

# Investment Management Update

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Summer 2009



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# Welcome to our latest edition of Investment Management Update

It has been an exceptional six months for the investment industry where the technical and operational infrastructure in managers and administrators has been well and truly stress tested. Some of the lessons learned form the basis of articles in this edition of Investment Management Update, together with an update on recent technical developments.

With the increase in use of derivatives in funds and the lessons learned from the challenging marketing conditions, our introductory article examines the knowledge gained and focuses on the regulatory, accounting and tax implications of using derivatives in investment funds.

Our article on page 6 examines the IMA and AIC's revisions to their Statements of Recommended Practice for financial statements, focusing on the key changes for investment companies and authorised funds and considering how the revisions are designed to reflect the difficult current market conditions.

The European Commission has recently published proposed amendments to the Capital Requirements Directive. The existing framework has been a bone of contention for the asset management industry. On page 8, we discuss how the

EC's amendments will have a favourable impact on the large exposure regime as it applies to UK investment managers.

Funds that are looking to take advantage of the current price levels in commercial property, often view stamp duty land tax (SDLT) as a real obstacle. On page 9, we comment that SDLT is far from an inevitable outcome of a property acquisition. Thorough planning and preparation can help in managing this charge and we list the SDLT planning opportunities still available.

In light of the transformed financial landscape, we thought it apt to revisit the conclusions reached in our 2008 study on performance fee arrangements for UK listed funds. On page 10 we examine how market falls impact on performance fee arrangements and what actions boards can take.

The European Parliament's adoption of the UCITS IV proposals paves the way for the next round of changes to the retail funds regime: the proposed amendments seeking to address criticism that UCITS was failing to create a fully functioning and cost effective cross-border model.

Finally, we herald the resolution of the investment versus trading issue through the introduction of legislation in this year's Finance Bill in our article on page 14. We hope that you find these articles of interest and please do continue to provide us with your feedback and any suggestions for future topics of interest.

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# The use of derivatives in investment funds

In this article we look at the regulatory, accounting and tax implications of using derivatives in investment funds.

With the increased usage of derivatives in funds over the last 18 months and lessons learned from challenging market conditions we thought that this would be a good point to see what knowledge we have gained.

The use of derivatives has been on the increase through 2007 and 2008. In our experience, this has been driven by the end of the bull market and the desire to hedge, the UCITS III directive and the listing funds review increasing the range of instruments that can be used in investment funds and some clarification of the tax rules in the UK.

Whether the fund is overseen by an ACD or an independent board, it is critical that the oversight body sets the agenda for governance of the fund. Over the last 18 months we have seen boards and ACDs becoming more active in challenging the derivatives framework and requesting more analysis of both the financial risks and operating model.

Boards and ACDs have overall responsibility for ensuring the strategy is fit for purpose, approving policies and procedures, confirming that the investment manager/adviser has appropriate expertise and an appropriate supervisory structure, and to approve the form and content of the management reporting and incentive arrangements.

This is quite a laundry list, however, all of these areas are to be formalised and articulated by the investment manager.

FSA principle 3 states that a firm must take reasonable care to organise and control its affairs responsibly and effectively with adequate risk management systems. This includes an obligation to ensure that the derivative strategy is appropriate for any given fund (whether retail or institutional) and for establishing a derivatives risk management process.

There is guidance here derived from the FSA rules around authorised funds and from the UCITS directive which have been further developed within the joint guidance issued by the IMA, Depositary and Trustee Association and Futures and Options Association. This guidance would serve as a useful checklist of steps for a derivatives strategy in any fund.

Clearly, having the right people in the management, execution and monitoring roles is critical, and again the management firm is responsible for the selection and monitoring of those individuals – that they have the right level of experience and there is sufficient depth to those teams. Resourcing to this level at a time when many investment managers are looking to make cost savings is a challenge.

In terms of refining the controls over derivatives usage, the main areas of focus over the last 18 months have been counterparty risk, pricing and correlation of hedges. None of this is surprising, but as models have been ‘stress tested’ in challenging market conditions a number of quite

fundamental questions have been asked in these areas that had not been considered deeply before.

As a result, investment management companies, ACDs, trustees and boards should now be in a much better position to put in place and oversee a comprehensive framework around derivatives usage in funds, and also to review and challenge those already in place.

Accounting is another area where we have seen increased due diligence. Identifying whether the return from a derivative or structure is capital or revenue drives the ultimate fund return to the investor and also the tax treatment of that return.

The Association of Investment Companies (AIC) and the Investment Management Association (IMA) both published revised SORPs in 2008, and both make it clear that the underlying nature of the returns from a derivative or structured product need to be considered in determining the appropriate treatment of the returns in an investment fund portfolio.

Aside from accounting for the returns, the area of disclosure has also been receiving some focus. Using derivatives in funds can fundamentally alter the risk return profile, such that a simple analysis of the portfolio does not really show the full gross economic exposures or give an indication of the potential volatility.

In our experience an early review of derivatives usage and how that is

proposed to be explained in a fund's public reporting is highly advisable. The IMA guidance advocates the publication of value at risk information for the more sophisticated strategies, but this might need to be combined with more narrative explanation in order to make it understandable to end users.

On tax, as noted above, there has been clarification of the treatment of derivatives and in particular whether the use of derivatives could be considered to be trading. The proposed 'white list' applying to authorised funds and 'equivalent offshore funds' will provide certainty for these funds going forward. However, notably, investment companies are not covered by the 'white list', nor are authorised funds which do not satisfy the 'genuine diversity of ownership' condition, and an element of uncertainty does still exist for those funds.

In conclusion, the market conditions have stress tested the usage of derivatives in funds at a time when their usage was increasing substantially. It remains to be seen the extent to which counterparty risk concerns and a desire to keep products 'straightforward' reduce the usage of derivatives going forward. For those who continue to use these instruments – and we see that they have a very useful role to play in certain instances – a periodic review of governance, accounting and tax would hold guard against the consequences of

changing market conditions and progressing standards.

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# Revised Statements of Recommended Practice for authorised funds and investment companies

2009 heralds another year of accounting changes as both the IMA and AIC have published revisions to their Statements of Recommended Practice (SORPs) for financial statements. Both SORPs are effective for accounting periods beginning on or after 1 January 2009.

Although the underlying UK accounting framework has changed relatively little since the 2005 SORPs were published, the revisions aim to keep the SORPs in line with current developments. Boards, managers and administrators will need to work together in order to plan for timely implementation.

## Key features of the revised AIC SORP for investment companies

The main change for investment companies is in the extension of the application of the SORP, so as to formally bring VCTs within its scope. Historically, some VCTs have elected to follow the SORP but others have discontinued this practice after relinquishing s833 status. Where VCTs are required to re-adopt the SORP or to follow it for the first time, boards will need to consider any relevant policy matters arising. For example, the proposed policy which the company will follow in relation to the allocation of management fees between revenue and capital will need to be clarified. Ideally this should be done before the start of the relevant accounting period as any treatment will also apply for half-yearly accounts.

Other features include new guidance on:

- **Accounting for returns from derivatives** – this is broadly in line with the principles adopted by authorised funds and will help investment companies to determine when gains or

losses on a derivative should be reflected as capital or revenue in the accounts, based on the motives and circumstances of the transaction

- **The presentation of capital reserves** – this will assist investment companies in maintaining a consistent accounting presentation following the finalisation of the ICAEW guidance on distributable profits
- **Treasury shares** – this reflects current best practice in relation to accounts presentation and making NAV per share disclosures

Following extensive consultation on whether C shares should be accounted for as equity or debt, the revised SORP concluded that the accounting treatment will need to be determined on a case by case basis, having regard to the specific terms of the issue. Boards of companies with C shares will need to consider the accounting treatment with their administrators and advisers, but in future it's possible that the potential problems of liability treatment could be mitigated if the terms are capable of being constructed such that the board has discretion as to whether or not C shares are converted to ordinary shares. In other words, the company is under no obligation to convert the C shares to ordinary shares.

## Key features of the IMA SORP for authorised funds

The revised SORP for authorised funds

formalises the role which the SORP will have going forward in setting out principles for determining whether transactions are capital or revenue in nature. In practical terms this brings it into closer alignment with the aims and objectives of the investment companies' SORP, but unlike investment companies, authorised funds have never presented their accounts in a columnar format and it is perhaps worth emphasising that there are no proposals to change this.

Key features include:

- **Enhanced guidance on effective interest rate accounting (EIR)** – this is broadly consistent with previous IMA guidance on the topic, but the scope of the application of EIR is slightly wider. It is important for funds to check that they are complying in full as there is a significant amount of material which is now incorporated within the body of the SORP which previously had less formal status. Importantly, there is also greater clarification on dealing with impairment and distressed debt situations
- **Developments in relation to accounting for returns from derivatives** – there is no change to the underlying principle introduced in the 2005 SORP of having to consider both motives and circumstances of a derivative transaction in order to determine whether returns are capital or revenue. There is, however, additional clarification on the definition of a

derivative for this purpose and around the treatment of total return instruments where gains or losses may need to be apportioned

- **Specific points of clarification for funds of funds** – reflecting the recent growth in the number of funds investing in other collectives, these recommendations deal with such matters as accounting for fee rebates, trail or renewal commissions and equalisation received
- **Revised disclosures relating to credit quality** – these will be applicable not only to bond funds but to any fund with a significant proportion of its portfolio invested in debt securities
- **Condensed half-yearly reports** – the requirement for the inclusion of detailed notes to the half-yearly accounts has been removed

Consideration should be given to the revised format and content of both annual and half yearly accounts' formats and to the need for comparative information for any new disclosures. There has been particular interest in early adoption of the new authorised funds' SORP as it offers the advantage of improved presentation in certain areas; it also enables the industry to take advantage of the ability to prepare condensed half yearly reports at the earliest opportunity.

### **The SORPs and current market conditions**

There are a number of revisions to the authorised funds' SORP which reflect the current difficult market conditions. The enhanced credit analysis for bonds is one example. Also, in current markets, when particular care needs to be taken to ensure that bond interest is not

recognised at inappropriate rates in distressed debt situations and that impairment does not distort revenue, the enhanced guidance on EIR gives some flexibility. The revisions should also help funds minimise any capital/revenue distortion should AG8 adjustments arise on bonds held.

So far as portfolio valuation is concerned, there has been much published by the accounting standard setting bodies in recent months regarding the issues of valuing securities according to whether markets are active or inactive. Neither SORPs seek to replicate that guidance in any way. In regards to the financial statements of investment companies, the guidance published by the ASB and the IASB is directly applicable. It also has ongoing relevance for authorised funds, however, as the revised SORP specifically clarifies that fair value for financial statements purposes is defined by reference to the relevant guidance in FRS 26. In the current financial reporting environment, funds will therefore need to be cognisant of the published guidance which, inter alia, deals with matters such as the role of observable transaction prices in determining fair value and the circumstances under which broker quotes and other valuation techniques may be appropriate.

In difficult market conditions, good disclosure will be a key factor in ensuring that the accounts contain meaningful information for investors. The authorised funds' SORP has taken the opportunity to re-emphasise the importance of narrative financial instruments risk disclosure. In volatile markets this is a particular challenge for

funds using complex instruments or derivatives – managers and administrators are likely to need to work closely together in the production of the relevant information. The same issues are applicable to the investment company sector, where although derivatives have generally been used rather less, special care will need to be taken when explaining any credit risk or liquidity risk exposure and in providing sensitivity analysis having specific regard to the instruments held.

### **Conclusion**

In the absence of any recent fundamental changes in the overarching accounting frameworks within which investment companies and authorised funds are required to operate, these new SORPs play an important role in helping to keep UK fund financial reporting up to speed with current developments. In a reporting climate more difficult than it has been for many years, close liaison between boards, managers and administrators can help ensure that a smooth transition is achieved and that accounting and disclosures meet investors' expectations.

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# A welcome review of the large exposure regime



The existing framework is over 16 years old and has been a bone of contention for some time for the asset management industry as it has always been very much founded upon a banking perspective of risk. CRD is broadly based on an assumption that firms spread their exposures to clients and therefore the stated aim of the large exposure regime is to act as an overlay “to prevent a firm from incurring disproportionately large losses as a result of the failure of an individual client or group of connected clients due to the occurrence of unforeseen events”.

What the existing rules have, however, failed to recognise fully is that there are some major differences between credit institutions and investment managers. Investment managers are not dealing on their own account or otherwise carrying client deposits or liabilities to customers on their balance sheets. Arguably, the principle protection for their clients stems from two core features of the wider regulatory regime – provisions relating to proper conduct of business and the segregation of any client assets and monies from those belonging to the firm.

The European Commission has published proposed amendments to the Capital Requirements Directive (CRD) which, when implemented, will have a favourable impact on the large exposure regime as it currently applies to investment managers in the UK.

In recognition of these factors, the proposed EC amendments acknowledge that the existing rules place “unwarranted compliance cost burdens” on the asset management industry. The proposal is therefore to exempt limited licence and limited activity investment firms from the large exposure regime going forward. This is a welcome development. Many investment managers have been enduring the recurring (and in some cases unavoidable) complications of large exposure breaches arising from management fee debtors over which there is negligible risk of non-collection. In some cases this has resulted in firms having to amend billing terms with clients or to hold additional capital. In addition, when markets have fared well, many performance fee arrangements have given rise to rule breaches which are both systemic and unavoidable. The regime has also been an irritation for smaller asset management start-ups when applying for FSA authorisation.

The proposed amendments to the directive were adopted by the European Parliament on 6 May and now only require approval by the Council of Ministers. When approved, investment managers should look out for forthcoming consultations from the

FSA as to how this will be implemented in the UK. The date from which the amendments would require to become effective would be 31 December 2010, but industry bodies are likely to lobby the FSA for earlier implementation.

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# Stamp Duty Land Tax – managing the inevitable?

In the current climate of economic stringency there is an increasing focus on minimising the costs associated with the acquisition of property. Professional advisers, among others, are all too aware of this trend.

In particular, funds which are looking to take advantage of the current price levels in commercial property and wish to offer the best returns to investors can often view the stamp duty land tax (SDLT) charge at 4% on consideration over £500,000 as a real obstacle to doing a deal at the right overall price. How the SDLT is dealt with can be one of the key factors in whether an acquisition is ultimately worthwhile.

Can SDLT be managed or is the property fund or other acquirer seeking to buy property faced with the inevitability of this impost? The short answer is that there are a number of ways of structuring property acquisitions which may materially reduce, or eliminate altogether, SDLT. The recent Budget was, unlike in many other respects, as benign as it could be as far as SDLT planning is concerned, short of the abolition of this tax. In addition, while SDLT is subject to wide-ranging anti-avoidance provisions these are far from comprehensive in their reach.

While the most obviously straightforward method is, if possible, the acquisition of shares in a property owning company, the stamp tax advantages (0.5% stamp duty/stamp duty reserve tax on shares in UK corporates and possibly no duty on non-UK corporates) can be outweighed by the direct tax disadvantages of holding property through a corporate vehicle.

Among the SDLT planning opportunities still available are:

- using the SDLT partnership provisions. By themselves these can be used to reduce or eliminate SDLT where it is possible to create a (very broadly defined) “connection” between seller and buyer; and the relevant legislation can allow connections to be created between previously unrelated parties
- moving on, despite the anti-avoidance legislation referred to above, it may still be possible to combine the SDLT partnership provisions and the treatment of subsales and similar transactions to achieve a nil, or reduced, charge to SDLT.

Such planning may be particularly appropriate if the fund in question is structured as a partnership.

Further possibilities, again in suitable circumstances, can be offered by the

alternative property finance SDLT legislation. The scope of the exemption from SDLT offered by this legislation is rather wider than the bare title of the statutory provisions might suggest.

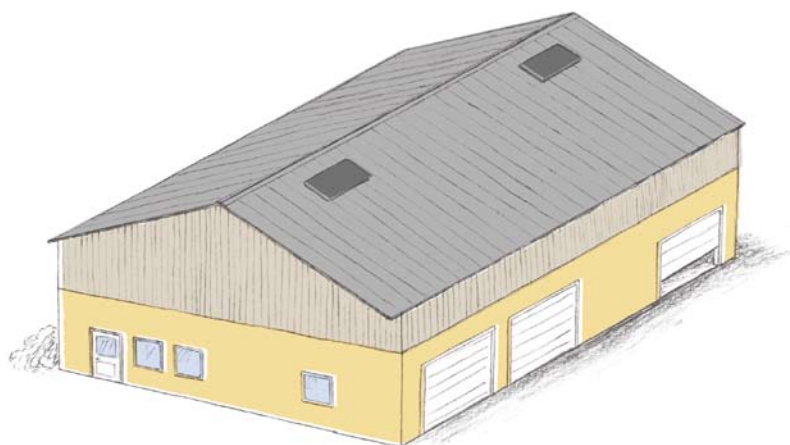
In addition, remodelling the transaction can frequently offer SDLT savings. In these difficult times sellers are much more likely to agree to a different structure, and without financial inducement, if it results in a sale without a (further) price reduction.

SDLT is not the inevitable outcome of a property acquisition, and proper planning and preparation can help in managing this charge.

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# Performance fees – where next?

In the summer of 2008, Grant Thornton published the results of a major study of performance fee arrangements in place for UK listed funds. Since this time, the financial markets have declined sharply and many performance fee arrangements will be heavily under water. This article revisits the conclusions from the study in the light of current market conditions and also considers appropriate actions that boards can take in response to the changed circumstances.

## What did the study conclude?

Our study concluded that performance fees were now commonplace with over 45% of UK listed investment funds having performance fees. Although there was no indication that performance fees resulted in better performance compared to funds without performance fees, it was noted that generally they had resulted in increased fees for the investment management firms. We noted the alignment of interests between investment managers and shareholders as a result of higher fees from good performance and lower fees from poor performance. However, it was observed that over the cycle the reduction in fees in poor periods would generally be smaller than the increase in good periods.

The investment firms that we interviewed indicated that performance fees enabled them to provide remuneration packages to attract and retain good managers. However it was noted that the firm's bonus scheme will not necessarily align a particular manager's reward with the performance fees earned from the funds that they manage.

## How do market falls impact on performance fee arrangements?

Clearly, the most significant effect of the market falls is that many

performance fee arrangements based on absolute performance will not be paying performance fees in the current period and may not for the foreseeable future. In our 2008 study, 28% of performance fees were based on absolute performance.

Where performance fees are based on relative performance, there is the prospect of paying additional fees to the investment management company for not losing quite as much shareholder money as the benchmark performance. Although it feels uncomfortable paying extra when the fund has made losses, it does recognise that the investment management decisions resulted in a better outcome than would have been the case with benchmark performance. It may be judged that relative performance based fees have done what was intended.

Whether performance fees are relative or absolute, one of the significant conclusions from our study – that investment management firms will earn more fees – may not now be the case. In fact, many managers will be earning considerably less as a result of lower management fees on lower portfolio values without a performance fee to compensate.

While the issue lies primarily with absolute performance fees, all boards

should periodically consider the appropriateness and competitiveness of fee arrangements from time to time. But what should fund boards do when there is little prospect of performance targets being met in the foreseeable future?

It may be argued that they should do nothing. The investment manager is paying the price for failing to avoid portfolio losses. They have a commercial agreement and the investment manager has an obligation to deliver on it, regardless of the prospects of earning performance fees in the future. There may, however, be situations where the arrangement might be reconsidered. For instance, if the objective was, in part, to secure the services of the right manager, the situation might need to be looked at again.

In order for there to be a change in terms or a non-contractual resetting of a performance hurdle, the investment manager would need to offer something in return. A further reduction in management fees could be a little like a gambler increasing the stakes to try to recover the previous losses. However, there may be service benefits that the manager might offer in return for an enhanced prospect of reward.

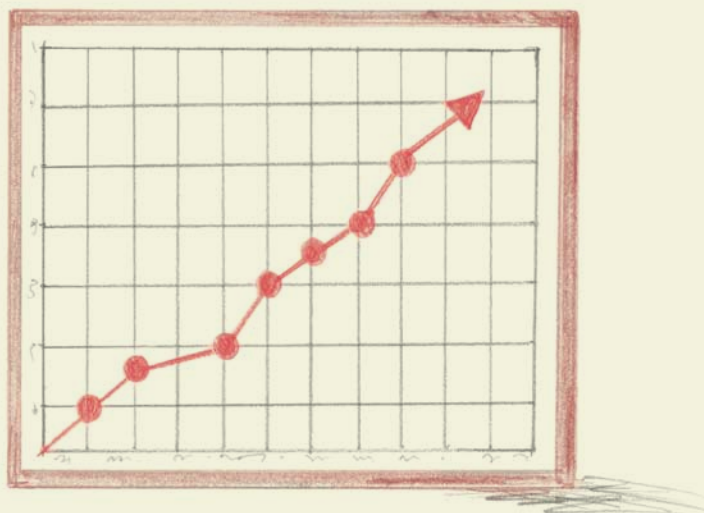
In most situations, an amendment to the fee arrangements solely due to the

lack of performance incentive would seem inappropriate and, if it were concluded that the appointment of the investment manager on the present terms was not appropriate, this might suggest that the entire relationship with the investment manager should be reviewed.

### What other factors result from market falls?

There are several other matters that may need consideration as a result of market falls:

- **Gearing and covenants** – funds with gearing or the ability to gear should consider any action required as a result of changes to risk and possible new opportunities resulting from market falls
- **Asset allocations** – for funds with the ability to move the portfolio across asset classes, there may be an opportunity to rebalance or adjust the strategic asset allocation of the portfolio
- **Portfolio size** – some smaller funds may have fallen to levels that are not viable and so there will be a need to propose some form of transaction to shareholders that might result in the fund being wound up
- **Discount control measures** – market volatility may be compromising discount control arrangements which may have lost effectiveness as a result
- **Service provider stability** – service providers (including the investment managers) whose fees are based on the size of the portfolio may have suffered significant falls in revenues (not just in relation to the listed fund). Some of



the corrective actions taken may have resulted in an increase in operational risk for the listed fund

- **Serious loss of capital provisions** – UK domiciled funds need to be alert to the provisions in the Companies Act requiring a shareholder meeting to be called in the event that the company's assets are less than half of its share capital
- **Dividend legality** – A UK domiciled fund can only exclude capital losses in determining profits available for distribution if its assets are greater than 1.5 times its liabilities. Otherwise, there will be additional tests to determine the legality of distributions

### Actions and considerations for boards

In the scheme of things, the performance fee arrangements may be the least important consideration for boards of listed funds in this challenging environment. Boards will as a matter of course have maintained their review of fund performance and, as necessary, considered strategic choices.

Boards should pay particular attention to risk, not only in relation to

the portfolio but in relation to the proper operation of the fund, ensuring that control and management processes continue to be conducted in an appropriate manner.

Some boards may conclude that their management and performance fee arrangements have not achieved what was intended. If the fund in itself has operated as intended, then there may be grounds for considering the appropriate fee arrangements going forward. If the fund has not done what was intended, then a wider review of strategic options may be appropriate.

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# UCITS IV – beginning to come together

The recent adoption by the European Parliament of the so-called UCITS IV proposals paves the way for the next round of changes to the retail funds regime across Europe. 1 July 2011 is the scheduled date by which the amendments would need to be implemented by EU member states. Over the summer, CESR will be considering what they believe the more detailed level 2 provisions should contain, and in due course the FSA will need to consider what measures are necessary to implement UCITS IV in the UK.

UCITS IV seeks to address some of the main shortcomings which emerged from the vigorous debate sparked by the European Commission's July 2005 Green Paper on 'Enhancing the framework for investment funds'. Post UCITS III, there has been general agreement that passporting has not been working at either the management company or the fund level. Critics have said that proliferation of small funds in home states points to the failure of the UCITS regime to create a fully functioning and cost effective cross-border fund market.

The amendments now proposed are an effort to address these issues from a number of different angles. Summarised below are the main highlights of the directive:

- **Improved notification procedures for cross-border registration of funds** – this involves simplifying the administration process, specifying standard information which needs to be provided, reducing the timescales involved in turnaround, and restricting the ability of host state regulators to demand additional documentation or to challenge the UCITS status of the fund concerned
- **Replacement of the simplified prospectus** – as the simplified prospectus has turned out to be far from simple, it is to be replaced by a 'Key Investor Information' (KII) document. This will cover only investment objectives/policy, past performance, costs and risk/reward profile – all in non-technical language. Indications are that it will be no longer than two pages, but in a common, prescriptive format. The KII will be valid in all member states and, other than for translation, it will not be altered for cross-border marketing
- **New master-feeder structures** – new rules will enable managers to offer feeder funds and master funds either in one country or across different member states. Individual feeder funds set up in different countries could for example all invest into one master fund, offering a cost effective alternative to running a separate UCITS in each country. Feeder funds will need to hold a minimum of 85% of their assets in the form of an investment in the master fund, leaving up to 15% available for investment in what the directive refers to as ancillary liquid assets. In order to ensure

consistent levels of investor protection, master funds must be UCITS schemes and, in order to avoid complex structures, must not themselves be feeders or invest in a feeder. In addition, no feeder will be able to invest in more than one master. The directive emphasises that the timing of net asset value calculations will need to be coordinated in order to avoid potential market timing or arbitrage issues, and CESR is currently considering what measures might be appropriate in this area

- **A cross-border merger framework** – in order to facilitate the merger of funds established in different member states, a new regime is proposed containing provisions for regulatory and shareholder approval and setting out the information to be provided to investors. Shareholders will have the right to request redemption of units before the merger should they wish and, as a general matter of principle, should not bear the merger costs. The depositary or the auditor will be required to validate share exchange ratios and the criteria for valuing assets at the effective date

- **A less restrictive management company passport** – a management house will no longer be required to have an ACD in the member state in which the fund is domiciled. This will enable an ACD established in one state to manage funds established in another. In principle, an ACD's home member state would supervise its organisation and lay down prudential and internal control requirements, while host state regulations would govern the constitution and functioning of the fund

In European terms, the implementation timetable is ambitious and there is at this stage no detailed guidance on how the regime will operate in practice. To have the proposals working by 2011 would mean having to have much of this detail in place by mid 2010. In particular, a substantial amount of effort will be required to translate the directive level provisions relating to the management company passport into reality. This is an area where there are still divisions between the member states, and the differences of opinion are unlikely to speed up the process as more of the detail is worked through.

UCITS IV looks set to improve on the 10-year timescale it took to implement UCITS III, but European fund industry reform remains a lengthy process. If it can be made to work, however, it may be worth the wait. As an overall package, the changes proposed have the potential to offer considerable flexibility in terms of how cross-border operations could be structured.

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# Investment versus trading: Progress for authorised investment funds and equivalent offshore funds

A crucial issue, which has been challenging the industry for some years now, has reached a conclusion following the recent Budget. This follows the issue of a discussion paper by HM Treasury on 16 December 2008 entitled: ‘Trading and investment for authorised investment funds.’ The importance and relevance of the investment versus trading issue has been accentuated recently, partly due to the advent of UCITS III, which extended the ability of funds to use derivatives other than for pure hedging strategies.

For some years now, authorised funds have faced the risk of being found to be trading, with the impact that gains from trading transactions would be taxed as income at a rate of 20%, rather than being exempt from capital gains. Furthermore, there was the possibility that such transactions could result in all the AIF’s transactions being considered to be trading, which would have been calamitous for the fund and its investors (the so-called ‘precipice problem’).

Although previous guidance, most notably the guidance issued at the time of the 2007 Pre-Budget Report, was helpful it did not remove the risk entirely. Hence, the introduction of legislation in this year’s Finance Bill will be a very important step forward.

The legislation will introduce a ‘white list’ of financial investment transactions which will be completely safe as transactions which would never be taxed as trading.

In addition, HMT has confirmed that such transactions would not be tainted by any other transactions undertaken by the AIF, and that any transactions not appearing on the ‘white list’ would not automatically be considered to be trading in nature – the status of those transactions would continue to be determined by the application of general principles to each relevant transaction in isolation.

In a situation where an AIF undertakes a ‘non-white list’ transaction, and that transaction is subsequently found to be trading, only that particular transaction would be taxed as a trading item, and it would not result in the entire AIF activity being treated as trading – hence addressing the key ‘precipice problem’ issue.

It is important to note, however, that this certainty would only apply to those AIFs which satisfy a ‘genuine diversity of ownership’ condition in a

similar way to that introduced for qualified investor schemes. This certainty is not therefore likely to apply to, for example, private unit trusts.

The proposed ‘white list’ of transactions for AIFs include the following transaction categories:

- shares and stock
- loan relationships (including money deposits, loans and debt instruments)
- derivative contracts (including futures, options, contracts for differences, swaps and warrants)
- units in collective investment schemes
- securities of any description not included in the above categories
- buying or selling foreign currency and
- carbon emission credits.

By way of background, this 'white list' follows a similar model to that recently introduced for the purposes of the Investment Manager Exemption (IME).

The development is warmly welcomed by the industry, as is the extension of this 'white list' to 'equivalent offshore funds' for the purposes of the new reporting funds regime. This will provide greater certainty to such funds when calculating reportable income – although the key question at the time of writing is what is an 'equivalent offshore fund'. Will this extend to UCITS funds only or could it apply to hedge funds which are applying for reporting fund status? The latter in particular would be a significant step forward in allowing UK investors to be taxed in a consistent way on holdings in all offshore funds. However, of note is the fact that investment trusts are not covered by the 'white list'. Investment trusts have

suffered over the last two or three years, and as a result, offshore jurisdictions such as the Channel Islands have benefited as a location for closed ended funds, unconstrained by the uncertainty of the trading versus investment debate. The Association of Investment Companies (AIC) continues to engage in discussions with the government on this issue, and is committed to pursuing this agenda to make the investment opportunities already available to AIFs to Investment Trust Companies (ITCs) as well.

The new rules will come into force from 1 September for AIFs and from 1 December 2009 for equivalent offshore funds.

If you require further information on this area, please contact Anne Stopford.



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