Alternative Asset Management

Quicknews

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Proposed changes to the Investment Manager Exemption

The Finance Act 2008, which became law on 21 July, outlines changes to the IME, which aims to make it easier and quicker to define transactions for the purposes of the legislation. New regulations, encompassing the current primary and secondary legislation, will be established to allow HMRC to specify any transaction as an "investment transaction" under the IME. This means the existing definitions will no longer apply once the regulations have been introduced. The new regulations will make it quicker and easier for HMRC to admit suitable products and the definitive list will all be in one place.

Current Groups	Proposals
Shares and stocks	Shares and Stocks
Securities of any description; and Placing money at interest	Debt
Futures and Options contracts (not relating to land); and Swaps and contracts for differences	Derivative Contracts
Buying or selling foreign currency	Buying or Selling Foreign Currency
Carbon Emission Credits	Carbon Emission Credits

From the current seven categories, qualifying transactions will now be simplified into five generic categories listed above.

The definitions of the categories shares and stocks, buying or selling foreign currency and carbon emissions will remain largely the same under the new set up. HMRC are consulting on carbon emissions to ensure all available products are captured.

Within debt, 'Securities of any description' and 'Placing money at interest', will be expressed as 'loan relationships', whereby a transaction in debt equates to an investment transaction. The concept of loan relationship was introduced in Finance Act 1996. HMRC will use the definitions in there while making sure that "related transactions" in that definition is wide enough to cover cases where the fund is not the original lender and that the receivable transactions included in SP1/01 are accommodated in the new regulations.

The proposed category to cover futures, options and contracts for differences, will be termed derivative contracts as defined in Schedule 26 FA 2002. The definitions of options and futures will include warrants and forward contracts. However, contracts which provide for cash settlements only, are now included under the definition for contracts for difference and swaps. FA2002 does not

deal with the current prohibitions in the IME legislation with regards to insurance contracts, capital redemption policies and contracts relating to land. These prohibitions will be retained under the new regulations, but with an adjustment to the land definition to "contracts relating to land other than indices of land with certain characteristics". HMRC intends to continue the prohibition of physical delivery of commodities and other property so that the IME does not apply to contracts where physical delivery does actually occur, unless the property delivered would itself qualify for the IME.

Finally, HMRC intends to extend the definition of carbon emission credits, to incorporate contracts known currently not to be included, such as Verified Emission Reductions or Voluntary Emission Rights ("VER").

The changes are broadly as anticipated and do not change the nature of transactions covered by the IME. The use of existing legislation to define qualifying transactions should be broadly welcomed provided the new regulations do stand alone making interpretation as simple as possible.

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Changes to the VAT exemption for fund management services

HM Revenue and Customs ("HMRC") announced via Budget Notice 74 that the VAT exemption for fund management services would be extended with effect from 1 October 2008. The draft Statutory Instrument ("SI") has now been published by HMRC. The changes extend the exemption for fund management services to the management of the following entities:

a) closed-ended collective investment undertakings which invest wholly or mainly in securities, whose shares are included in the UK Official List and are admitted to trading on a regulated market in the UK;

b) collective investment schemes established in another EEA State, or in Gibraltar, where notification of the intention to market the units of those schemes to UK investors under section 264 FSMA 2000 has been given to the FSA;

c) collective investment schemes established in Guernsey, Jersey, the Isle of Man and Bermuda, which have been recognised by the FSA under section 270 FSMA 2000; and

d) collective investment schemes established elsewhere which have been recognised by FSA under section 272 FSMA 2000.

After 1 October 2008, the recovery by a UK fund manager of input VAT on the costs and expenses incurred for the provision of fund management services to the funds falling within the new exemption will be blocked. The exemption will also extend to sub-funds within umbrella funds and to fund management services provided on a sub-advisory basis by a UK fund manager, when the services are provided in relation to funds which fall within the new exemption.

Fund managers will have to review their fund portfolios and their sub-advisory agreements in order to identify the funds which would fall within the new exemption. They should then consider whether the following actions must be taken:

- Apply for a partial exemptions special method (or, if they already have one, amend it) in order to calculate their input VAT recovery rate;
- Review their existing investment management agreements and sub-advisory agreements, especially with regard to the determination of the fees, to take into account the higher costs; and
- Review the range of services they provide and consider whether they fall within the definition of "management" as determined in VAT statute and case law.

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Substantial donors to charity

In 2006 HMRC introduced legislation to tackle the abuse of charitable tax reliefs. The rules started from the position that any transaction between a charity and a "substantial donor" (as defined) would result in a taxable payment by the charity. There were then a number of exemptions introduced to remove "innocent transactions".

In practice, the new rules caused problems for charities and HMRC have now announced a consultation on a number of changes. As the changes are intended to provide further relief, they will be effective from 22 March 2006 which is the date the original anti-avoidance measures took effect.

In outline, the consultation proposes to:

- Introduce a £1,000 per annum de minimis on gifts which will not count towards the amounts which create a substantial donor;
- Extend the thresholds for assessing whether or not a donor is substantial. The annual and cumulative amounts are increased to £50,000 and £125,000 respectively and the cumulative period halved to three years;
- Disregard the provision of small (less than £500) benefits or payments by the charity to a substantial donor;
- Include in the exemption, genuine arm's length remuneration to a substantial donor who genuinely works for the charity; and
- Include in the exemption, charitable grants by the charity in the course of actually carrying out the primary purpose of the charity.

Collectively, the changes are designed to include in the exemptions further genuine transactions and, by amending the limits for substantial donors, to reduce the record-keeping burden on the charity.

Responses to the consultation need to be made by 7 October 2008.

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Swiss consultation on new reporting regulations for foreign investment funds

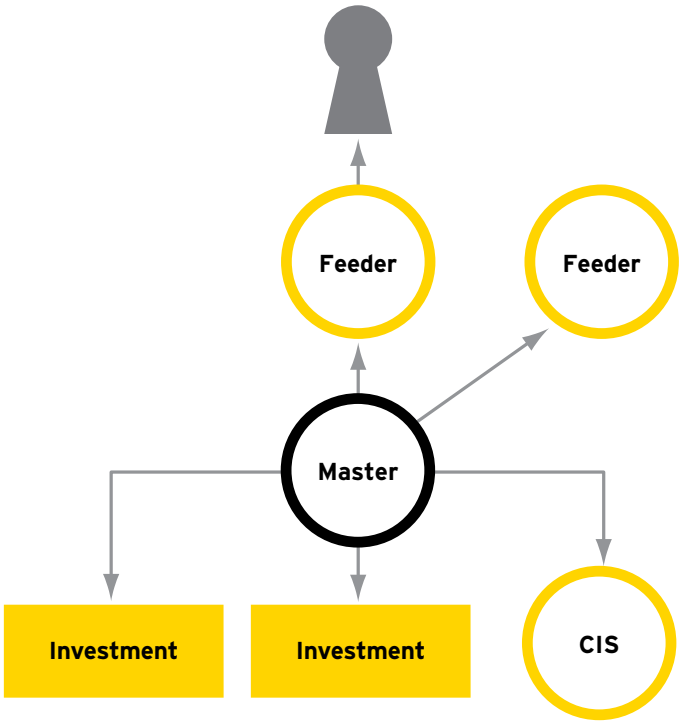
The Swiss Federal Tax Administration ("SFTA") has issued two draft circular letters for consultation which cover the taxation of Collective Investment Schemes for Swiss resident investors. Some of the proposed regulations will also impact foreign collective investment schemes ("CIS"). The proposals are summarised below. However, changes may occur over the course of the consultation process.

Generally speaking, CIS are regarded as transparent for tax purposes in Switzerland. This means that a Swiss resident investor incurs taxable income in the amount of his pro-rata share of dividends and interest income earned by the CIS and distributed to the investor or reinvested. Whilst dividends, interest and other income items are generally subject to tax in the investor's hands, capital gains realised by the fund do not constitute taxable income for private investors. However, capital gains need to be delineated from the income items. This can be achieved by reporting the different classes of income to the SFTA for publication in their official gazette ("Kursliste").

In the absence of such information, the assessing tax administration will consider all distributions or reinvested income as fully taxable items in the investor's hand. Furthermore, if the tax administration does not have any of the above information at all, it will assess the investor's income on a discretionary basis.

Reporting Duties in Case of Foreign CIS

If the foreign CIS can produce audited statements according to recognised foreign GAAP, the SFTA will accept the income figures (provided they have been orderly listed) and the capital gains figures and will publish them in the official gazette. The SFTA will only accept charges against the taxable income items to the extent that they do not exceed 1.5 % of the fund's NAV at the end of the fund's fiscal year. All charges exceeding this threshold will need to be charged against the realised capital gains/losses account. Hence,



adjustments might become necessary when lodging the report with the SFTA.

Reporting Duties for Fund-of-fund Structures

Fund-of-fund ("FoF") structures need to abide by a special set of rules. FoF structures are understood to encompass Feeder Funds investing in a Master Fund, which, in turn, holds investments directly or indirectly through other CIS – as depicted below:

Provided the Master and Feeder funds were transparent, had they been set up in Switzerland, they will be treated as transparent CIS for Swiss tax purposes. Income from direct investments ("Investment" in the depicted structure) accruing to the Master fund as well as income from a second-tier CIS ("CIS" in the depicted structure) can then be aggregated and allocated to the Feeder fund for which a reporting becomes necessary. For this purpose, the recognised GAAP figures of CIS are required, irrespective of whether CIS directly holds other investments or is a FoF structure itself. Again, there is a restriction of allowable expenses to be charged against taxable income items of 1.5% of the fund's NAV.

For the Master fund to be recognised, it needs to be a CIS holding a minimum of five direct investments or target funds. Failing which, it is likely that a look-through needs to be done to the next lower tier of investments.

The tax reporting must be set up as per end of the fiscal year for the relevant Feeder fund and needs to be based on the latest available audited financial statements.

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The MiFID Effect

MiFID took effect on 1 November 2007 and it is already clear that its measures have resulted in several fundamental changes to the European securities market structure as we know it. The incumbent regulated markets such as stock exchanges that have, until now, enjoyed near-monopolistic status as national utilities, are increasingly witnessing fragmentation, with other commercial organisations competing in their space. Despite the downturn in the credit markets, July 2008 is witnessing a European liquidity "land-grab". There are 8 new venues forecast for launch during the remainder of 2008 to add to more than 100 alternative electronic trading venues called multi-lateral trading facilities ("MTFs") spanning all asset classes offering new and differentiated business models.

So what does this mean for hedge funds – whether they are operating long/short, macro, arbitrage or multi-strategy models? Firstly, the larger investment banks who function as prime brokers themselves are poised to become direct competitors of exchanges. They would either form consortia such as Turquoise, facilitating the crossing of order flow internally without price formation taking place on a public exchange or offering "dark pool" functionality. Hedge funds will need to decide where to place their trades – onto venues which are 'lit' (public/evidenceable prices) or venues which are 'dark' (anonymity so lower market impact).

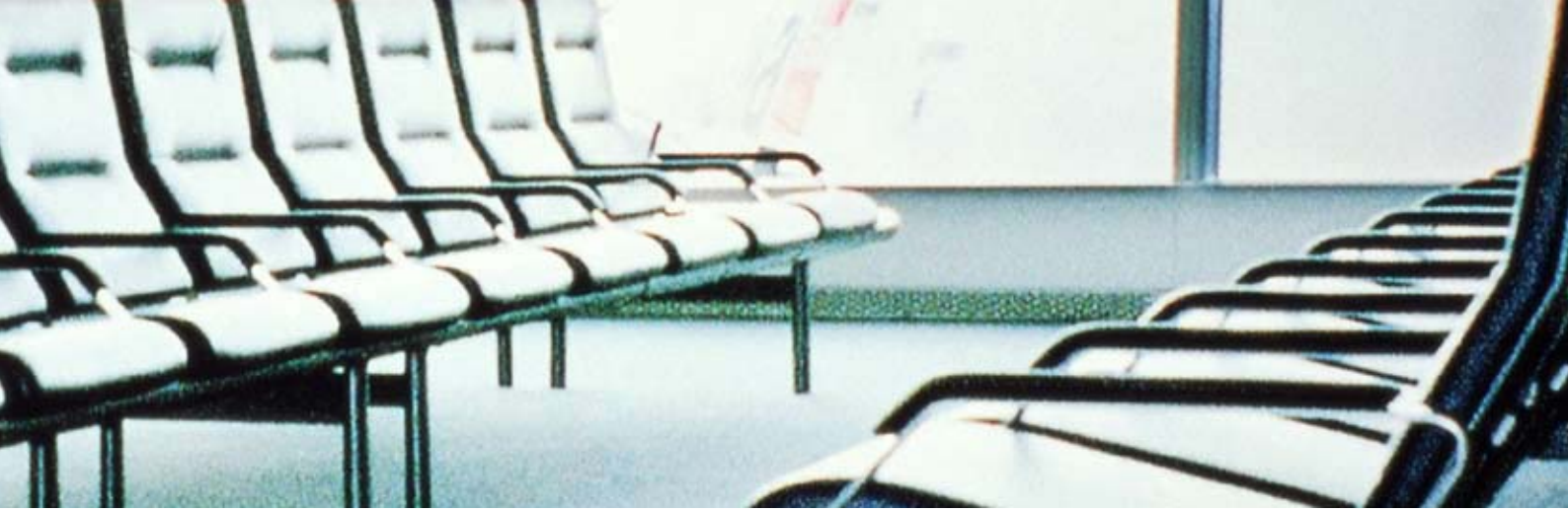
Secondly, it is expected that at least 10 to 15 investment banks will continue functioning as 'Systematic Internalisers' for equity trades. A sub-set of this group comprise prime brokers who are highly advanced in their preparations, with over 70% of the 'low-touch' high-frequency computer-generated algorithmic trade flows in equities carried by only 7 investment banks. Systematic internaliser trading off-exchange is already estimated to account for at least 17% of European equity volumes according to industry estimates, and cross-border trading outside the home domicile is increasing (21% of German stocks are traded outside Germany according to Thomson Reuters as at April 2008). Hedge funds will need to decide where to send their trades – whether to executing brokers acting as internalisers (managing the conflicts of interest) or to MTFs, and manage the rising complexities accordingly (managing timing risk). The decision matrix for hedge funds is shown in figure 1.

The key to hedge funds engaging in this manner will be their appetite to seek new forms of enhanced-alpha, particularly through interaction with the maximum number of execution venues. Several industry observers have noted that liquidity itself is not a zero sum game. A combination of extrinsic factors (i.e. appropriate regulation and market structure) and intrinsic factors (i.e. style changes and removal of dependencies) can both contribute to greater liquidity if powered by appropriate technologies.

Figure 1: Illustration showing the potential trade-offs between different execution venues

	Executing broker / SI	MTF / Exchange
Dark	✓ Crossing with significant liquidity pools ✗ Toxic liquidity pool interaction	✓ Anonymity / lower impact of prices on market ✗ Opportunity cost if cannot locate on other side
Light	✓ Immediacy (from capital commitment) ✗ Need to manage conflict of interest (COI) e.g., risk of front-running	✓ Evidencable prices (easier "best execution" ✗ Difficult to achieve information advantage

Key: ✓ Advantage
✗ Disadvantage



Extrinsic factors may consist of regulatory constraints, market practices and characteristic criteria of the market as a whole, e.g., national best bid/offer ("NBBO") systems, opening hours and market practices etc. Intrinsic factors might consist of greater contributions from hedge fund players (pure return generators) and the growing availability of order management systems ("OMSs") and execution management systems ("EMSs"), plus collateral and liquidity management facilities which are operationally "fit-for-purpose".

With multiple speeds, feeds and connections to consider, there are several unknowns at work, and chief among them is the degree of 'latent' liquidity locked up between the largest hedge funds. As many of the alternative managers are already high-frequency liquidity generators, we must look to these firms for a key to answering this question. Several of these players generate orders in relatively large blocks and employ 'high-touch' trading techniques when executing trades with their brokers, often for reasons of portfolio research, trading expertise or relationship value. Some agency brokers provide an extremely high level of professional, unconflicted execution via this model and it is highly unlikely that this will go out of fashion.

Some of the key issues that hedge fund managers should be considering when assessing the possibilities of connection to emerging venues:

- What are the incremental cost dynamics (including total cost to serve) when hedge funds connect to new venues?
- Are the hedge fund's systems and controls ("SYSC") proportionately risk-based and proportionately adequate when managing the pre-trade complexities (e.g., associated with indications of interest, orders, executions)?
- Does the hedge fund have multiple lines of defence should it come under regulatory (or significant client) scrutiny in order minimise the drain on senior management time?
- Does it have the appropriate audit trails in place for evidencing purposes to fulfil the above?
- How will the firm capture their operational metrics with regard to their trade confirmation/ affirmation processes and mitigating cancel/ re-bookings?
- Does the firm have the appropriate migration, scalability and business continuity plans in place when taking on new subscriptions and mitigating redemptions given the increased volumes and frequencies (intensity) of trading?
- Does the firm understand the dynamics of the new burdens of proof as demanded by MiFID?
- Has the firm conducted an effective audit of the middle office functions such as collateral management, liquidity management, securities financing and valuations?
- Has the firm studied the "less-intended consequences" for both hi- and low-touch trading models and the informational requirements behind the correct functioning of each?
- Does the firm have the ability to generate, assess and report appropriate management information to senior management in respect operational matters to satisfy the regulators?
- Does the firm have the appropriate record-keeping procedures to gather, store and retrieve the relevant market, client, transactional and organisational data to help validate outcomes, back-test algorithms, capture TCA information, and evidence best execution and client reporting needs?
- Is such data standardised and "reconstitutable" on demand?

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IRS address tax treatment of management fees for fund of funds

The IRS has recently published Revenue Ruling 2008-39 which states that Fund of Funds ("FOFs") management fees should not be categorised under section 162 of the Internal Revenue Code ("IRC") but should instead be under IRC section 212.

Many FOFs that classify their activities as 'trading' with stocks and securities, would have their expenses pass through to the limited partners as deductions under IRC section 162. However, since FOFs may hold limited partnership interests in underlying funds, the ruling states that FOFs are not engaged in a trade within the meaning of IRC section 162 and if management fees are not paid or incurred on behalf of an underlying fund's trade or business, then they would not be deductible under this section. Instead, an FOF's annual management fees are in connection with the FOF's investment activities under IRC section 212. This section has the potential to limit any deductible expenses, for example, a 2% floor or elimination under the alternative minimum tax.

The Ruling also states that the management fees paid or incurred by an underlying trader fund will retain such IRC section 162 characterisation when passed through to the FOF and its partners.

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What's new?

VAT penalty regime

HMRC believes that the present penalty regime is flawed and has resulted in a low number of penalties being issued. The new regime is designed to maximise revenue and to minimise errors when accounting for tax. The new regime will affect VAT returns with a due date on or after 1 April 2009 where the penalties start at 30% and can rise up to 100% depending on the taxpayer's responsibility, compared to 15% at present. The only situation where the new penalties will not be levied is when the taxpayer makes a mistake despite taking 'reasonable care'.

Foreign Profits Update

Following extensive consultation with industry and representative bodies, HM Treasury responded to industry in the form of formal letters to the Confederation of British Industry and the Hundred Group, effectively deferring the introduction of some of the proposals regarding foreign profits to 2010 and abandoning others completely. The changes are likely to effect exempt foreign dividends from tax, anti-deferral rules, debt levels and Treasury Consent. HMRC will continue to consult on the reform of the Treasury Consent rules. They aim to replace the current rules with a less burdensome reporting requirement.

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