

Investment Management Update

Spring Edition 2010

Clearing the landmines of the Alternative Investment Fund Managers Directive

An update on fund management would not be complete without some comment on the progress of the proposals for a Directive on Alternative Investment Fund Managers (even though it will be out of date before it reaches you!).

First published in April last year the original text was politically motivated, poorly drafted and imposed significant constraints and requirements unrelated to the issues it sought to address.

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From its first publication there has been an army of politicians, bureaucrats, trade bodies, regulators, industry professionals and customers seeking to clear the minefield of proposed regulations.

The EU presidency has passed from the Czechs to the Swedes and now to the Spanish. There have been substantial revisions to the original text and some 1,700 proposed amendments have been submitted by MEPs prior to discussion at meetings of the Economic and Monetary Affairs Committee over the next couple of months.

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The main proposals in the draft directive as published by the Spanish presidency are now that:

- managers of Alternative Investment Funds (any funds which are not UCITS), excepting some smaller managers, are subject to the directive
- those manager require authorisation to manage Alternative Investment Funds
- remuneration policies are consistent with effective risk management
- conflicts of interest are identified, prevented and where necessary disclosed
- a functionally separate risk management process is maintained
- liquidity risks in the funds are managed and stress tested
- there be restrictions on certain securitisation positions
- a valuation function which is, where appropriate, independent of the portfolio management function, is operated
- if the valuation function is not external, an external review of the valuation function may be required
- for funds established in a Member State, a depositary is appointed whose functions will include:
 - overseeing the subscription and redemption of units or shares in the funds
 - safe custody of the funds' financial instruments
 - overseeing the valuation of shares or units.
- the annual report of the funds are available within four months of the year end
- the Alternative Investment fund Manager provide reports to its home state regulator on its activities
- the home state regulator can impose leverage limit
- on attaining control of a non-listed entity, this fact is notified and information on the debt position is reported
- information on the non-listed entities controlled is included in funds' annual reports
- authorised Alternative Investment Managers can market the funds in any Member State
- funds established in non-Member States can only be managed if it can be shown that the funds will comply with the standards set out in the directive
- funds established and managed in non-Member States can only be marketed if appropriate co-operation arrangements are in place.

Many of these proposals have their root in the approach to the regulation of UCITS funds and they will have a fundamental impact on all other funds offering the collective management of customer assets, particularly those prevalent to the private equity, real estate fund, hedge fund and investment company markets.

These markets have developed and evolved fund and regulatory structures designed to fit customer and market needs and so the proposed Directive will cause major disruption to the shape and operation of funds in these sectors. Indeed the impact assessment commissioned by the Economic and Monetary Affairs Committee suggested that the directive could reduce growth by 0.1-0.2% per annum over the next 10 years.

The drafts published by the Spanish presidency does not significantly vary the core proposals from the final draft published by the Swedish presidency.

Accordingly there remain many concerns as to the impact and operation of the directive. The lobbying effort continues and the focus of the investment industry, with much political support, is on engaging with the policy makers to adapt some of the principal proposals so they take account of commercial realities and are proportionate to the regulatory benefits they are seeking to achieve.

The timetable assumes that a final Directive is voted on in July this year and the FSA has indicated that its consultation process on UK implementation of the directive may extend into 2012 with implementation possibly late 2012 or mid 2013.

It is impossible to judge what the end result will be as there may be substantial change during the committee stage but some form of legislative and regulatory change is inevitable.



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FIN 48 for Investment Funds – Accounting For Uncertain Tax Positions



In June 2006, the Financial Accounting Standards Board (“FASB”) in the US released interpretation No. 48 (“FIN 48”) with the aim of clarifying the approach to uncertain tax positions under US Generally Accepted Accounting Principles (“GAAP”).

In previous years the FASB has deferred the effective date of FIN 48 for all non-public entities. This is no longer the case. This interpretation needs to be addressed in all US GAAP financial statements for US and non-US funds and management companies.

Evaluating tax positions

Entities will need to consider the adequacy of their management processes for identifying and monitoring potential uncertain tax positions. This evaluation, in accordance with FIN 48, is a two-step process:

1. Recognition

The enterprise determines whether it is more likely than not that a tax position will be sustained upon examination;

2. Measurement

A tax position that meets the more likely than not recognition threshold is measured to determine the amount of benefit/liability to recognise in the financial statements.

Impact for funds and managers to consider

Accounting Standards Update 2009-6 (“ASU 2009-6”) clarifies the application of FIN 48 to funds and managers. There are a number of issues that should be addressed as they can create tax uncertainty, including:

- Challenges to taxpayer status and the classification of the entity;
- Failure to file income tax returns or to pay taxes;
- Underreported taxable income;
- Taxes related to international operations should be evaluated and documented. With regards to operations, several countries (Australia, Brazil, Germany and Spain amongst others) may impose tax on capital gains and other income based taxes on trading and other activities;
- FIN 48 requires affected entities to review all of their prior tax positions that are uncertain as of the first day of the year in which the entity adopts FIN 48, and apply the interpretation to each of them.

Where appropriate, documentation will be required for the above. Consequently, FIN 48 could lead to fundamental changes in basic tax reporting systems and processes as well as potentially influencing entities’ policies and procedures concerning taking uncertain positions on their tax returns.



Conclusion

ASU 2009-6 goes some way to clarifying the impact of FIN 48 on the investment management industry. Affected entities may need to consider whether they have the necessary resources and management in place for the implementation of processes to ensure compliance with FIN 48 in a timely manner.

Furthermore, comprehensive tax related internal controls may be required to take FIN 48 into account. This increasing pressure on funds and managers to ensure that their tax risk is being managed has been reinforced by the International Accounting Standards Board through their exposure draft to International Accounting Standard 12 which introduces similar reporting requirement to FIN 48.



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Internal Audit opportunities and challenges



In March last year, the FSA published **The Turner Review: A regulatory response to the global banking crisis**. More recently, Sir David Walker issued his final review of corporate governance in UK banks and other financial industry entities.

Both reports make a number of observations about the cause of the financial crisis. In addition to inadequate regulation, failures in governance and risk management practices within the financial services sector are highlighted as key factors.

This presents internal audit functions with a clear opportunity to influence the corporate governance initiatives and risk management programmes within their organisations by understanding the underlying causes of the crisis and the recommendations made in the Turner and Walker reports, as well as other influential sources.

At the same time, audit will be challenged to demonstrate that they have an understanding of the complex issues faced by financial services

organisations as well as the ability to provide effective challenge to management.

In the prevailing climate, there is an inevitable focus on all aspects of risk management. To be able to give effective assurance as to whether risk management practices are up to scratch, audit will need to demonstrate increasing levels of technical expertise to be able to assess the effectiveness of controls and challenge the assumptions made by business units. This will entail

greater understanding of product and technological complexities and quantitative techniques.

Regulatory change is already in progress and major changes are inevitable. Audit must have a strong understanding of the changes taking place and how they will effect their organisations.

Audit will also be expected to make assessments in areas that may traditionally have been outside of their normal areas of focus. For instance,



public and regulatory focus has questioned the incentive and remuneration models in place within the financial services sector. Whilst audit may previously have considered the mechanics of providing for and paying compensation, they will now need to consider the model for assessing individual performance and ensure it is consistent with strategic and longer-term corporate objectives.

As well as assessing internal risks to organisations, there will be a greater expectation for Audit to identify, assess, and report on strategic and reputational risks.

Auditors will need well-rounded commercial experience to provide effective comment on the economic realities of the businesses they review and to consider possible future consequences of emerging risk conditions.

The effectiveness of organisation's governance arrangements is another heightened area of focus. Audit will be at the heart of reviewing existing governance structures and providing meaningful recommendations for change. Audit must show their ability to work with Management but demonstrate the independence and expertise to challenge existing methods at all levels of the organisation.

Finally, audit must be prepared to accept greater scrutiny of their own working practices and be able to justify their approach to audit planning, execution and reporting as well as demonstrating their independence, objectivity and the quality of challenge they provide to the business.

To meet all these challenges, internal audit functions will have to revisit or at least consider the current quality, experience and expertise of their personnel to ensure that they have the appropriate business, management and technical skills to meet the heightened expectations from both the business and regulators.



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The future of UK GAAP – bringing us to tiers?

The ASB has published its long awaited consultation paper dealing with the future of UK GAAP. In this article we examine the potential implications of these proposals for authorised funds.

The future of UK GAAP

It has been some four years since the initial batch of IFRS convergence standards were introduced in the UK, and the ASB has been largely true to its word when it stated that there would be a stable platform and no further major changes in standards before 2009.

The main reason why UK GAAP has been put on ice for so long can be attributed to the complexity of IFRS.

The realisation that IFRS in its full form was going to prove unsuitable for smaller entities has caused the IASB to spend much of the past few years

developing a second tier of simpler standards – IFRS for Small and Medium-sized Entities ('IFRS for SMEs'). Now that this has been finalised, the ASB is proposing that it should effectively take the place of UK GAAP.

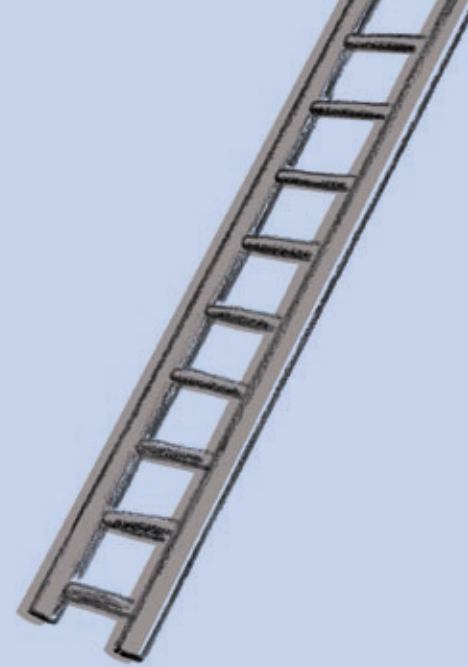
One of the key questions raised in the consultation paper is where the boundaries between the three tiers should lie. The IASB is proposing to adopt a definition of publicly accountable entities which is very close to that used by IASB and the intention is that this should apply regardless of size. The definition includes all listed entities (which would automatically bring in all investment trust companies and venture capital trusts for example) but it also makes specific reference to mutual funds as having public accountability. As it stands, all such entities would therefore be expected to fall into tier 1.

The ASB proposals – a three tier framework

Tier 1 Full IFRS for all publicly accountable entities

Tier 2 IFRS for SMEs applicable to non-publicly accountable entities

Tier 3 The ASB's existing Financial Reporting Standards for Smaller Entities ('FRSSE') for the smallest entities



The future of SORPs in the UK

The consultation paper also sets out the ASB's proposals in relation to SORPs. The IFRS framework makes no provision for SORPs and although the ASB recognise that sectors moving to IFRS may wish to retain sector specific guidance, it seems that the ASB does not intend to endorse this in the way that it has in the past with SORPs.

From a funds industry perspective, both the AIC and IMA SORPs have played a major role in financial reporting for a number of years and given that these are now as much to do with clarifying capital/revenue issues as they are about pure accounting it would seem essential for them to continue in some shape or form. The ASB's proposals have not been well received as industry guidance would, in principle, carry less formal status than the SORP and there are concerns over how HMRC and the FSA would view this given that both tax legislation and UK regulation rely heavily upon it.

How converged are authorised funds?

IFRS is now beginning to enter an upgrading and amendment phase, but in terms of the scope of existing IFRS convergence standards in the UK, the key standard is FRS 26 'Financial Instruments: Recognition and Measurement'. As authorised funds are neither listed nor subject to the Companies Act, FRS 26 has not yet formally applied and as a result this has, to date, left them outside of some of the converged framework.

The two main aspects of FRS 26/IAS 39 which have

already been implemented by funds relate to bid price valuation of investments and effective interest rate accounting for debt instruments.

The main effect of FRS 25/IAS 32 has involved the classification of units/shares issued as liabilities. Although this aspect has been much debated, particularly in light of recent amendments to these standards (which have served only to muddy the waters unfortunately), it is still the case that liability presentation may have some potential advantages under full IFRS. This is because some disclosures which only apply to equity shares could potentially be avoided – earnings per share and share class reconciliations for example.

How easy will it be to convert to full IFRS?

Although there are certain key measurement changes which have already been made to the SORP as explained above, there would inevitably be some residual measurement issues to be considered when converting to full IFRS. These might include matters such as the valuation of unit liabilities, the functional currency of the fund and recognition of income from preference shares for example

Although some investment trust companies in the UK have been preparing accounts under IFRS for some years now, and have done so without having encountered insurmountable measurement difficulties, it is fair to say that these companies have not found IFRS to be fund-friendly.

The table below summarises which of the main potentially relevant convergence standards apply to authorised funds at the present time:

Financial Reporting Standard	Application	Points to note
FRS 23 'The Effects of Changes in Foreign Exchange Rates' (IAS 21)	No	Authorised funds currently follow SSAP 20
FRS 25 'Financial Instruments: Presentation' (IAS 32)	Yes	Adopted as part of 2005 SORP
FRS 26 'Financial Instruments: Recognition and Measurement' (IAS 39)	No	Partially adopted as part of 2005 SORP
FRS 29 'Financial Instruments: Disclosures' (IFRS7)	No	Authorised funds currently follow FRS 13



In particular, as IFRS does not make any distinction between capital and revenue, the benefits of IFRS for UK funds are unlikely to outweigh the costs, particularly given the existence of short reports.

At the same time it is well known that the IASB has a dislike of allowing carve outs from any of its standards, either for specific industries or special cases. There will therefore be no exemptions from preparing cash flow statements for example.

Furthermore, IFRS is written around a traditional closed-ended company model and does not cater directly for open-ended entities. Much of the ongoing debate about whether units in a fund are debt or equity bears this out.

There is also likely to be discussion around how equalisation ought to be presented. And earnings per share is a further potential complication – arguably an inferior performance measure compared with distribution per unit in an open-ended fund.

The most likely cumulative impact of all of this is that, notwithstanding the question mark over the continued existence of the SORP, the funds industry will potentially have less influence over what fund accounts look like than it has in the past.

The IASB have demonstrated that they can be difficult to influence and it is likely that the industry will have less

say over the specific relevance of disclosures for UK fund investors. The experience of the investment trust industry with regard to IFRS rather bears this out, particularly in relation to financial instruments disclosures, which were arguably written mostly with banks in mind.

Experience suggests that under IFRS accounts have got longer but not more readable, and the more this trend continues the harder it will be for an investor to pick out what really matters from all the material which simply has to be there because IFRS requires it.

Conclusion

The ASB's proposals put down a clear marker that administrators and managers may need to brace themselves for changes to the form and content of fund accounts and they appear to put UK funds on a much faster track towards IFRS convergence than many European counterparts.

IFRS is much less of an unknown quantity than it was four years ago. Although many of the implications of IFRS for funds are better understood now than they were then, there will be a need to deal with an evolving set of standards as IFRS is amended and updated, particularly in the area of financial instruments. Also, it would remain for generally agreed industry standards to be developed to ensure

consistent approach and presentation is maintained. One of the biggest discussion points is proving to be around the form which guidance could take and what formal status it could have bearing in mind the need for endorsement. Many respondents on the consultation have urged the ASB to rethink their SORP proposals.

If the proposals go ahead as currently published, it is likely to be 2012 at the earliest before changeover to IFRS would be required. This would appear to give nearly two years to plan and prepare, although the transition window is not as long as it appears if comparative figures are to be brought into the equation. A 2012 changeover would therefore seem optimistic.

In the meantime, it's a last call for UK GAAP. Expect an exposure draft outlining the ASB's recommendations later this year.



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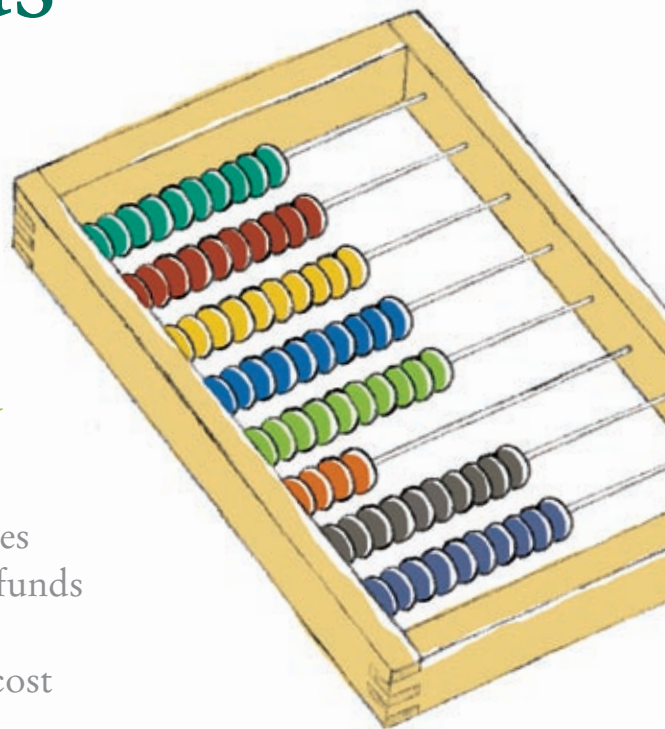
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Taxation of Authorised Investment Funds

There have been various substantial changes to tax legislation affecting both authorised investment funds (AIFs) and closed ended vehicles.

The Government's original aim behind these changes was to improve the tax competitiveness of the UK funds market by removing impediments from the UK tax regime, in an attempt to make it simpler, more cost effective and improve certainty for investors.



The tax reforms are clearly a positive step for UK taxpayers including UK funds, although whether they will be enough to reverse the trends of recent years and the competition from the Irish and Luxemburg markets in particular remains to be seen. The focus of this article is the practical impact the changes will have on the taxation of AIFs.

Taxation of Foreign Profits

The introduction of exemptions from tax on overseas dividends is a very positive step for the UK funds industry and the competitiveness of the UK market in general. However the changes should be looked at carefully as although they are generally beneficial, there are potential traps.

The application of the legislation depends on the size of the recipient company, that is whether it is 'small' or 'not small'. AIFs, however are specifically treated as being not small for the purposes of the legislation.

In the case of 'not small' companies, all UK and foreign dividends falling into an exempt class are tax free if received on or after 1 July 2009, subject to certain conditions. The main exempt class which is likely to apply to funds is where the recipient holds less than 10% of the paying company's shares, with rights to less than 10% of distributable income and assets on winding up.

It is worth noting that some UK double taxation agreements (DTAs) contain a condition that dividends must be 'subject to tax' in the recipient's country in order to receive a reduced withholding tax, however this is limited to a small number of UK DTAs (eg Germany, Russia, Portugal and Israel). To address this issue, the new rules enable taxpayers to make an election to become 'subject to tax' on specified dividends to enable taxpayers to access reduced withholding rates. Portfolios should therefore be reviewed to assess whether such elections could be beneficial.

For AIFs there is an impact on corporate streaming rules particularly in relation to the increase in the non-taxable, franked element of dividends. The impact on unit pricing purposes may require more regular review of tax provisioning in particular during the transitional period of when dividends were received around 1 July 2009.

Overall, the tax charge for funds investing in overseas equities should be restricted to the treaty rate of withholding tax on dividends received. However if they have not already done so, funds should consider making reclaims under the Denkavit/Fokus Bank cases which open up the opportunity to seek reclaims of withholding tax from EU member states.

Genuine Diversity of Ownership (GDO)

The GDO has now become standardised and has been incorporated into regulations for all AIFs wishing to rely on the white list for investment transactions as well as Tax Elected Funds (TEFs), Qualified Investor Schemes (QISs) and Property AIFs (PAIFs). Broadly, this condition is satisfied if the documentation of the fund demonstrates how the fund is widely available and that there are no special restrictions on intended categories of investors. The aim is to ensure that the fund is not owned by specific or limited persons and that they are genuinely widely-held funds. To provide certainty for investors, funds which need to rely on the GDO provisions may apply for advance approval from HMRC.

Trading vs Investment

One area for which the GDO is important is the long awaited clarity regarding whether a fund could be considered to be trading. Previously there was a risk that HMRC would treat a fund's activities as trading (and therefore tax the gains on investments as income) but the 'white list' now specifically contains all transactions that will not be treated as trading. The 'white list' came into effect from 1 September 2009 for AIFs. To the extent that transactions are not included on the list (which is extensive and linked to the white list for IME purposes) then they will not taint other transactions in the fund that are on the list.

This clarification and certainty is a helpful step forward for AIFs, however because of the GDO condition it is important to note that it will not apply for private funds.

Tax Elected Funds (TEFs)

Although not suitable for all funds, the introduction of the elective TEF regime for AIFs can be beneficial for the certain types of funds and investors. AIFs operating under the TEF regime should be able to operate in a way which results in no UK tax charge, an improvement on the current tax rules available for AIFs.

The TEF regime is an elective regime that applied from 1 September 2009 and is open to AIFs meeting certain conditions. The regime moves the point of taxation from the fund to the investor who will generally be taxed in the same way as if they owned the underlying assets directly.

Where a fund receives predominately UK and overseas dividend income, there may be limited benefit in entering the TEF regime as it is currently unlikely to have a UK tax liability (especially after the changes to the taxation of foreign profits from 1 July 2009). However, the TEF regime will still be of interest to mixed funds

receiving both dividend and interest income where they might otherwise have a UK tax liability.

Under the regime the fund will be required to stream income and distributions with non dividend distributions (i.e. interest distributions) being deductible from taxable profits and subject to a deduction of income tax as appropriate.

There are a number of conditions which must be satisfied in order for a fund to enter the regime and these should be reviewed carefully, and include a property condition (which prohibits the fund from having a UK or overseas property business) and the GDO condition described above.

It is worth noting the TEFs can not elect to tax overseas dividends. Therefore where dividend income is received from countries with a DTA containing a 'subject to tax' clause,

a TEF would not be able to access the reduced withholding tax rate. It is also important to note that a tax charge can still arise in certain other scenarios, for example, on the disposal of non-reporting offshore funds





Offshore Funds

The new offshore funds regime provides greater certainty and certain competitive efficiencies. However the new rules are still complex with the added possible disadvantage of investors being taxed on amounts which they do not actually receive.

The new regime replaced the concept of distributing funds and non-distributing funds with that of reporting funds and non-reporting funds and came into effect on 1 December 2009.

The amended definition of an offshore fund means that a fund may now fall within the scope of the offshore funds regime for the first time. It is important for AIFs to review their portfolio holdings and seek confirmation of the status of offshore fund holdings which were not previously within the regime.

For existing funds transitional provisions mean that the earliest period for which they can apply for reporting fund status is the first accounting period

beginning on or after 1 December 2009, but they have the option of delaying entry into the regime until the subsequent period as well. Much will depend on the fund's distribution policy, investors' view of potentially being taxed on amounts not distributed, the benefit of the existing de minimis exemption and the 5% investment restriction.

In a similar way to the current position under the distributing funds regime, a UK investor which disposes of an interest in a reporting fund will be subject to tax on any gains realised (as capital gain rather than income). Such investors will also be subject to income tax or corporation tax on the distributions made by the offshore fund and their share of the excess of the offshore fund's reported income over the distributions made (ie they will be subject to income tax or corporation tax on their share of the offshore fund's income regardless of whether this is distributed or not).

In contrast any gain realised by a UK investor on the disposal of an interest in

a non-reporting fund will be subject to tax as income and not capital. Therefore the ability of funds to obtain reporting fund status has significant implications for AIFs as gains arising to them are exempt.

Reporting funds will be required to make available to each investor who is resident in the UK a report within six months of the end of the reporting period. The report must include the amount actually distributed to investors and the excess of the amount of the reportable income over the amount actually distributed.

The excess of reportable income will be treated as a distribution made on the date the report is issued (or six months after the end of the reporting period if earlier). The distribution will be treated as overseas income and so is not likely to be subject to tax for AIFs following the changes to the taxation of foreign profits. However the additional income will need to be recorded in the accounts for AIFs and so will affect the amount of profits available for distribution to investors.

Funds Investing in Non-Reporting funds (FINROFs)

As noted previously, where a fund invests in a non-reporting fund this could result in a tax charge within the AIF. In order to facilitate the introduction of Funds of Alternative Investment Funds, a new regime has recently been introduced which applies for funds investing in non-reporting funds (either on an elective basis, or automatically where an AIF holds more than 20% in such funds).

The impact of the regulations is that the AIF will be exempt from tax on gains arising from holdings in non-reporting funds, but investors in the AIF will be treated as if their holding in the AIF is a non-reporting fund. Although these regulations are a helpful step forward, as they stand they will be of benefit primarily to AIFs which invest wholly (or almost wholly) in non-reporting funds and to AIFs with tax exempt investors only, but not to AIFs more generally. The rules took effect from 6 March 2010 to coincide

with the introduction of the FSA's rules for Funds of Alternative Investment Funds (FAIFs).

In conclusion, there have been several recent changes affecting the taxation of AIFs as outlined above. In addition there were changes to the tax regime for QISs and the introduction of PAIFs during 2008. Overall these changes are a positive step for UK funds and promotes the UK as a more competitive jurisdiction in which to set up funds. However the new tax regimes remain complex and the full practical consequences are yet to be seen.

The UK market is still perceived as one in which funds bear certain tax burdens, not least stamp duty reserve tax, whilst needing to overcome hurdles to reach a favourable tax position. Hence further changes are, in our view, needed to overcome that perception and maintain the UK's competitiveness in the global funds market.



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