

## Investment Fund Regulatory and Tax developments in selected jurisdictions

### REGULATION

## European Union

### Mapping of duties and liabilities of UCITS depositaries

In January 2010 the Committee of European Securities Regulators (CESR) issued a table (Ref: CESR/10-175) mapping the duties and liabilities of UCITS depositaries across Member States in the following main areas:

- General criteria for the depositary; covering eligibility requirements; prudential requirements; requirements in relation to the experience and skills of the key personnel; organisational requirements; and any other requirements.
- Liability of the depositary where delegation of custody functions.
- Obligation of means/obligation of result.
- Legal framework (administrative / civil).
- Requirements on depositaries when delegating (due diligence).

The 121 page table can be found at the following web link:

<http://www.cesr.eu/popup2.php?id=6473>

### CESR Report: Implementation of CESR's guidelines to simplify the notification procedure of UCITS

On 29 January 2010 the CESR issued a report (Ref: CESR/09-1034) containing the results of a peer review of how the 27 Member States apply the CESR guidelines to simplify the notification of UCITS across the EU. These guidelines were initially published in June 2006 to simplify the notification process and facilitate cross-border fund distribution. Only five Member States (Belgium, Bulgaria, Italy, Luxembourg and Norway) have fully applied the key guidelines, with another four Member States (Hungary, Portugal, Romania, Sweden) partially applying all the key guidelines. The remaining Member States have not applied at least one key guideline. The peer review was conducted as at 1 April 2008 and it is expected that this situation will have improved in the meantime.

The full details and comparative tables

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between Member States are contained in the 31 page report that may be found at the following web link:

<http://www.cesr.eu/popup2.php?id=6476>

## **CESR Consultation on guidance to report transactions on OTC derivative instruments**

On 29 January 2010 the CESR launched a consultation on guidance to report transactions on OTC derivative instruments. This consultation paper aims to define useful common standards for consistent collection of data from investment firms. It defines and explains, for each derivative instrument type, how the fields of transaction reports should be populated to represent in a harmonised manner the execution of a transaction on such instrument. The consultation closes on 1 April 2010 and the consultation paper and other related documents can be found at the following web link:

[http://www.cesr.eu/index.php?page=consultation\\_details&id=156](http://www.cesr.eu/index.php?page=consultation_details&id=156)



## **BaFin draft circular relating to the duties and obligations of a Depository Bank**

The German supervisory authority (BaFin) released a draft Circular on the duties and obligations of the depository bank, with the objective of clarifying the provisions set out in §§ 20 ff. of the German Investment Act. The consultation period runs to the beginning of February 2010 and it is expected that the BaFin will finalise the circular within a few months.

The key contents are as follows:

- Authorisation requirements to act as depository. Only credit institutions can act as depository bank. There is a minimum capital requirement of €5million as well as the obligation for senior management in charge of the depository function to have appropriate experience.
- Custody of financial instruments, differentiating between instruments that can be kept in custody and those that cannot be held in custody.
- Sub-custody arrangements. According to §5 of the German Custody Act the depository bank may mandate a foreign credit institution or another foreign custodian with the custody of securities if this institution is performing the duty as custodian and is supervised by a state supervisory authority or another equivalent supervision for the protection of investors.
- Liability of the depository bank for default of the sub-custodian. The liability is limited to the due diligence process of selecting the foreign sub-custodian, only in those cases where the sub-custodian is independent from the depository bank.
- Due diligence in selecting the sub-custodian and ongoing monitoring. The Circular states that the BaFin would expect the depository bank to appoint a group entity to act as foreign sub-custodian. The depository bank cannot justify the appointment of an independent entity in cases where a

group entity could act as sub-custodian, and accordingly would not be able to discharge its liability through appropriate due diligence. The reasoning provided is that the depository would not be considered as acting in the best interests of the shareholders as it would unjustifiably give up the control of the assets under custody.

- Approval of certain business transactions, including the sale of real estate and the placing of cash on deposit with other banks.
- Control duties including compliance of the Management Company (Kapitalanlagegesellschaft) instructions with the law and management regulations; control of NAV calculation; control of management fees and other fees; control of best execution; control of collateral in the case of securities lending; control of investment restrictions. Investment restrictions should be monitored on a daily basis, also for German specialized investment funds. The key issue is how to perform the daily controls which may be done either on the depository bank's own system, through access to the Management Company system or based on reports generated by the Management Company (only permitted if additional systems testing is performed, otherwise this would not be allowed). The monitoring of investment policy is not included in the depository banks duties.
- Outsourcing/In-sourcing. The control function may not be outsourced but the IT tools and systems may be outsourced.
- Depository agreement. There is an obligation to put in place a contract between the Management Company and the Custodian Bank with requirements concerning the content of the agreement in line with the CESR Technical Advice 09-963.

## **The FSA to update its COLL rules for the winding-up of AUTs**

On 6 January 2010 the Financial Services Authority ("FSA") issued its first quarterly consultation of 2010 (CP 10/1) covering a range of topics which included updating and clarification of the COLL rules for the winding-up or termination of Authorised Unit Trusts ("AUTs").

The proposed changes to the FSA's Collective Investment Schemes rules ("COLL") have the goal, where possible given their different legal form, of aligning the winding-up and termination of AUTs to the procedures established in COLL for Open-Ended Investment Companies ("OEICs").

For both AUTs and OEICs it is made clear that, on commencement of a termination, normal business ceases and the Manager must notify investors. However, the main additions to COLL relate to AUTs:

- guidance summarising the main steps in winding-up or terminating an AUT;
- the requirement to prepare a final account for a winding-up, or a termination account for a termination, of an AUT showing how the winding-up/termination has been conducted and the scheme property disposed of; and
- the Manager must ensure that there is an auditor report on this account.

Responses to CP10/1 are required by 6 March 2010. It is available via

the following web link and the relevant sections are Chapter 4 (pages 16-18) and Appendix 4 which documents the amendments to COLL (five pages):

[http://www.fsa.gov.uk/pubs/cp/cp10\\_01.pdf](http://www.fsa.gov.uk/pubs/cp/cp10_01.pdf)

## **FSA is expected to ratify and introduce regulations for FAIFs**

In the light of the announcement that HM Treasury will introduce tax regulations for Funds Investing in Non-Reporting Funds ("FINROFs") (see article in UK Taxation). The Board of the Financial Services Authority ("FSA") will consider, at its January meeting, the ratifying of the proposed COLL rules for Funds of Alternative Investment Funds ("FAIFs"), and, if confirmed by the FSA Board, these could be expected to come into force in early March 2010.

The FSA consulted on the extension of its rules for Non-UCITS retail funds between 2006 and 2008 and concluded that its regime for Non-UCITS Retail Schemes (or "NURS") should be extended to allow funds of funds that invested up to 100% in unapproved collective investment schemes. Such schemes were referred to as "alternative" funds and hence the acronym "FAIF".

The FSA was naturally reticent to permit FAIFs until there was also a tax framework in place and, with other changes in the taxation of funds over the last 18 months, the lack of a tax framework has contributed to a delay in the COLL rules allowing the establishment of FAIFs. It remains to be seen what will be the level of interest in FAIFs

amongst product development teams in 2010 since fund propositions and alternatives mechanisms within the UCITS Directive have developed substantially since the period when the FSA consulted on permitting FAIFs.

## **FRC consults on Stewardship Code for institutional investors**

In January the Financial Reporting Council ("FRC") commenced consultation on the content; operation and oversight of its proposed Stewardship Code. The code aims to establish standards by which institutional investors will engage with listed companies in which they invest on behalf of clients, including funds.

In the light of the Walker report on corporate governance of banks and other financial institutions, issued in November 2009, the FRC agreed to take responsibility for establishing the Stewardship Code. The code is intended to generate more effective engagement between companies and shareholders and thereby lead to improvements in the governance and performance of UK listed companies. It will provide clarity to asset managers as to their responsibilities and will assist the ultimate asset owners with holding to account those acting on their behalf.

Responses to the consultation should be submitted by 16 April, and, once the Stewardship Code is established, the Walker report recommends that the FSA should require authorised asset managers to disclose whether and how they have complied with the code on a

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“comply or explain” basis. The FSA is expected to consult on this when the FRC’s consultation is completed.

The FRC’s press release and consultation paper (39 pages) are available via the following web links: <http://www.frc.org.uk/press/pub2216.html>

<http://www.frc.org.uk/images/uploaded/documents/Stewardship%20Code%20Consultation%20January%202010.pdf>

## **New Fund Re-domiciling Law**

Under the Companies (Miscellaneous Provisions) Act 2009, there is now a streamlined process to allow a non-Irish corporate fund to re-domicile to Ireland. The process consists of filing registration documentation with the Irish Companies Registration Office and simultaneous application for authorisation as a UCITS or non-UCITS with the Irish Financial Regulator.

The legislation will be followed by a statutory instrument listing those countries whose funds can avail of this new simplified process. It is anticipated that these countries may include the Cayman Islands, Bermuda, the British Virgin Islands, the Channel Islands, the Isle of Man and Gibraltar.

## **Amendment to UCITS Notice 10**

Notice 10 allows a UCITS to reduce its risk exposure to an OTC derivative counterparty where the counterparty provides the UCITS with “permitted collateral.” In December, the Irish Financial Regulator issued a policy change note to extend permitted collateral to include equity securities traded on specified stock exchanges. As CESR is also carrying out work in this area, the Irish Financial Regulator notes that this policy change should be “regarded as an interim measure” and may be changed in 2010.

## **Extension of permitted 100% investment in Specified Assets**

Both UCITS (Regulation 50 EC (UCITS) Regulations 2003) and non-UCITS (Paragraph 7, Notice NU 13) may invest up to 100% of their assets in specified financial instruments subject to the prior authorisation of the Irish Financial Regulator. The Irish regulator has now confirmed that these specified financial instruments now include securities issued by the Government of Singapore and Straight-A Funding LLC.

## **Consultation on Remuneration Policies**

The Irish Financial Regulator is currently considering how to implement the European Commission’s Recommendation on Remuneration Policies in the Financial Services Sector. In December, the Irish Regulator wrote to certain firms seeking comments on how these recommendations might be implemented.

## **Guidance Note No. 7 – Final Terms**

The Financial Regulator has issued Guidance Note No. 7 which clarifies a number of issues relating to Final Terms documents under Rule 4.12 of the Prospectus Rules.



# UK

## HM Treasury announces the introduction of "FINROFs"

On 20 January HM Treasury ("HMT") and HM Revenue & Customs ("HMRC") released draft tax regulations for Funds Investing in Non-Reporting Offshore Funds ("FINROFs"). The proposals will allow all UK Authorised Funds that invest in non-reporting offshore funds ("NROFs") to move the point of taxation of returns from the fund to the investor. The proposed regime will automatically apply for authorised investment funds ("AIFs") which invest more than 20% of their assets in non-reporting offshore funds.

The revised regulations will enable funds that invest in NROFs to avoid tax at the fund level, which can be tax inefficient for certain investors. The result will be that an investor in such a fund ("a FINROF") will be taxed on their investment returns in a similar manner to directly investing in the non-reporting offshore funds.

It is important to recognise that the total return to an investor in a FINROF will be subject to income tax so that it is unlikely to be efficient to combine investments in reporting and non-reporting funds in the same AIF where there are tax paying investors in that AIF. However, the proposed regulations will be attractive to exempt investors, such as pension funds, since the taxation of gains realised on investments in non-reporting funds, which would otherwise have been taxed in the AIF, will be avoided.

Funds that hold less than 20% of their assets in NROFs will be permitted to elect into the regime and there will be the capacity for the investors in AIFs that are to become FINROFs to elect for a "deemed disposal" so that the investor's returns to that date are taxed under the existing combination of capital gains and income taxation.

This tax provision supports the introduction by the FSA of Funds of Alternative Investment Funds ("FAIFs"), and the FAIF regime is now expected to come into force from 6 March 2010 (see article in UK Regulation).

This is not a formal consultation but interested parties were invited to make comments on the proposals up to 2 February 2010.

The draft tax regulations (14 pages) will come into force on 6 March and are available through the following web link:

[http://www.hm-treasury.gov.uk/d/draftregulations\\_finrofs\\_2010.pdf](http://www.hm-treasury.gov.uk/d/draftregulations_finrofs_2010.pdf)

### Clarification on the electronic filing of tax returns for UK AIFs

As previously noted, from 1 April 2011, for all accounting periods ending after 31 March 2010, the corporation tax return of an Authorised Investment Fund ("AIF") must be filed electronically. The electronic filing includes the accounts of the entity. However, in January, following representations from industry, HM Revenue & Customs ("HMRC") clarified that AIFs will not currently be

required to submit the financial statements of the AIF in iXBRL format but that other formats of electronic filing of the financial statements will be permitted.

This clarification will reduce the burden on AIFs that would otherwise have arisen from the conversion of the information in financial statements into iXBRL format. In place of conversion into iXBRL an AIF can file the annual report and financial statements electronically in pdf format alongside the AIF's corporation tax computation and return in the agreed electronic format (iXBRL online filing).

The following is a web link to HMRC's directions with respect to the compulsory electronic tax returns, which were issued on 6 January (5 pages):

<http://www.hmrc.gov.uk/ebu/mandatory-online-filing.pdf>

### Late applications for distributor fund status by offshore funds

HMRC has confirmed that an application made more than six months after the end of the accounting period for which distributor status is sought will not result in the refusal of that application so long as the other conditions for approval are met.

However where such a fund must make appropriate distributions to qualify for distributor status, those distributions must be made within six months of the end of the

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accounting period and HMRC will only allow the payment of late distributions where: the shortfall is trivial; or the investor profile has been constant for the period and subsequently; or where there is a reasonable excuse for not distributing within six months and the distribution was then made as soon as the fund was able to do.

The announcement is available via the following web link:

<http://www.hmrc.gov.uk/collective/offshore-funds-late-distributions.htm>



## **New Tax Circular on Islamic Finance**

On 12 January 2010 the Luxembourg Tax Authorities issued a tax circular (Circular L.G.-A No. 55 of 12 January 2010) on the subject of Islamic finance. The Circular provides a general overview of the major Islamic finance principles and instruments, and in particular sets out the tax treatment of Murabaha contracts and Sukuk.

In relation to Murabaha and subject to appropriate documentation the Circular provides for a beneficial tax treatment of that part of the profit realized by the financial intermediary for the granting of a deferral payment. Any commission for intermediation services of the financial intermediary is however excluded. While in principle the entire profit is realized upon disposal of the asset to the client, the Circular allows the profit to be taxed in a linear fashion over the life of the contract, regardless of the actual repayments made.

The Circular confirms that the treatment of a Sukuk is identical to the treatment of a loan in conventional finance. Consequently, payments made to sukuk holders are treated under domestic tax law as deductible interest expenses at the level of the paying entity.

At the level of the recipient, payments under the Sukuk are classified as interest within the meaning of art 97 (1) 3 LITL and assimilated to the corresponding payments under bonds in conventional financing.

The Circular confirms that no Luxembourg withholding tax is levied

on payments to Sukuk holders.

The full text of the Circular can be accessed via the following web link (in English):

[http://www.lff.lu/fileadmin/redaction/News/TaxCirc\\_2010\\_12Jan\\_IslamFin\\_EN.pdf](http://www.lff.lu/fileadmin/redaction/News/TaxCirc_2010_12Jan_IslamFin_EN.pdf)

## **The Indonesian Directorate General of Taxation attempts to take measures in order to prevent treaty abuse**

In order to prevent treaty abuse, the Indonesian Directorate General of Taxation (DGT) has issued new procedures for claiming tax treaty relief for Indonesian withholding tax. The procedures require the demonstration of foreign residency and beneficial ownership in order to benefit from reduced withholding tax treaty rates.

Previous administrative requirements permitted a foreign entity to demonstrate its tax residence status by submitting a Certificate of Domicile issued by its own tax authority. However, under the new administrative requirements, completion of a specified form is required and this form has to be endorsed by the tax authority in the relevant entity's own jurisdiction.

The new regulations and associated forms took effect as from 1 January 2010.

### *Impact on Luxembourg SICAVs*

Under the new regulations, a Luxembourg SICAV will need to obtain the new Certificate of Domicile (COD) in the prescribed format.

The form DGT1 must be obtained by the

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SICAV for interest and dividend revenues. For capital gains received from transfer of bonds or stocks listed on the Indonesian stock exchange and held through a custodian in Indonesia and for foreign banks, the prescribed form is the form DGT2.

The COD must be stamped by the Luxembourg Tax Authorities and should in principle remain valid for 12 months as from the date of certification by the Luxembourg Tax Authorities.

The form DGT1 contains a number of specific questions which must be answered by the Luxembourg SICAV and one of these questions concerns the determination as to whether the earned income is subject to tax in Luxembourg. This question should be answered with a "no".

In case the Indonesian DGT denies treaty benefits, based on the fact that the Luxembourg SICAV is not subject to tax, the Luxembourg Tax Authorities indicated that they would approach the Indonesian DGT to regulate the situation. Indeed, upon conclusion of the double tax treaty with Indonesia, a Luxembourg SICAV is meant to benefit from treaty protection.

## Clarification of consolidation rules for Luxembourg special purpose vehicles (SPVs)

Many alternative investment funds use Luxembourg SPVs for efficient tax structuring, with these SPVs often being at the top of a target group. On 18 December 2009 the Luxembourg Accounting Standards Board ("Commission des Normes Comptables" or CNC) issued an interpretation document clarifying the conditions required to be met should an SPV wish to exclude a subsidiary from consolidation. The conditions are as follows:

- The Luxembourg company must be held by one or more well informed investors;
- The sole objective of the company must be the investment in one or more targets representing risk capital, with a view to their launch, development or listing on a stock exchange. Such investments must be held with the objective of realising gains on disposal.
- The company's board must ex ante formally communicate to investors the investment exit strategy, which should be over the medium term,

generally between 3 and 8 years.

- The company's objective must be to generate returns for investors commensurate to the risks taken.
- The fair value of the target investment must be disclosed in the annual accounts.
- Any event, guarantee or uncertainty which may have a significant impact on the company's ability to continue as a going concern, on its cashflow, liquidity or solvency must be disclosed in the annual accounts.

This interpretation applies to period ends beginning on or after 1 January 2009.

The interpretation document is available on <http://www.mj.public.lu/legislation/commerciale/avis-CNC-2-1.pdf>

For a more detailed analysis and further information, please contact Jane Wilkinson (jane.wilkinson@kpmg.lu or +352 22 51 51 6325).



## IFRS publications

In December 2009, KPMG's International Financial Reporting Group issued two publications covering significant changes to IFRS.

*IFRS Practice Issues: Fair Value Hierarchy* covers the requirements in *Improving Disclosures about Financial Instruments – Amendments to IFRS 7 Financial Instruments: Disclosures*. The amendments to IFRS 7 require entities to classify fair value measurements for financial instruments using a three-level fair value hierarchy that reflects the significance and observability of inputs used in the measurements. The new requirements are effective for annual periods beginning on or after 1 January 2009.

*First Impressions: IFRS 9 Financial Instruments* covers the requirements of *IFRS 9 Financial Instruments*, the first instalment of a phased project to replace the existing standard on financial instruments, *IAS 39 Financial Instruments: Recognition and Measurement*. The new standard applies only to financial assets and retains a mixed measurement model, with some financial assets measured at amortized cost and others at fair value. Accordingly, the existing IAS 39 categories of "Held-to-maturity", "Loans and receivables", and "Available-for-sale" have been eliminated. IFRS 9 also eliminates the exemption allowing some unquoted equity investments and related derivative assets to be measured at cost. The new requirements are effective for annual periods beginning on or after 1 January 2013; early adoption is permitted.

These publications can be found at the following links:

<http://www.kpmg.lu/Download/IFRS/2010/First%20Impressions%20-%20IFRS%209%20Financial%20Instruments.pdf>

<http://www.kpmg.lu/Download/Brochures/2010/IFRS%20Practice%20Issues%20-%20Fair%20Value%20Hierarchy.pdf>





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January 2010

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