport*.

2. Whereas many market participants were more or less unconditionally in favour of a full Management Company passport, others were concerned that the proposals in the form of the drafts published by the Presidency of the European Commission, even if amended to take account of certain recommendations made by CESR in its advice, would leave unsolved major legal, regulatory and tax issues incompatible with the maintenance of high investor protection standards which to date have been the hallmark of the UCITS brand.

3. Although many of the issues raised in the aforementioned debate have not been resolved to date and will require further discussion and clarification, it seems that on 2 December 2008 the European Council obtained the support of the ECOFIN Council and the European Parliament's Economic and Monetary Affairs Committee on the Presidency compromise. By mid December 2008 the Council, the Parliament and the Commission had agreed on a common text in their so called *interinstitutional dialogues*. Upon the agreement of the Permanent Representatives Committee (COREPER), which came through on 17 December 2008, the European Parliament could vote the UCITS IV package, comprising a full Management Company passport, as early as the week of 12 January 2009 to be then formally adopted by the Council in the first half of 2009. Member-States would then be required to implement these

amendments to the UCITS Directive in their local laws and regulations by 1 July 2011 at the latest.

4. The purpose of this contribution is to briefly outline and discuss the proposal for a Management Company passport as reflected in the EU Council's Presidency compromise of 20 October 2008 (reference 14332/08) (the "Proposal"). Changes made to the Proposal after 20 October 2008 as a result of the events referred to in section 3. above could not be included in this contribution but are not significant.

THE PRINCIPLES OF THE PASSPORT

5. A Management Company authorised by its home Member State may carry on in all EU Member States the activity for which it has been authorised, either through the establishment of a branch or under the freedom to provide services.

6. Hence, a Management Company, when carrying out activities in other EU Member States, has the choice of either setting up a branch in other Member States or providing services under the freedom to provide services without the establishment of a branch. This contribution will focus on the situation where the Management Company provides services under the freedom to provide services without the establishment of a branch.

7. With regard to collective portfolio management (i.e. management of common funds and investment companies), these activities comprise (i) the distribution in all EU Member States of the units/shares of UCITS managed by the relevant Management Company ; (ii) the collective portfolio management of UCITS including all associated functions and tasks (i.e. to be the Management Company of common funds or the designated Management Company of investment companies) and (iii) the provision of investment management, administration and /or marketing services to other Management Companies or investment companies under delegated mandates. It is

only the activities referred to under (ii) which are being discussed in this contribution.

PASSPORTING OF COLLECTIVE PORTFOLIO MANAGEMENT

8. Consequently, under the Proposal, a Management Company, once authorised in its home Member State, can set up and manage not only common funds set up and authorised in the Management Company's home Member State, but also common funds set up and managed in other EU Member States. For example, a Management Company set up and authorised in Luxembourg can create and manage common funds set up and authorised in other EU Member States. Similarly, a non-Luxembourg Management Company set up and authorised in its home Member State, can create and manage a Luxembourg common fund. It is worth noting that the Proposal defines the home Member State of a common fund as being the Member State in which the common fund is authorised. Currently, the UCITS Directive defines the home Member State of a common fund as the Member State in which the common fund's Management Company has its registered office, thus requiring that a common fund and its Management Company are both situated in the same Member State.

9. Similarly, a Management Company set up and authorised in its home Member State, can act as a designated Management Company not only for investment companies established and authorised in the Management Company's home Member State, but also investment companies established and authorised in any other EU Member State. For example, a Management Company set up and authorised in Luxembourg may be designated as a Management Company by investment companies set up and authorised in other EU Member States. Similarly, investment companies set up and authorised in Luxembourg may designate a Management Company set up and authorised in any other EU Member State. In contrast with the situation for common funds as described in the last sentence of the preceding paragraph, the text of the existing UCITS Directive already provides for the provision of cross border collective portfolio management services by management companies to investment companies, but

this was not recognised in practice by EU Member States authorities.

NO MANAGEMENT COMPANY PRESENCE REQUIRED IN THE UCITS HOME MEMBER STATE

10. Subject to the scope for delegation arrangements as discussed under 14. below, a Management Company provides (under the freedom to provide services, i.e. when not acting through a branch) its collective portfolio management services, namely investment management functions, administration functions and marketing functions, in and from its home Member State. Consequently, where a Management Company provides cross border Management Company services to UCITS (common funds and/or investment companies) set up and authorised in other EU Member States, the collective portfolio management services, including the relevant administration functions, are performed in the Management Company home Member State and not in the UCITS home Member State. This is a significant change from the present UCITS Directive where, under the head office concept, it is implied that administration functions have to be performed in the UCITS home Member State.

11. These rules have been emphasised in the Proposal as a matter of principle as the Proposal provides that "it must not be made a condition of authorisation that UCITS be managed by a Management Company having its registered office in the UCITS home Member State or that the Management Company performs or delegates any activities in the UCITS home Member State".

COMPETENCIES OF THE MANAGEMENT COMPANY HOME MEMBER STATE AUTHORITY

12. The Management Company's home Member State authorities are the competent authorities for authorising the Management Company and supervising its compliance with the rules and applicable provisions in the Management Company's home Member State. These rules comprise rules relating to the authorisation (authorised services; minimum capital and own funds requirements; shareholder require-

ments; authorisation of persons who conduct the business) and organisation of the Management Company (including delegation arrangements, risk management procedures, prudential rules and supervision, the requirement to have administrative, accounting and control procedures and the Management Company's reporting requirements).

COMPETENCIES OF THE UCITS HOME MEMBER STATE AUTHORITY

13. The rules of the UCITS home Member State apply to the constitution and functioning of the UCITS and the competent authorities of the UCITS home Member State are responsible for supervising compliance with those rules. In an effort to distinguish between the scope of the Management Company home Member State rules (and consequent competence of the Management Company home State authority) and the UCITS home Member State rules (and consequent competence of the UCITS home Member State authority), the Proposal specifically lists the rules which relate to the constitution and functioning of the UCITS as those rules which cover (a) authorisation of the UCITS; (b) issue and redemption of units and shares; (c) exercise of unitholders' voting rights; (d) investment policies and limits; (e) restrictions on borrowing, lending and uncovered sales; (f) valuation of assets and accounting for the UCITS; (g) calculation of the issue price and/or redemption price; (h) distribution or reinvestment of the income; (i) disclosure and reporting requirements of the UCITS, including the prospectus, the key investor information and periodic reports; (j) marketing and distribution of the units; (k) relationship with unitholders; (l) merging and restructuring of UCITS; (m) winding-up and liquidation of the UCITS. In addition the Proposal refers to the rules set forth in the UCITS instrument of incorporation and its prospectus.

DELEGATION OF FUNCTIONS BY THE MANAGEMENT COMPANY

14. In the same way as is presently provided for in the UCITS Directive, the Proposal allows Member States to permit Management Companies established in their juris-

dition to delegate to third parties one or more of their functions on certain conditions which remain substantially unchanged from the current UCITS rules. It should be noted that it is therefore the Management Company's home Member States rules which determine the extent to which the Management Company may delegate functions and it is the Management Company's home Member State authority which must authorise any proposed delegation within the scope of the applicable rules. The UCITS home Member State rules are not applicable and the UCITS' home Member State authority has no authority in this regard, except for a right to information from both the Management Company (see 16. below) and the Management Company's home Member State authority.

ADDITIONAL ROLE OF THE DEPOSITORY IN THE CASE OF CROSS BORDER MANAGEMENT COMPANY SERVICES

15. In the case of cross border Management Company services, the depository of the UCITS must sign a written agreement with the Management Company regulating the flow of information deemed necessary to allow it to perform its depository functions. In addition, the depository must establish procedures that enable the UCITS home Member State authority to obtain on request all information which the depository has obtained while discharging its duties. These specific requirements do not apply where a UCITS is managed by a Management Company set up and authorised in the same EU Member State as the UCITS.

AUTHORISATION OF THE MANAGEMENT COMPANY FOR THE UCITS BY THE UCITS HOME MEMBER STATE AUTHORITY

16. When authorising a UCITS, the UCITS home Member State authority must

approve the Management Company, the choice of depository and the UCITS rules (constitutional documents). If the Management Company is authorised in a Member State other than the UCITS home Member State, the UCITS home Member State must also receive from the Management Company its written agreement with the depository (see 15. above) and information on delegation arrangements (see 14. above).

17. The UCITS home Member State authority may refuse the approval of the application of the Management Company only in specific circumstances set forth in the Proposal and after requests for clarification and information from and consultation with the Management Company's home Member State. Similarly, if a Management Company is in persistent breach of the legal and regulatory provisions applicable in the UCITS home Member State, the authorities of the UCITS home Member State may, after certain procedures involving the Management Company home Member State authority, prevent the Management Company from providing services in the UCITS home Member State territory.

18. It should be noted that a Management Company, prior to the first filing of an application for authorisation of a UCITS in a specific EU Member State, must inform its own home Member State of the application proposed to be made in the other Member State and provide a programme of operations stating the activities it envisages it will undertake whereupon its home Member State authority will forward this information to the Member State in which the proposed UCITS is to be authorised.

IMPLEMENTATION MEASURES TO BE ADOPTED BY THE COMMISSION

19. In a number of areas, the Proposal provides that the Commission may adopt implementing measures to amend non-essential elements of the Directive by supplementing it which must be adopted in accordance with the regulatory procedure

[provided for in article 5 a) (1) to (4) of article 7 of Decision 1999/468/EEC, having regard to the provisions of article 8 thereof.

POTENTIAL IMPLICATIONS/OPPORTUNITIES FOR LUXEMBOURG

20. Although the Management Company Passport will provide more flexibility for non-Luxembourg Management Companies to provide administrative services to Luxembourg UCITS from abroad, we believe that the qualification and professionalism of the Luxembourg service providers will result in such foreign Management Companies still outsourcing administrative functions to the Luxembourg service providers and is also likely to afford new opportunities to Luxembourg service providers to provide administrative services to non-Luxembourg UCITS. In addition, tax and regulatory considerations of supervisory authorities in non-EU Member States might continue to favour the establishment of the Management Company and UCITS in the same Member State. ■

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NEW COMPLIANCE REQUIREMENTS – CONSEQUENCES OF THE VAT PACKAGE

Major changes to VAT rules effective 01.01.2010

On December 29, 2006, the Luxembourg VAT authorities issued circular nr. 723 relating to the European Court of Justice Cases involving “BBL” and “Abbey National” stating that investment vehicles listed in article 44 1 d of the Luxembourg VAT laws have to be considered as taxable persons for VAT purposes. The circular was revolutionary in the Luxembourg approach to VAT as prior to implementation of this circular, investment funds were considered as non VAT payers and having no obligations with respect to VAT compliance.

Life has changed and now these vehicles have been required to register for VAT in order to comply with their VAT obligations. In this context, the first round of annual VAT returns have been completed this year listing services received from non Luxembourg suppliers which are not VAT exempt and which are covered by the reverse charge mechanism. Those services are typically of an intellectual nature, for example lawyers' fees incurred in the set-up of the relevant vehicle or other specific consulting services.

However across the EU, other important VAT changes are emerging. The first one is the famous VAT package adopted at the end of December 2007 and the second is probably the proposal for a Directive regarding financial and insurance services although at the time of writing no definitive proposal as to the Directive's contents is available.

The VAT package adopted by ECOFIN will introduce the most fundamental changes to the VAT system since 1993.

To summarize, the key changes involve:

- A change in the place of supply rules which in future will be determined by reference to where the customer rather than the supplier is located. This change takes effect from January 1, 2010.
- A new obligation to complete an Electronic Sales Listing report regarding the supply of cross border services. This change also takes effect from January 1, 2010.
- Electronic VAT refunds improving the timing and efficiency in the VAT refunds.
- Changes to the place of supply rules for services supplied electronically. This change will take effect in 2015.

This article focuses on the practical issues resulting from the first two changes mentioned above as they will generate major change for the finance industry.

CHANGE TO THE PLACE OF SUPPLY AND REPORTING RULES

The changes regarding the place of supply and the additional reporting obligation without doubt crystallize the most fundamental changes to EU VAT requirements.

It is quite clear that the present rules governing the place of supply of services are too complicated such that the VAT payer can never be completely confident as to the correct application of the applicable VAT rules on the supply of cross border services. For example, publication fees for investment funds, what is the current correct VAT treatment? Based on our experience we have seen some EU countries apply the general rule (taxation in the country where the supplier is established) even though the Luxembourg investment fund is VAT registered. In that case foreign VAT is charged to the fund. Other service suppliers apply the reverse charge mech-

anism. These different approaches create uncertainty and in the worst case scenario could result in double taxation for the VAT payer i.e. the recipient of the services concerned.

However, now the VAT logic will be reversed and will have to be integrated into business processes.

In addition, the requirement to report a summary statement (so-called “EC sales listing”) for services to which the new general rule of reverse charge applies suggests that the IT system of the relevant business owner (supplier of the service) must be capable of capturing the information necessary to complete the statement. At the same time this data has to correspond to the data reported by the recipient of the service to avoid any discrepancies which could result in a different VAT treatment.

While this system may be familiar to the commercial industry due to obligations to establish an EC sales listing regarding the cross border intra-community sales of goods it is different for the financial industry.

In the financial sector, many accounting systems would have to be adapted to produce the required reports. Indeed until now, the reporting of this information has never been required in such a prescribed manner and it is quite certain that it will be very difficult to obtain the information if appropriate steps are not taken.

While the production of multiple reports might yield the information required, neither the inherent risk of inaccuracy nor the disproportionate amount of time which will be involved in collection of the required information can be ignored in such an approach. In addition, it will almost certainly be necessary to rigorously train people involved in this business process with respect to VAT and the related accounting requirements. Under the proposed Direc-

tive the recipients of services would be required to complete monthly VAT listings, detailing the value of reverse charge services purchased in the EU.

The details which would have to be provided in these listings are not yet precisely defined. However the proposal suggests that the report would include invoice-level data for all suppliers and not just a summary of the transactions. However, what is certain is that these rules will take effect from January 2010.

At this stage it is still quite unclear whether the listing should also disclose VAT exempt supplies, i.e. the totality of the cross-border transactions or whether only taxable supplies which are not covered by a VAT exemption in the country of the recipient should be declared.

The first approach, i.e. that any cross border supplies would have to be reported, would have the advantage that the guideline is quite easy to understand in the sense that a detailed knowledge of the VAT legislation and the possible VAT exemptions would not be required.

The second approach, that the report would only include services to which the reverse charge mechanism applies in the recipient's EU country would require that the supplier has to be familiar with the reverse charge mechanism, in particular with the respective provisions in the Member States into which he provides services.

This system will be very complicated and will probably generate discrepancies in practice which will have to be reconciled.

For example a supplier located in EU Member State A provides investment advisory services to a securitization vehicle covered by the VAT exemption in Luxembourg. Should these services be mentioned in the EC sales listing? Under its own VAT rules probably yes but under the Luxembourg VAT rules, no.

Additional difficulties which may arise are the consequences of any discrepancies detected by the cross-border EU system put in place by the EU Member States. This system will either be similar to the present system VIES or form part of the existing VIES system of exchange of information between Member States.

Parallel to the current situation existing for intra – community cross border transactions on goods, the supplier and the recipient of the service(s) will probably be asked

to reconcile differences found by the system. Consequently, the business process of the supplier and the recipient should prepare for this eventuality and include features to ensure accurate compliance and appropriate information.

As already mentioned, based on the proposal of the Council Directive, monthly reports would have to be completed when the VAT payer acquires intracommunity deliveries of goods or services covered by the reverse charge for a total amount exceeding €200 000 per year. Fortunately, if the VAT payer does not exceed that threshold, Member States may reduce the frequency to quarterly or, at a minimum, annual reporting.

These additional compliance requirements and the associated short time frame for implementation should not in principle create huge problems for the commercial industry, for which the requirement to report statistics is nothing new as EC sales listings of goods are presently filed on a quarterly basis. However, as mentioned previously the situation is different for the financial sector and probably more problematic again for the investment fund industry. We observe that VAT compliance reporting is something which is very new for this sector, considering that until now, VAT registered investment funds only had to file a simplified VAT return on a yearly basis. Indeed when circular 723 was implemented, the Luxembourg VAT authorities denied Luxembourg investment funds the right to recover input VAT (paid or declared). Even if this approach might be questionable based on the EU VAT directive, in most cases it has the undeniable advantage of relieving the investment fund industry from the administrative burden of filing monthly and annual VAT returns.

Does this mean that the VAT package and related EC sales listing requirements would result de facto in a switch to a monthly process with a significant effort in time and resources to comply with this new obligation?

No definitive answer can be given for the time being.

But what is certain is that we have just less than 12 months until these changes come into effect to adapt accounting and IT systems, design the solutions, test the modifications across the system to be ready to deal with those practical issues

and challenges. If the business process is not adapted in time, the VAT package and related additional VAT requirements could be problematic for the financial sector.

SUMMARY

The VAT environment for the investment industry has significantly changed since April 1, 2007. Not only in that investment vehicles now qualify as taxable persons and are liable to pay VAT on services or goods received under the reverse charge mechanism, but also in that the compliance requirements of the VAT package might lead to additional administrative and organisational challenges.

Thus, companies in the investment industry should verify in the first place whether they receive services from abroad and, if so, whether the new rules of the VAT package might impact the current VAT treatment. Insofar as the current VAT treatment is not affected by the new rules, it seems advisable to ensure that all information required regarding the compliance obligations are made available from accounting systems. Generally speaking, the accounting processes should reflect all relevant information at the invoice level (i.e. name of supplier, identification number, and amount invoiced...) for services received under the reverse charge mechanism and account for VAT.

Given the recent inclusion of investment funds among the VAT payers and the additional reporting requirements, more time and effort will be required to evidence the accuracy and completeness of the numbers in VAT returns and financial statements. ■

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CALLS FOR MORE REGULATION OF HEDGE FUNDS

The Rasmussen and Lehne resolutions

On 23 September 2008, the European Parliament adopted a resolution requesting the European Commission to submit legislative proposals “on hedge funds and private equity”¹; the scope of the resolution, however, goes well beyond hedge funds and private equity. On the same day, a second resolution was also adopted “on transparency of institutional investors”²; this second resolution focuses mainly on hedge funds and private equity. In this article, we outline the resolutions and reflect on some of the measures relevant to hedge funds.

OVERVIEW OF THE RESOLUTIONS

The European Parliament’s resolution on hedge funds and private equity was drafted by Paul Nyrup Rasmussen, a member of the European Parliament and former Prime Minister of Denmark, on behalf of the Committee on Economic and Monetary Affairs. The resolution, hereafter referred to as “the Rasmussen resolution”, calls for legislative proposals from the European Commission covering, *inter alia*, the following areas:

- Financial stability, capital and universal regulatory coverage including:
 - Capital requirements for investment firms including partnerships and limited partnerships, insurance companies, credit institutions and conventional funds
 - Alignment of the interests of originators and investors in securitized loans
 - EU oversight of credit ratings agencies

- Principle based measures on the valuation of illiquid financial instruments
 - Transparency requirements applicable to prime brokerage services
 - Transparency
 - Private placement regime: An EU framework for cross-border distribution of investment products, including alternative investment vehicles to investors. Disclosure to investors and public authorities should include areas such as investment strategy, fee policy, leverage, managers’ remuneration, etc.
 - Rules for disclosure of relevant information to investors
 - Employee protection when the control of a business is transferred by investors, including hedge funds
 - Information to employees or staff representatives regarding the way pensions are invested and the associated risks
 - Conflicts of interest
 - Financial institutions providing a range of services should have mechanisms to identify, assess and address conflicts of interest
 - Separation of business activities of credit rating agencies
 - Review of market concentration and the effects of dominant players in financial services
 - Review of existing financial services legislation to identify gaps relating to hedge funds and private equity
- The resolution on transparency of institutional investors was drafted under the leadership of Klaus-Heiner Lehne, a member of the European Parliament, on behalf of the Committee on Legal Affairs. The resolution, hereafter referred to as “the Lehne resolution”, calls for the Commission to examine a number of issues with a view to proposing appropriate legislative measures. These include:
- Contract terms providing for disclosure on risk, thresholds being exceeded, lock-up periods and conditions regarding termination of contract
 - Anti-money laundering procedures in relation to hedge funds and private equity
 - Reducing the threshold for notification of issuers whose securities are admitted to trading on a regulated market - where voting rights exceed or fall below the threshold – from 5% to 3%. For hedge funds and private equity, disclosure of investment policy and associated risks should be provided to the company in which the acquisition is made as well as investors, prime brokers and supervisors.
 - A register of shareholders holding more than a certain proportion of holdings and disclosure of their strategies and intentions
 - Establishing transparency of voting policies of hedge funds including investigating
 - The effects of securities lending and borrowed stock
 - The application of reporting requirements to cooperation agreements between shareholders and indirect acquisition of voting rights via options
 - Enabling shareholders to participate in voting at general meetings via intermediaries
 - Reinforcing long term investment against short term excessive risk taking in corporate governance
 - Full transparency of managers’ remuneration systems
- While both resolutions were finally adopted by an overwhelming majority, the heated debate in the Parliament prior to the vote revealed a significant divergence of views on the issues and how they should be tackled. I shall cover some of the points raised later, but first I want to stand back and look at some of the challenges and how they may be tackled.

WHAT ARE THE CHALLENGES?

The hedge fund industry has grown at a tremendous pace over the last 20 years to a point where it has acquired significant influence in financial markets. It is certainly right to ask, for example, whether it poses systemic risks, whether further transparency is needed and whether there are undesirable social consequences of hedge funds. The hedge fund industry, however, should not become “the” scapegoat for today’s financial crisis, leading to quick regulatory fixes. The European Parliament has certainly, and rightly, stimulated debate, but greater evidence is needed to support calls for increased legislation.

Despite the Parliament’s calls for action, it is in fact the European Commission which is responsible for proposing legislation; the Commission has indicated that it is committed to transparent, evidence-based policy-making founded on a dual commitment to open consultation and impact assessments³. Indeed, on 18 December 2008, the Commission issued a Consultation Paper on Hedge Funds to gather information and evidence from interested parties.

Production side regulation	Distribution side regulation
Product - Product specific - General rules for a set of products, or all Investment firm/managers Service providers - third parties (e.g. prime brokers)	Investors - Eligibility - Quantitative investment criteria Eligible providers or intermediaries (European and foreign)

REGULATORY OPTIONS

The regulatory options open in relation to hedge funds, at least in principle, are as follows:

Overall, the European Parliament is requesting the review and, on occasion, rebalancing of the patchwork of regulation we already have in relation to hedge funds and private equity products; neither the Rasmussen nor the Lehne resolutions, however, call for a rethink of the overall regulatory framework.

BEST PRACTICES NEED TO PLAY A LEADING ROLE

A number of voluntary codes, sometimes described as “sound” practice standards, have already been developed for the hedge fund industry, including those of The Alternative Investment Management Association (AIMA)⁴, the Hedge Funds Standards Board (HFSB)⁵ and the President’s Working Group on Financial Markets (PWG)⁶. These standards cover areas such as risk management and controls, compliance, conflicts of interest, raising capital, disclosure to investors and counterparties and shareholder conduct. The codes are addressed primarily to hedge fund managers. The complex issues are well understood and have been carefully assessed by the bodies drawing up the voluntary codes. Bodies such as AIMA and the HFSB are committed to update the codes in the light of new sound practice developments.

The recitals of both the Rasmussen and Lehne resolutions call for a one-stop shop for codes of conduct with a register of those who comply, their disclosure and, for those who choose not to comply, reasons for non-compliance.

Since the two resolutions were adopted, the declaration of the G20 *Summit on Financial Markets and the World Economy* has called for the private sector bodies which have developed best practices for private pools of capital and/or hedge funds to come forward with proposals for a set of unified best practices which should then be assessed by Finance Ministers. The signatories included France, Germany, Italy, Spain, the Netherlands, the United Kingdom and the European Union.

The G20 leaders call for voluntary codes, and perhaps a single unified code, is one way to move forward, and move forward swiftly, to address current issues. Investors and peers will pressure non-complying managers to fall into line. It may be the closest we will get in the near future to global regulation of the hedge fund industry.

CAPITAL REQUIREMENTS

The Rasmussen resolution calls for capital requirements to be mandatory for all financial institutions and for this capital to reflect

the risk from the type of business, exposures and risk control. It also calls for the consideration of longer term liquidity horizons.

While the principles seem laudable, the report does not provide details of how such capital requirements should be implemented.

At the level of the investment fund vehicle, most hedge funds are limited liability companies or limited partnerships, thereby limiting investor exposure to capital invested. At the manager level, the management of hedge funds is carried out by firms which may be subject to certain capital requirements.

It should be noted that leverage in the hedge fund sector is considered to be relatively low. Third parties providing leverage – the prime brokers – are usually themselves banks (and given what has happened over the last few months will more than likely be banks in the future) which are already subject to capital requirements. Prudent risk management principles are key to preventing defaults. The main hedge fund industry voluntary codes cover risk management, including, for example, provisions on leverage and liquidity risk at manager level.

On the issue of financial stability, a study conducted for the European Parliament’s Committee on Economic and Monetary Affairs (ECON) in November 2007⁷ found that “hedge funds are in general less risky than banks” and that there is not “much evidence for the fear that hedge fund failures can trigger a systemic crisis in the banking sector”.

EU PRIVATE PLACEMENT REGIME

The Rasmussen resolution calls for an EU private placement regime allowing cross-border distribution of investment products.

The European Parliament’s continued support for an EU private placement regime is welcome. An EU private placement regime complementing existing national regimes would enable investors to access non-harmonized products which they may not have been able to access otherwise. It should also simplify the legal and administrative requirements around the distribution of such securities.

INVESTOR PROTECTION

The Rasmussen resolution also calls for disclosure to investors and public authorities in a number of areas such as fee policy, leverage, remuneration systems, etc. The Lehne resolution suggests contract terms covering areas such as lock-up periods. It would be useful to distinguish between qualified (e.g. professional) and retail investors here.

Qualified investors with access to such products are expected to perform their own due diligence and, on that basis, make informed decisions. Guidelines on due diligence are available, for example, from AIMA⁸ and the HFSB. One may therefore argue that there is no need for further regulation here.

Hedge funds are not generally available directly to retail investors in Europe, although retail investors may be able to gain access via funds of hedge funds. Neither of the two resolutions appears to tackle the issue of the “retailization” of alternative investment funds. If an EU private placement regime did provide some “retail” investor access to alternative investment products⁹, then some harmonization of the required disclosure to investors may indeed be highly relevant and desirable.

ONGOING TRANSPARENCY

The Rasmussen resolution calls for the Commission and regulatory authorities to devise rules to ensure clear disclosure and communication of relevant and material information to investors.

However, the key conclusion of second study conducted for the European Parliament’s Committee on Economic and Monetary Affairs (ECON) in December 2007¹⁰ was that the industry should “adopt a strengthened voluntary code of conduct, building on the proposals already put forward by the Hedge Fund Working Group.” The report suggests some sort of external verification of compliance, and relaxation of barriers to market access for those complying.

HEDGE FUNDS AS SHAREHOLDERS

The Lehne resolution calls for disclosure on investment policy and associated risks to be provided to investee companies as well as investors, prime brokers and supervisors where a hedge fund or private equity fund acquires shares with voting rights exceeding 3% of the voting capital of the investee company. It also calls for enhanced transparency in the voting policies of hedge funds.

Such rules could be applied to all investors. It may be difficult to understand why hedge funds and private equity as investors are being singled out here.

TRADING ACTIVITIES OF HEDGE FUNDS

The Lehne resolution calls for a code of best practice to discourage short-term excessive risk taking and irresponsible behavior. During the Parliamentary debate, Mr Lehne called, *inter alia*, for the issue of short selling to be examined and legislative proposals to be brought forward if necessary.

In November 2008, global securities regulators set up three task forces - the first to study abusive short selling. The SEC has underlined that short selling is a legitimate investment strategy; however, it has highlighted that naked short selling can distort markets.

Considering current circumstances, the immediate reaction of many regulators was to place a temporary ban on naked short selling, or equivalent measures, whilst considering whether further long term action would be necessary.

The task force aims to take action to coordinate global regulatory measures on abusive short selling, involving reporting of short positions.

The second task force will examine ways of introducing greater transparency and oversight over unregulated financial markets and products, such as OTC markets for derivatives and other structured financial products. The third will examine unregulated entities, such as hedge funds, *inter alia*, with a view to developing regulatory practices to mitigate risks associated with their trading activities.

CONCLUSION

The hedge fund industry has entered a phase of maturity. However, many of its activities are not sufficiently well understood. Calls for further regulation of hedge funds are in many ways reactions to this lack of understanding. The industry needs to provide coordinated responses. Working together to develop a single global code of best practice will be one of them.

According to the Commission’s Consultation Paper on Hedge Funds, any new regulation of hedge funds will be part of “a coherent and comprehensive policy response to the financial crisis”. Such a response will be presented before the 2009 European Parliament elections. ■

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¹ European Parliament resolution of 23 September 2008 with recommendations to the Commission on hedge funds and private equity (2007/2238(INI))

² European Parliament resolution of 23 September 2008 with recommendations to the Commission on transparency of institutional investors (2007/2239(INI))

³ White Paper on Financial Services Policy (2005-2010)

⁴ *Guide to Sound Practices for European Hedge Fund Managers*, May 2007, and others, The Alternative Investment Management Association

⁵ The HFSB Standards included in the *Hedge Fund Standards: Final Report* of the Hedge Funds Working Group (now the Hedge Funds Standards Board), January 2008.

⁶ *Best Practices for the Hedge Fund Industry* a report of the Asset Managers’ Committee to the President’s Working Group on Financial Markets, April 2008.

⁷ *Hedge Funds and Financial Stability – Study* (IP/A/ECON/IC/2007-23) by Prof. dr. Casper G. de Vries & Prof. dr. Philip A. Stork, November 2007

⁸ e.g. AIMA’s due diligence questionnaire for investors on hedge fund managers

⁹ An EU private placement regime would be likely to set certain minimum investor qualifications.

¹⁰ *Hedge Funds – Transparency and Conflicts of Interest* (IP/A/ECON/IC/2007-24) by Prof. Narayan Naik, December 2007.

DEMATERIALIZED MUTUAL FUND SALES AGREEMENTS

Mutual fund sales agreements and the associated commissions processing activities are some of the least standardised and automated aspects of the world-wide fund industry. It's a commonly-held view that there is little possibility for improvement. This paper argues otherwise, and shows how the development of open standards could be achieved with no loss of flexibility or competitive potential.

CURRENT PRACTICE

In today's mutual fund industry, fund sales agreements are very often customised documents. They are individually written by lawyers using word-processors, printed onto paper and signed with ink by each party. When firms talk about «standardisation» as a means to avoid the expense and delay of the customised process, they invariably mean using their own standard form of an agreement. That is clearly not equivalent to an industry standard as every firm of significant size, whether on the sell-side or the buy-side, has developed its own «standard» fund sales agreement. The first step to contracting most agreements is therefore a «battle of forms», in which the parties involved decide whose preferred form they will use as the basis for their agree-

ment and how much modification will be necessary to make it acceptable to both sides.

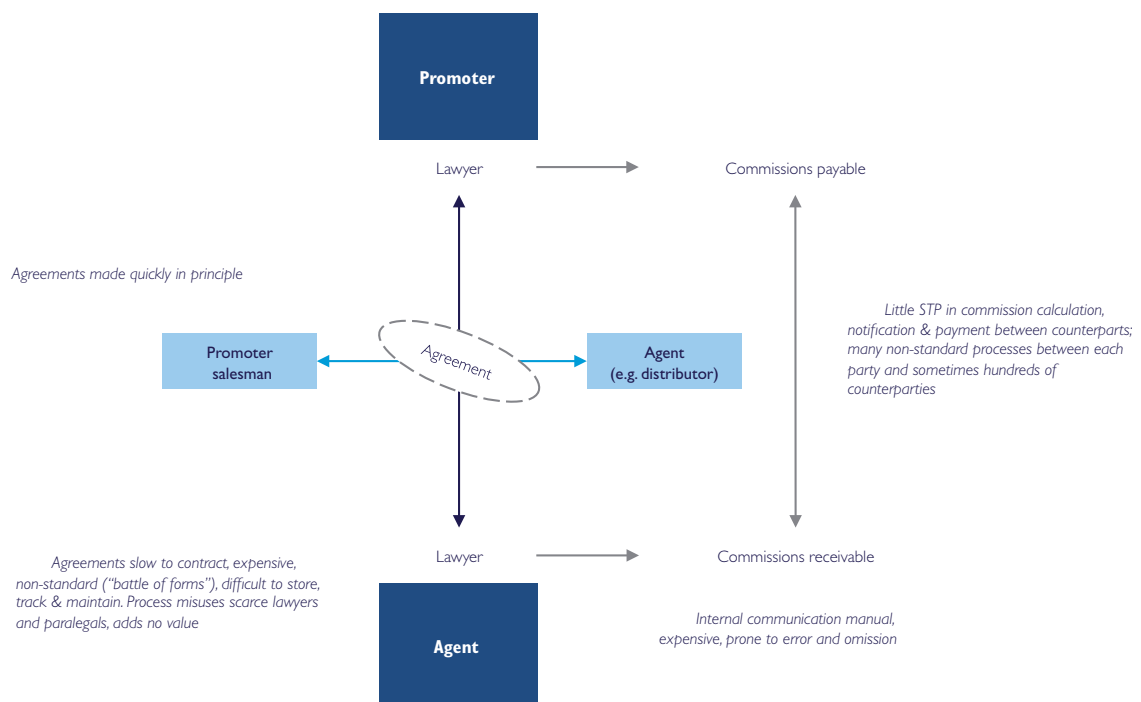
This is essentially a zero-sum effort: each party reviews /negotiates the other's agreement(s) to ensure that the other's preferred form is acceptable to it. However this work rarely achieves more than ensure that the agreement is reasonable from the perspective of both parties and that it conforms to some basic legal principles, which are commonplace in the mutual fund industry throughout the world.

This practice presents the fund industry with several problems (see also *Figure 1* below):

Expense

Fund sales agreements are expensive to implement because they need lawyers or paralegals to draft them and each amendment must be explained, considered and debated, often in writing between the

Figure 1: current practice - paper, ink, expense and delay



parties, before it is accepted. For what are often not much more than a collection of commonplace legal principles committed to paper, such agreements are poor value for money, and firms should be able to contract a satisfactory agreement at a much lower cost.

Misuse of legal resource

There is a shortage of legal skills within the mutual fund industry and time spent on fund sales agreements cannot be spent on higher value professional work, such as the design of new products.

Constraint on growth

There are limits to the legal resources that firms can employ on fund sales agreements, which constrains their ability to build and maintain distribution networks. Consequently, distribution networks are smaller than they otherwise could be and are not easily maintained as the promoter develops its product range (in fact, few distribution networks are maintained as actively as they ought to be). In effect, neither the promoter nor the distributor can realise the full economic potential of the distribution network.

Poor communication

Precedent agreements do not always ensure or enable the complete and accurate transfer of information between sales representatives, lawyers, commission calculation agents, transfer agents

and other service providers. This means that the terms of business provided for in the finished agreement might only be an approximation of what the sales representatives agreed and, notwithstanding any omission or transcription error that might arise as the agreement is implemented in the back office, often contain insufficient information for the commission calculation agent and transfer agent to allow for clear interpretation and implementation of the agreement.

No support for automation

Because no standard description of fund sales agreements exists, there is little opportunity for straight-through processing within the order-routing and commission calculation processes, and little prospect of improving the speed and accuracy with which commissions are calculated and paid throughout the industry.

A MODEL FOR THE FUTURE

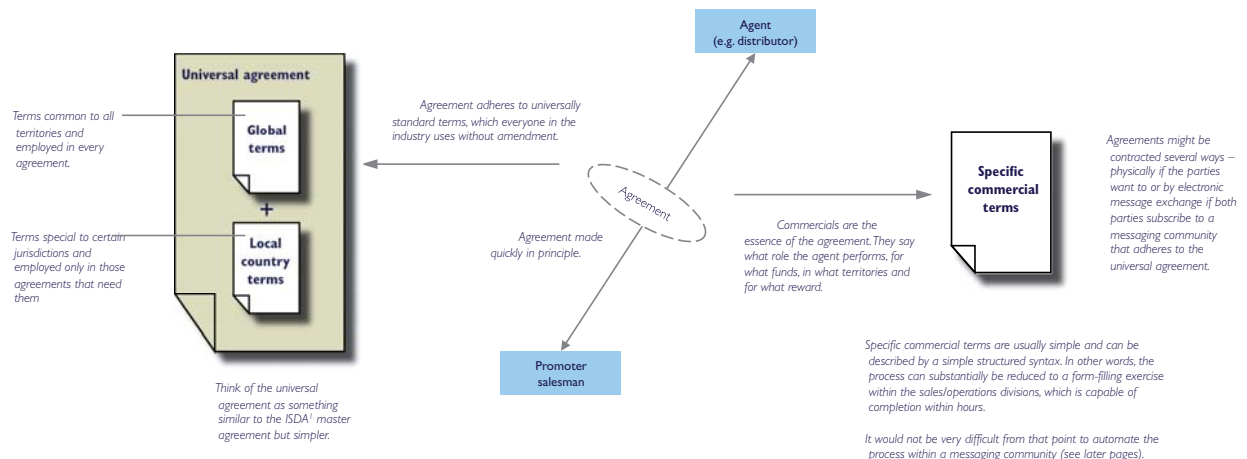
Fund sales agreements could and should be made more cost effectively, using a universally acceptable master agreement and custom-made term sheets (see *Figure 2* below). The contributors to this project have prepared a draft text for the master agreement, which provides a suitable

legal foundation for domestic and cross-border fund sales. They have also prepared a standard syntax for term sheets (see the synoptic chart at the end of this article), which encourages comprehensive and standardised communication and processing across the industry without limiting the ability of companies to do business together on entirely proprietary terms.

The concept of an industry standard master agreement is not new to the financial services industry. The best known example is the International Swap Dealer's Association master agreement (commonly known as the «ISDA» agreement). Within the mutual fund industry, the most successful standard fund sales agreement is probably the Swiss Fund Association's. The benefit of such standards is that they:

- Establish a commonly accepted legal foundation upon which industry participants can do business.
- Help to reduce legal risk and cost.
- Encourage basic standards of good practice.
- By promoting standardisation in services where difference provides no competitive advantage, help firms to concentrate their effort upon services where they believe they can make a difference, which, in turn, improves competition and service.

Figure 2: a model for the future – universally standard terms with custom-made commercials



The draft master agreement that has been prepared in the course of this project has been written within the context of European Union law to support domestic and cross-border fund sales within the European Union and international fund sales beyond the European Union's borders, excluding the United States. With the exception of some important references to the European Directive 91/308/EEC on the prevention of the use of the financial system for the purpose of money laundering and the European Directive 2003/48/EC on the taxation of savings, the draft contains no explicit reference to national legislation, and it requires the contracting parties to declare in their term sheet which law their agreement is made under and to which courts they will submit.

The master agreement is also designed to be invoked in several parts:

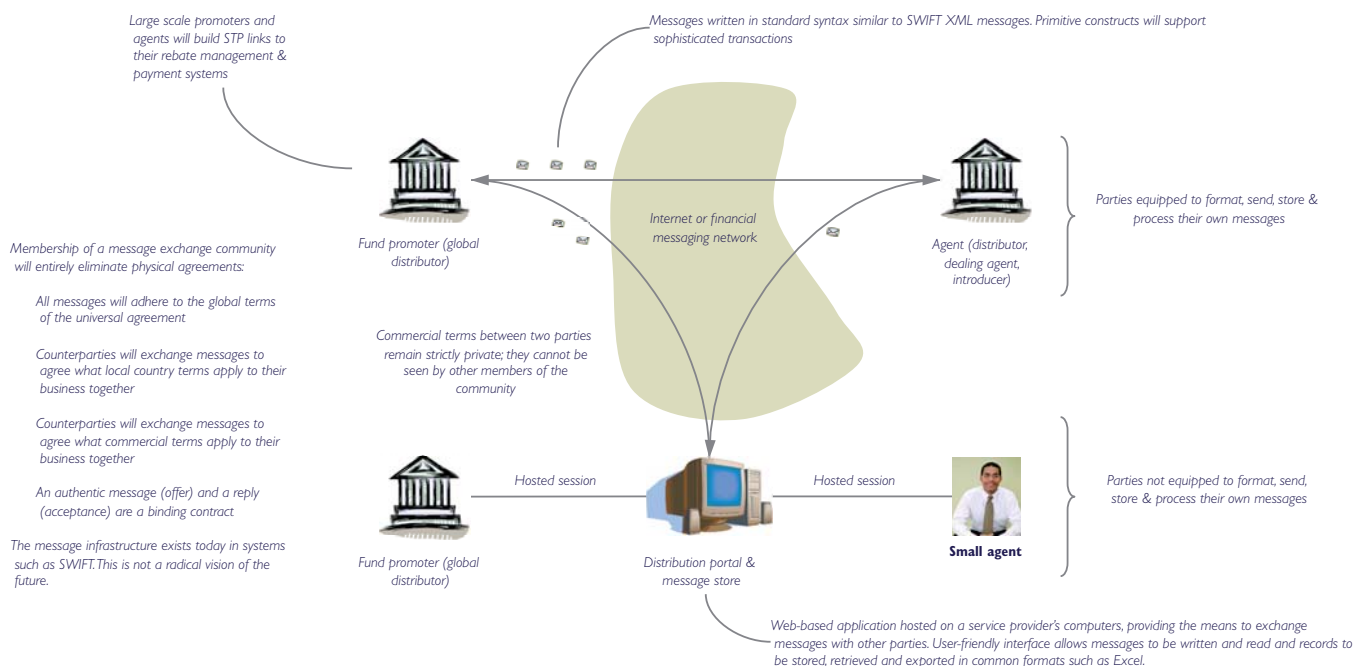
- **Global terms**, which are common to all territories and which are employed in every agreement.
- **Local country terms**, which are unique to a particular country and should only be invoked if the parties are contracting an agreement for business to be conducted in that country.

At present, only the global terms have been written. An example of something that might be included in a set of local country terms might be Luxembourg's requirement that fund sales agreements should contain provisions to defend funds against market timing.

The adoption of a standard master agreement allows firms to concentrate upon their term sheets, where they can achieve true competitive differentiation. The syntax for commercial terms allows for the creation of term sheets efficiently, either as printable documents, which may be signed in ink according to current practice, or as electronic messages, which if exchanged using a suitable message protocol over a suitable infrastructure, would permit the industry to "dematerialise" agreements in the manner imagined in Figure 3 below. To keep it simple, the syntax for commercial term sheets is limited to what must be defined in order to construct a valid agreement (which is often surprisingly little) and excludes what else the parties to an agreement might wish to define in support of the business between them (reporting messages for commissions, for example). When the

dematerialisation concept starts to win general acceptance, work on commission reporting and payment can begin. If a firm wished to manage its term sheets in a word processor using macros to control data entry or in a simple database application linked to a document generator, it could do so very quickly. The syntax for commercial terms is well-developed, being supported by a comprehensive technical reference, and is simple for a technician to understand. Such a tool would effectively shift the agreement preparation process from the legal domain to the sales and operations domains, and reduce production time to a matter of minutes. In that scenario, agreements are transformed into operational documents with a legal basis. The contributors to this project have prepared a model term sheet in Microsoft Word (without macros) to illustrate the concept, and have prepared a concept demonstrator in software, which shows how agreements can be prepared and stored in a database application before being printed to paper or written as a structured electronic message, ready for transmission over a computer network.

Figure 3: infrastructure – emergent dematerialised platforms



It is likely to be some time before the industry will adopt fully dematerialised agreements, principally because it will take time for companies to develop the necessary message protocols and services. The vision of dematerialised fund sales agreements does not call for a single infrastructure, and there is no need for a central message repository because the messages between a fund promoter and its distributors or agents must remain private bilateral agreements. The definition should therefore be stateless (i.e., it should not call for the creation of a central repository in which all participants' commission terms will be stored, and each message need not be «aware» of previous messages that parties have exchanged). However, in practice the parties who will use the concept must keep a record of the history – or state – of the communication between them, which will form the corpus of their dematerialised sales agreements. The vision therefore allows market participants to decide whether they will build for themselves the capability to create, send, receive, store and generally manage their messages or whether they will buy the capability from specialised service companies. What is important is that the industry should promote open standards and encourage peo-

ple to adapt existing systems to exchange and manage messages (e.g., over SWIFT and through bureau service companies). The success of dematerialisation will depend on the extent to which it is adopted (the «network effect»), which in turn will be determined by how well it can be applied by a large number of companies to their normal business practices. For that reason the draft master agreement and the syntax for commercial terms have aimed to strike a balance between detail and generality, standardisation and flexibility, prescription and choice. To maintain standardisation and inter-operable, open systems, the project must go on to define a legal governance model for the master agreement (perhaps like ISDA) and a technical authority (perhaps through ISO, in co-operation with SWIFT) for the syntax for commercial terms and any common message protocols. That work will begin in the following months. It is the opinion of the contributors to this project that neither they nor any other company or industry association should profit through controlling the governing authority, which should be established to advance the concept of dematerialised mutual fund sales agreements for the common good of the industry.

NEXT STEPS

The member companies of this project intend to begin a consultation exercise to invite feedback from industry participants and associations with a view to developing the draft master fund sales agreement and the syntax for commercial terms, and encouraging their adoption as standards for mutual fund sales within Europe on a domestic and cross-border basis and internationally between Europe and other markets. ■

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The syntax in alphabetic order

Agreement = Company, Counterparty, AgreementID, ExecutionDate, MasterAgreementVersion, {CountrySchedule}, GoverningLaw, JurisdictionCourts, ProductSet, {ProductSet}, Markets, FrontEndLoad, [Rebates], [Payments], Reports, CompanyContactPerson, CounterpartyContactPerson;

AccountType = 'CentralTransferAgency' | 'Clearstream' | 'Euroclear' | 'FundSettle' | 'Other';

AppliedLookup = 'RebateApplied' | 'LookupOnly';

BankTransfer = Currency, BeneficiaryAccountName, [BeneficiarySWIFT_BIC_Code], BeneficiaryAccountNumber, BeneficiaryBankSWIFT_BIC_Code, [BeneficiaryBankBranchNumber], [BeneficiaryBankName], [BeneficiaryBankAddress], {PaymentReference}, [CorrespondentBankSWIFT_BIC_Code], [CorrespondentBankName], [CorrespondentBankAccountNumber];

CalculationFrequency = Frequency;

Cheque = Currency, BeneficiaryName, PostalAddress, {PaymentReference};

Company = Name, PostalAddress;

CompanyContactPerson = ContactPerson, [SpecialInstructions], [CompanyContactPerson];

Counterparty = Name, PostalAddress, CounterpartyCapacity;

CounterpartyCapacity = (('Distributor', [SubNetworksAllowed]) | 'Dealer' | 'FinalBeneficialOwner' | 'FundofFunds' | 'PlacementAgent'), [CounterpartyCapacity];

CounterpartyContactPerson = ContactPerson, [SpecialInstructions], [CounterpartyContactPerson];

CountrySchedule = Country, Version;

DeMinimisEarnings = DeMinimisEarningsCurrency, DeMinimisEarningsThreshold;

DeMinimisPayment = DeMinimisPaymentCurrency, DeMinimisPaymentThreshold;

Frequency = 'Daily' | 'Monthly' | 'Quarterly' | 'SemiAnnual' | 'Annual';

FrontEndLoad = 'DealAtNAV' | (FrontEndLoadSet, [PaymentCurrency, PaymentFrequency, [SettlementWithin], [RetrospectiveAdjustmentPeriod], [DeMinimisPayment]]);

FrontEndLoadSet = [FrontEndLoadSetID], Discount, CounterpartyShare, CompanyShare {ProductSet}, [FrontEndLoadSet];

HoldingAccount = AccountType, AccountNumber, HoldingValue, ['SharedAccount', [HoldingUpdateFrequency]];

HoldingAccountSet = [HoldingAccountSetID], HoldingAccount, {HoldingAccount};

Holdings = HoldingAccountSet, AppliedLookup, [Holdings];

HoldingValue = 'DailyHolding' | 'PeriodEndHolding' | 'PeriodAverageHolding' | 'MonthlyPeriodAverageHolding' | 'QuarterlyPeriodAverageHolding' | 'GrossSalesValue' | 'NetSalesValue';

Markets = (Region | Country), [Markets];

PaymentCurrency = 'ShareclassCurrency' | SingleCurrency;

PaymentFrequency = Frequency - 'Daily';

Payments = PaymentType, (ReinvestFunds | BankTransfer | Cheque), [Payments];

PaymentType = 'FrontEndLoad' | 'Rebate' | 'GeneralPayment';

PeriodDays = 'CalendarDays365' | 'CalendarDays366' | 'BusinessDays' | '30';

PostalAddress = AddressLine, {AddressLine}, PostalCode, Country;

Products = ProductSet, AppliedLookup, [Products];

ProductSet = [ProductSetID], [ISIN, [Name]], {ISIN, [Name]};

RebateFee = 'ManagementFee' | 'DistributionFee' | 'CombinationFee' | 'TotalExpenseRatio';

RebateMethod = 'BasisPoints' | 'Percentage';

RebateRateTable = [LookupFrequency], Currency, Rows;

RebateRateType = 'FlatBand' | 'SlidingScale';

Rebates = RebateSet, PaymentCurrency, PaymentFrequency, [SettlementWithin], [RetrospectiveAdjustmentPeriod], [DeMinimisEarnings], [DeMinimisPayment], [Rebates];

RebateSet = [RebateSetID], RebateTermStartDate, RebateTermEndDate, Products, (Holdings | 'DefineLater'), RebateFee, CalculationFrequency, PeriodDays, YearDays, RebateMethod, RebateRateType, RebateRateTable, [RebateSet];

RebateTermEndDate = Date | 'Open';

RebateTermStartDate = Date | 'FirstInvestment';

Region = [RegionID], Country, {Country};

ReinvestFunds = 'ProRata' | ('SingleAccount', AccountType, AccountNumber) | ReinvestFundSet;

ReinvestFundSet = AccountType, AccountNumber, [ISIN, [Name], Ratio], {ISIN, [Name], Ratio}, [ReinvestFundSet];

ReportMethod = (('Postal', PostalAddress) | ('Email', EmailAddress) | ('Fax', FaxNumber)), [ReportMethod];

Reports = ReportMethod, {Reference}, [SpecialInstructions], [Reports];

RetrospectiveAdjustmentPeriod = (Number, 'Months' | 'Years') | Other;

Rows = Floor, [Ceiling], Rate, [Rows];

SettlementWithin = (Number, 'BusinessDays' | 'CalendarDays') | Other;

YearDays = 'CalendarDays365' | 'CalendarDays366' | 'BusinessDays' | '360';

NON-FINANCIAL ASSETS: NEW CHALLENGES FOR CUSTODIAN BANKS

New asset types force Luxembourg custodians to go back to the basics of safekeeping, surveillance and investor protection in order to set new standards in fulfilling their duties

EXOTIC ASSETS AND CREATIVE PROCEDURES

The servicing of private equity funds by custodian banks requires the adoption of new and altered processes when it comes to dealing with non-financial assets. Asset acquisition, safekeeping and the related legal framework for such funds necessitate radical changes in the traditional role and procedures adopted by custodians where Luxembourg providers have demonstrated their competence for many years.

Non-financial assets include commodities and assets which are differentiated by their methodology of investment and ownership process. They include various commodities such as fine wines (by the bottle or “primeur”), art works, fine music instruments, forests or wood. Why not also include carbon emission credits? They may take a “contractual” form such as in shipping arbitrage, football players’ careers or forest exploitation arrangements. Pure real estate investments are excluded from the scope of this article. However infrastructure funds, being at the intersection of real estate and private equity, almost fall into the same category as private equity funds and overall necessitate a similar approach to custodial duties and processes. Luxembourg offers the right corporate and legal framework for all these asset types in a regulated environment, hence the growing diversity of assets custodians are faced with.

Non-financial assets are the area where custodians have to creatively put into practice the concept of surveillance of the assets of the funds. Many factors necessitate this, including:

- Assets are rarely acquired directly by the fund but are often acquired through intermediary Special Purpose Vehicles, a combination of SOPARFIs in Luxembourg and commercial companies located in the countries of the investments themselves. SOPARFIs help the SICARs or the SIFs benefit from advantageous Double Taxation Treaties and repatriation of the revenues generated by the operation or the disposal of assets. The assets are consequently acquired by the lower level in the cascade of companies without any reference to the custodian and rarely any to the master fund structure.
- The variety of assets require a greater diversity in safe-keeping approaches, all driven by the specific purchase process and the specific formalities of the ownership arrangements on an ongoing basis. A number of such examples will be described later.

NEW ASSETS AND OLD PRINCIPLES

The in-depth understanding by the custodian of the acquisition process is key and I would strongly recommend adherence to the following principles:

- The early involvement of the custodian in the manager’s deal flow: participation in the investment committees and various decisions of the board of directors of the General Partners, or at least immediate communication to the custodian of all committee minutes.
- The creation of asset-specific investment checklists whereby some indicators would trigger the initiation of payments by custodians in addition to the traditional proper instructions that would be

put on hold until specific criteria are met in the deal flow process. These indicators for example might be the establishment of an escrow account until deal completion, the final signature of finance or share purchase agreements, the delivery of commodities, direct contact with counterparties in order to validate the completion of various phases in the deal process.

- Provided that the custodian has been involved at a sufficient early stage as mentioned above, the accumulation of transaction and asset-related documents will have been initiated and an orderly follow up of the receipt of signed originals is then performed by the custodian with the objective of assessing the true ownership of the assets.
- A re-confirmation at least yearly of the ownership by circularisation or physical inventories is also necessary to complement all above steps.

A relevant illustration of the new challenges for custodians when safekeeping non-financial assets is the custody of fine wines, music instruments and forests. Banks’ vaults are not equipped to properly store wine bottles in terms of temperature, light, humidity or simply volume and weight: delegation to specialised providers is therefore necessary. In the instance of fine music instruments which may be used by soloists from time to time, i.e. where the instruments may be loaned to musicians but their ownership remains with the relevant fund, proper insurance and security measures must be organised and custodians should ensure the proper framework is in place by overseeing these measures are in place at the fund setup phase.

Art works follow the same process with temporary relocations for exhibitions, so that restoration, assessment of the works (eg for damage): transportation and related insurance are key issues.

Forest inventories introduce new challenges for custodians and their delegates. Let us dispense with the ownership confirmation which is very similar to the use of land registry confirmations when dealing with real estate funds investing in raw land: most market players are used to obtaining such confirmations at acquisition and on an ongoing basis, either directly (still with the help of the General Partner) or through the valuation reports provided by independent valuation agents. However in the context of forests the value derives from species, distribution of trees at various growth stages and as a consequence the present and expected future volume of wood to be exploited. Physical inventory, delegated to a third party or the forest management company is feasible when dealing with single-specie plantations. Huge surfaces and

diversified forests require more large-scale solutions such as satellite extraction of tree species information from forests. The minimum requirement for a custodian would be to obtain such reports and match related data in valuation processes. The difficulty for the custodian is also to establish the appropriate legal agreements with a new type of "sub-custodian" like warehouses. I think the approach should be similar to the recently confirmed standards when appointing a prime broker as developed in CSSF 08/372 Circular, namely the experience of the provider in its specific domain, the ability to report positions on a regular basis, the access available for the custodian to the assets and the formalisation of those elements in a bi- or tri-partite agreement between the "sub-custodian", the fund and the custodian.

WAYS FORWARD

There is definitely a need for fine-tuning the custodian's approach although considering the diversity of assets serviced in Luxembourg our market place has nothing to be ashamed of. However we need to share our experiences if we wish to market a truly "exotic" funds cluster. Open-minded staff and flexible custody systems are key to the equation. ■

Hervé Schunke
Head of Private Equity
& Real Estate Servicing
CACEIS Bank Luxembourg S.A.



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