

# TECHNICAL

## American Revolution

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On 21 July this year, seven months after it was initially proposed in Congress, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act into law. The Act brings the broadest and most dramatic changes to US financial regulation since the Great Depression – but what are the primary implications for Managers of European Private Equity and Property Funds?

### New definition of an 'Accredited Investor'

Dodd-Frank includes an immediate change to the definition of an 'Accredited Investor' that affects any Private Fund operating under Regulation D in the US. This change is outlined in Section 413 of the Dodd-Frank Act. As was the case under previous rules, a US natural person can qualify as an 'Accredited Investor' if he or she has a net worth (either on their own or with their spouse) of more than \$1m. What is different under the Dodd-Frank Act is the fact that such an individual can no longer count the value of their main residence towards this \$1m as they could under previous rules.

According to SEC officials, although the value of an individual's primary residence cannot count *towards* their net worth, neither will the value of their mortgage on this residence be counted *against* their net worth – so long as the market value of their property is not lower than the value of their mortgage.

A US natural person can also qualify as an 'Accredited Investor' if he or she earned more than \$200,000 in each of the previous two years – or a total of \$300,000 including their

spouse's income – and expect to earn either at or above this sum in the current year. This set of criteria was already in place prior to the introduction of the Dodd-Frank Act and remains unchanged.

The SEC is obliged to review and update the criteria for the definition of an accredited investor every four years – though it is also obliged to leave the criteria as they stand until 2014.

The good news for Funds operating under Regulation D is that there is no grandfathering provision in these changes. However, those issuing Private Funds must act now to revise their subscription documentation aimed at all new investors (and for any offering that had not closed by 21 July this year), as well as documentation aimed at existing investors seeking to take out further subscriptions.

### Adviser registration exemptions

Under Title IV of the Dodd-Frank Act, Advisers to Hedge Funds and other Private Funds are no longer automatically exempt from registration with the SEC, as they previously were under the 1940 Investment Advisers Act. Under Dodd-Frank, Advisers are only exempt under certain circumstances, including acting only for Alternative Investment Funds with assets under management totaling less than \$150m. (It should be noted that under the US Investment Advisers Act, the definition of an 'Adviser' also encompasses Managers of Private Funds.) Advisers to Venture Capital Funds will also be exempt from registration

requirements – though the precise definition of a Venture Capital Fund will be specified in future US laws. The question of whether Advisers to medium-sized Private Funds will be exempt from registration – and what these Advisers' registration requirements will be if any are imposed – is now at the discretion of the SEC, which will make a decision based on the risks associated with the Fund or Funds in question. Family Offices are also exempt from the definition of 'Investment Adviser' under the new law – and are therefore also exempt from associated registration requirements.

What about non-US Advisers? The Act provides limited exemption to this group so long as they have no offices in the US and advise fewer than 15 clients/investors in the US who collectively invest in private funds worth less than \$25m. In order to qualify as a Foreign Private Adviser, they must also meet other criteria, including refraining from marketing themselves to members of the US public. Clearly, the tight nature of these definitions means that many Foreign Private Fund Advisers, including many of those managing or advising Property and Private Equity Funds, will not qualify – and may therefore be required to register with the SEC for the first time. They will need to do this by the first anniversary of the Dodd-Frank Act – 21 July next year.

The Act also amends reporting and recording-keeping requirements for Investment Advisers to Private Funds – and allows the SEC to conduct regular



Barry Carroll  
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## Eastern Promises



David Bailey  
Managing Partner

Both Luxembourg and Mauritius are becoming increasingly attractive domiciles for both managers and investors across the Middle East, including those dealing in Islamic Finance investment instruments. So what tax treaties and other benefits do these two states offer to investors from Gulf Cooperation Council (GCC) countries and elsewhere in the region?

### Luxembourg

Luxembourg enjoys double taxation treaties with a number of Middle Eastern states including Bahrain, the United Arab Emirates, Kuwait and Qatar. These treaties offer a raft of benefits to investors in GCC countries. Under Luxembourg's 2009 treaty with the UAE, for example, interest and royalties are taxable only in the state of the beneficial owner's residence. Taxation of dividends cannot exceed 5% if the owner is a company holding 10% cent or more of the distributing company's capital, or 10% in all other cases.

Under the newly ratified tax treaty between Luxembourg and Qatar (effective from the beginning of 2011), interest is exempt from withholding tax in the source state, while royalty taxes cannot exceed 5%. Dividends given to a company that holds 10% or more of the distributing company's share capital are exempt from withholding tax. Tax on dividends distributed to an individual with a direct 10% participation that has lived in the state in question for 48 months or more cannot exceed 5%. Withholding tax on dividends is capped at 10% in other situations.

Under Luxembourg's treaty with Bahrain, interest and royalties payments are taxable only in the beneficial owner's home country. Dividends are exempt from tax if the beneficial owner is a company holding at least 10% of the distributing company's capital. Tax on dividends is capped at 10% in other situations.

Tax treaties are not the only attraction that Luxembourg offers to Middle Eastern investors. On 12 January this year, the *Administration des Contributions Directes*,

Luxembourg's direct taxation authority, issued a circular describing how various Islamic Finance investment instruments work and specifying how they will be treated for tax purposes in Luxembourg.

The circular provides welcome clarification for Funds using Islamic Finance instruments, which are migrating their activities to Luxembourg in growing numbers.

Specific issues addressed in the circular include:

#### Sukuk issuances treated as debt instruments

The circular states that under Luxembourg's taxation regime, *sukuk* issuances will be treated in the same way as standard debt instruments (despite the fact that *sukuk* revenues are tied to underlying asset performance). As the circular explains, this means that under Luxembourg tax rules, *sukuk* remuneration is treated in the same way as issuers' interest.

*Sukuk* payments are tax deductible at the level of the issuer of the instrument, so long as such payments fall within the issuer's corporate interest. In turn, revenues from *sukuks* are treated as income from moveable capital. Crucially, payments to those holding *sukuks* are not treated as dividends. This means that Luxembourg withholding tax does not generally apply to them.

The authors of the circular also state that any problems relating to the application of agreements regarding double taxation should be addressed using the mutual agreement procedure.

#### Murabaha transactions treated as sales agreements

The tax authority's circular states that the Luxembourg taxation regime will treat *murabaha* transactions as a sales contract between a capital provider and its customer. As a result, proceeds from such a sale, including profit, are immediately taxable. But

this is not the whole story. Because the profit in such a sale is in fact a return on a deferred payment that is payable over the lifespan of the *murabaha* (akin to interest in traditional finance). The profits can then be divided up and taxed in a linear fashion over the duration of the deferred payment.

The circular also specifies the criteria that a *murabaha* agreement must meet if remuneration from it is to be treated as an interest. These criteria include a clear definition of the financier's profit that both parties agree upon.

In June this year, the Luxembourg tax authority issued a further circular on the tax treatment of *murabaha* purchases. In particular, it states that if a special purpose vehicle designed to conduct a *murabaha* purchase (or take part in a *ljara* lease) is incorporated in Luxembourg, it will be treated as a payer of VAT. The circular also specifies that a 1.2% registration duty (based on the purchase price) will be imposed on *murabaha* transactions relating to property within Luxembourg. Finally, a €12 fixed registration duty will be imposed on share sales of special purpose vehicles that own real estate in Luxembourg.

### Mauritius

Middle Eastern investors are drawn to Mauritius by a number of factors.

First, the island nation enjoys double taxation treaties with Oman, Qatar, Kuwait and the United Arab Emirates (UAE). The Mauritian government is also in the process of negotiating further treaties with countries including Iran, Yemen and Saudi Arabia.

These tax treaties offer a range of specific benefits to Middle Eastern investors operating in Mauritius. For example, under the treaties with Oman and the UAE, dividends, interest and royalties are all exempt from withholding tax. Under the Mauritian tax

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# TECHNICAL

## Is Consolidation under IFRS Changing?



Ian Kelly  
Partner & COO (Europe)

There is a general consensus among accounting experts that consolidation is not meaningful for investors receiving reports from investment companies because it does not accurately reflect the commercial reality of the relationship between the investment company and its portfolio companies. However, under the existing IFRS rules, consolidation is almost inevitable if the Fund is to apply full IFRS.

There are always exceptions to the rule (e.g. US and Lux GAAP) but with the global convergence to IFRS these options may also be under threat.

We have assisted many clients in avoiding consolidation. In many cases this has resulted in the audit reports representing compliance with the Funds legal agreements ('Legal GAAP') rather than compliance with the standard.

However, this landscape might change in the near future. If that happens it will potentially have a huge impact on the accounting for Private Equity and Property Funds allowing them to provide arguably more meaningful information to their investors.

This change of landscape goes back to June 2003 where the objective of the project was to publish a single IFRS on consolidation to replace the consolidation requirements of IAS 27 and SIC-12. The IASB published the ED 10 in December 2008. In response to ED 10, many professional bodies such as the BVCA and the ILPA responded with comments in support of the view that the investment entities need to be excluded from the scope of the standard. The IASB reacted to the response and decided to adopt the same approach as in US GAAP, i.e. an exemption for investment companies, and in February 2010 published a tentative decision as part of a separate subproject to the Consolidation project. The IASB conducts the project jointly with the US Financial Accounting Standards Board (FASB), though with different time lines from the main Consolidation project.

The project objective is to define an investment entity and to require that an investment entity should not consolidate investments in entities that it controls, but to measure those investments at fair value, with changes in fair value recognised in profit or loss.

So what metrics will the two Boards use to determine whether an entity qualifies for the definition of an investment entity/company? In order to qualify, the IASB and FASB have tentatively decided that an entity must meet all of the following criteria:

- 'Substantially all' of the entity's activities must be investment activities designed with the explicit intention of creating capital appreciation and/or current income. Indeed, these intentions must be the 'express business purpose' of the entity. In addition, the entity and affiliated entities cannot receive benefits from investees that are not also available to other investors.
- The entity's ownership must be expressed in terms of investment units.
- The entity must have scoped out both potential exit strategies and timeframes for exiting the investment in question.
- All investments must be managed on a fair value basis, with performance evaluated externally as well as internally in the same way.
- The entity has to be a reporting entity.
- The entity owners' funds must be pooled in order for the owners to take collective advantage of professional asset management.
- Anyone providing debt to the entity's investees must not have direct recourse to any other investees.

Now that the IASB and FASB have made these tentative decisions, what happens next? The two Boards have instructed their officials to make further clarifications on the above criteria when they produce further draft definitions of an investment company.

It should be noted that any tentative decisions made by the IASB and FASB do not alter existing requirements until they are officially incorporated into an accounting standard. However, if the above decisions are factored into the new standard, they could have a significant impact on whether or not a Private Equity Fund or Property Fund will be treated as an investment company.

Fortunately, we will not have to wait for too long to find out. For the Consolidation and Disclosure project, the IASB expects to issue the final requirements in Q4 2010. The FASB will decide in Q3 2010 whether to issue an exposure draft for the same requirements. For the Investment Entities project, the IASB will issue an exposure draft early in Q4 2010 and the comments period is expected to end in Q1 2011, while the FASB will decide early in Q4 2010 whether to issue a comprehensive exposure draft on consolidation. If everything is agreed and finalised it may be that Private Equity and Property Funds will be able to use the exemption and avoid the consolidation issue for their December 2011 year end and onwards.

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## Augentius Completes SAS 70 Type II

Augentius has successfully completed a SAS 70 Type II audit of its New York operation resulting in an unqualified audit opinion. "Investors and fund managers expect the highest levels of security, efficiency and ethical standards in our operating environment" commented Barry Carroll, President and CEO, Augentius Fund Administration (New York) Inc. "We now have independent verification of the effectiveness of our procedures and processes."



# TECHNICAL

## The End of an Era

Sadly Jose Sinai, the primary force behind the development of Investran (now Sungard Investran) passed away on 30 July 2010.

As the Founder and Chief Executive Officer of Financial Technologies, Inc., Jose fostered its growth from a small breakthrough technology company to a position of industry leadership. He was the creator of Investran as we know it today and turned both FTI and Investran into the market leaders that they are in the Private Equity industry. Jose was one of the true inspirational innovators in our industry.

A truly lovely man, he was a real friend to his clients and someone that was dedicated to his family. Indeed FTI was a truly family business. When we first met with the team, Jose's wife, Nelia, welcomed us to their offices whilst his daughter Lauren and son David had substantial roles in the development of the product – and still do today.

FTI was not Jose's first venture into technology, he co-founded Sinper Corporation in 1984, the company that developed the breakthrough TM-1 OLAP technology. Jose subsequently pioneered the use of OLAP technology to simplify otherwise complex reporting tasks to the financial sectors.

Not only will his technological mind be missed but also his friendship and his humour. Many fund administrators and others would not have the businesses they have today without Jose and his wonderful vision.

## Eastern Promises continued



treaty with Qatar, dividends and interest are also exempt, with royalties subject to a maximum tax rate of 5%. Under the treaty

with Kuwait, dividends and interest are exempt, with tax on royalties capped at 10%.

Like investors from elsewhere, those from the Middle East also benefit from the absence of capital gains tax in Mauritius. In addition, these investors can enjoy the fact that there is either very little time difference between Mauritius and their home country or in many cases no time difference at all, allowing for straightforward communications at every point in an investors' working day.

Meanwhile, Mauritius offers a further powerful attraction to many GCC-based investors: it is an excellent destination for conducting Islamic Finance activities. A number of banks have, for example, launched Islamic Banking services and capabilities. Shari'ah compliant investment activity is proliferating in Mauritius as a result – and the conditions are right for it to flourish further during the months and years ahead.

## American Revolution continued

as well as 'special' examinations of these Funds' records at its discretion. Even Advisers that qualify for registration exemptions are required to keep records and file reports as and when the SEC deems necessary in the interests of investor and public protection.

### Restrictions on Private Equity Investment

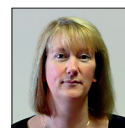
Under the so-called Volcker Rule, insured depository institutions and their holding company as well as 'banking entities' are barred from investing in, sponsoring or engaging in 'proprietary trading' with Private Equity or Hedge Funds. However, the Dodd-Frank Act also provides a number of exemptions to this rule. For example, exemptions apply for investments made entirely outside the US by a company operating outside the coverage of US law.

## Augentius Awards Long Service

Every member of staff who works with Augentius for over five years is awarded a time piece by the Partners. Recent awards include:



**James Watts, Head of Onshore Client Services** – James joined us as a fund accountant, has moved through the business and is now responsible for the day to day operations of the London Office.



**Jane Goddard, Office Manager** – one of the lynch pins of our Guernsey office and without whom everyone would struggle.

## We Rise to the Challenge

Over the August bank holiday weekend a team of staff from our Guernsey and London offices successfully overcame the Three Peaks Challenge. Starting with a morning ascent of Ben Nevis (1344m) the team were then driven to the Lake District to climb Scafell Pike (978m) through the night and then drove on to Snowdon (1085m) to complete the Peaks in challenging weather conditions.

In all over £3,300 was raised for 'Beating Bowel Cancer'.



### MORE INFO

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