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International Tax Supplement

Capital Market Regulation in Response to the Crisis

Karel De Gucht, the EU Commissioner for Trade, mapping the path for Europe

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These are the 'ALL HITS' Super 7 key reasons that make Durban attractive to both residents and visitors alike.

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Fiddling While the Eurozone Burns

Recent weeks have seen renewed turmoil in global financial markets, reminding many of the darkest days of autumn 2008. The crisis is not over; we are just at the next stage. We are moving from a private to a public debt problem. The bailing out of financial institutions and the provision of fiscal stimuli avoided the great recession from turning into a depression. But rising public debt is never a free lunch, eventually you have to pay for it.

We have to start to worry about the solvency of governments. What is happening in Greece is the tip of the iceberg of rising sovereign debt problems in the eurozone, in the UK, in Japan and in the US. This is going to be the next act in the global financial crisis.

One lesson from the failure of Lehman was that, in the midst of a systemic financial crisis, no significant bank should ever be allowed to fail. When an entire financial system is in peril, the cost of offering unlimited government guarantees and taxpayer bailouts will always be much smaller than the losses from allowing any significant bank to collapse. In dealing with systemic financial crises, the risks of increasing moral hazard are irrelevant in comparison with the certainty of disaster triggered by the failure of any significant bank. The same applies now to Greece.

If any such default were to occur, it could trigger a global financial catastrophe even larger than Lehman. If Greece were allowed to renege on its debts, the foreign banks that held Greek debt would move to dump their additional Portuguese debt and probably their Spanish debt. And who knows how Italian debt would be treated? The main French and German banks would require government guarantees that would run into trillions of euros.

Any such upheavals would dash hopes of global recovery from the financial crisis and would cause irreparable damage to public finances already on the brink of catastrophe. It is obvious that such calamities must be avoided, almost regardless of cost or whether it sets a bad example to improvident governments or bankers.

Europe was always heading for a crunch. For years the German and Dutch economies pulled in one direction (high saving, low spending), while the Club Med bloc – Greece, Portugal, Spain, Italy (and their Celtic outpost Ireland) – pulled in the other. At some point there was always going to be a problem, given that these two economic blocs were fixed together in the same currency. The financial crisis has effectively smoked out the European folly by shovelling an unexpected load of debt on to Greece's balance sheet.

The eurozone needs fiscal and structural reform. Reform is necessary, recovery or not. If you don't address the issues, you risk having a double-dip recession and one which is at least as severe as the first one.

Mervyn King, the Governor of the Bank of England, points out that sub-prime households – and the banks that lent to them – can usually be bailed out. Sovereign debt presents a different problem. The International Monetary Fund simply does not have enough cash to bail out a major economy like Spain or Italy. So, again, we find ourselves in unknown territory.

The challenge for governments is to create confidence in their policies whilst at the same time creating an environment where a financial crisis cannot reappear. They are failing the test. ■

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Contents

8 International Trade, European Values
Karel De Gucht

10 Should the EU Support Russia's Modernisation?
Fraser Cameron

14 The Myth of Jobs Shipped Overseas
Jonathan Huneke

16 Financial Regulation – From Micro- To Macro-Prudential Rules
Angela Knight

18 Private Air Charter: Changing Winds
Mark Briffa

20 The Outlook Remains Unclear For Trade Finance
International Chamber of Commerce

22 Capital Market Regulation in Response to the Crisis
Paul Richards

24 Public Finances Taking a Heavy Toll on the Incipient Recovery
Marc Stocker

26 The Rising Rupee Is a Concern for India's Exporters
Pritam Banerjee

International Tax Supplement: Practical Steps In Changing Economic Conditions

i The Role of Taxation in Rebuilding Europe's Economy
Algirdas Šemeta

ii Transfer Pricing: A Challenge for Developing Countries
Caroline Silberztein

iv The Use of Hybrid Legal Entities in International Tax Reduction Strategies, Part III
Jos Peters

vi A Seat at the Table: The Importance of Import Compliance in the Post-Recession Economy
James Sawyer

viii Taxation in Ukraine: Major Developments In 2010
Kostyantyn Solyar

xii Cyprus: New Option for Transfer-In Companies
Emily Yiolitis

xiv The Nicaraguan Tax Law Reform and Its Effects
Ramón Castro

xvi The Polish Tax System Is Beneficial For Foreign Investors
Paweł Jabłonowski

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Contents

27 Privatization of Public Enterprises in Saudi Arabia: Why the Process is Slow
Ibrahim A Onour and Bruno S Sergi

30 Antigua: A Serious and Progressive Financial Centre. Interview with Brian Stuart-Young, Chairman and CEO of Global Bank of Commerce Ltd

34 Listing Your Fund on the Cayman Islands Stock Exchange
Jonathan Culshaw and Jonathan Law

36 ICT in Bermuda: Measured Progress
Bermuda Ministry of Energy, Telecommunications and E-Commerce

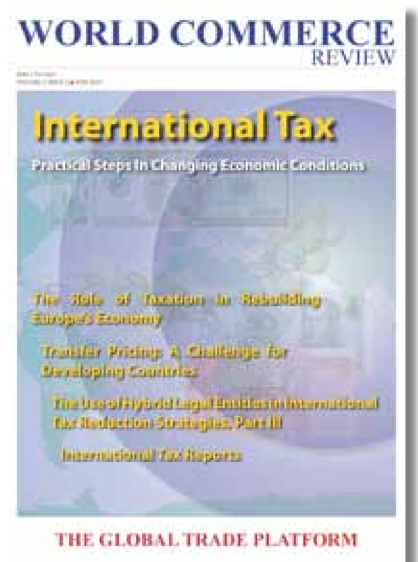
38 Special Economic Zones in Poland
Olga Zajączkowska-Drożdż

40 Poland: In the Heart of Europe... And of European Investors
Michal Bielinski

42 New Long-Term Funding Options for Brazilian Financial Institutions
Antonio Giglio Neto

46 Turkey: Eurasia's Energy Nexus
Kemal Mamak

50 The State Of Bavaria: A High Performer Heading For the Big Payoff
Invest In Bavaria



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International Trade, European Values

Karel De Gucht is the EU Commissioner for Trade

When I started as European Commissioner for Trade in February, I knew that there were tough times ahead. Not only had I taken over one of the most important portfolios the European Commission has to offer, but I was doing so at a particularly critical time: Was it not free trade that many saw as one of the things that got us into the crisis? And there I was, telling people that it was through international trade that our economies would eventually get out of it! This is still a conviction I hold, and one which will help to map out the path for my current mandate.

The crisis hit global trade hard. In 2009 EU exports fell by 16% and imports dropped by 23%. Overseas investment also fell – by some 38%. In a way, these drops in global trade were unsurprising since they are closely associated with the fragmentation of the international supply chains. This fragmentation means that trade always responds more than proportionately to any change in GDP. Moreover, the decline in trade could have been worse. Without the EU, global efforts to fence off protectionism would have been far less successful. Markets have been kept open and trade flowing. We are currently witnessing a clear recovery of trade.

But we are not out of the woods yet. Whilst we have avoided the worst type of protectionist spiral, the global recession is leaving its mark on the jobs market. EU unemployment has now reached almost ten percent - wiping away a decade of progress. Unemployment is likely to stay high for some time, and experience has shown that there is a causal link between unemployment and protectionism. And still it would damage the first buds of an economic spring more than anything else if governments gave in to the temptation of erecting more trade barriers. If protectionism was already not an answer at the time of Adam Smith, it is even less so today. The reason lies in the way trade and the production of goods changed.

Nowadays, international trade does not mean buying shoes made in China or a Japanese car instead of a local brand. It means that you can hardly tell what country a product really comes from. What constitutes an American car? Is it one made by Honda in its plant in Indiana or one designed by General Motors and built in Mexico? How Finnish is a Nokia phone, when at least half of the estimated 100 billion components the company handles every year come from elsewhere? The truth is that if you wanted to print all countries of origin on the back of an iPod, you would have to make it bigger.

The production and distribution of goods tends to involve more and more countries before the final customer is reached. This is not done out of altruism but because it allows efficiency gains compared to doing everything at home. It is because of these gains that trade matters and makes us richer. But it can only do so if there is a set of clear and global rules, that countries feel bound by. Therefore, multilateral trade liberalisation and rule-making will remain my priority for the years to come.

We need to keep working hard to conclude the Doha Development Round. It will greatly benefit the world economy, plus it holds a range of systemic advantages that cannot be allowed to slip out of reach. The political reality however is that concluding the Round in 2010 will be very difficult. We will therefore need to be prepared to continue the negotiations into 2011, if that is necessary to adjust the draft package in a way that is acceptable for all WTO members. But I remain determined to reach an ambitious and balanced Doha deal in the near future, and I believe our WTO partners share that objective.

Alongside the multilateral track, we will also pursue our bilateral agenda, with a particular focus on countries with strong growth potential. Part of the growth that Europe needs to generate over the next decade will come from the emerging economies, as their middle classes import goods and services in which the European Union has a comparative advantage. Consequently, we will centre our attention on Asia and Latin America.

In Asia we will carry forward our negotiations with the ASEAN region, in which Singapore is our largest trade partner – and we are already off to a good start there. Negotiations with Singapore have triggered the interest of other ASEAN partners. For example, we aim to launch FTA negotiations with Vietnam in the second half of the year. And I am also encouraged by the signals we are receiving from other ASEAN capitals.

"... multilateral trade liberalisation and rule-making will remain my priority for the years to come"

Apart from this we are negotiating an FTA with India, and it is our ambition to agree on the details still this year. The first country in Asia we have finished FTA negotiations with is Korea. This deal presents not only a very beneficial package for the European economy but is also symbolic of Europe's capacity to liberalise trade even in a downturn, where other trading partners are struggling to maintain trade openness in the current economic climate.

A further area of attention is Latin America. During my mandate we finished FTA negotiations with Peru and Colombia, and we agreed on the conditions for an Association Agreement with Central-America. Additionally, the Commission just took the decision to re-launch the negotiations with Mercosur – an important step, despite the concerns of some EU countries. I am asked mainly three questions on this initiative:

First: Is Mercosur an interesting market for European enterprises? The answer is clearly yes. Its combined GDP exceeds €1,300 billion. The two largest Mercosur countries, Brazil and Argentina, have been growing at rates of four to six and six to nine percent respectively. Forecasts for this year and the next hover around five percent. And these countries are so far relatively closed for EU products.

Second: Are the Mercosur countries willing to make the necessary concessions in order to conclude? Well, our negotiators have had four rounds of informal discussions with their Mercosur counterparts. In their opinion Mercosur gave sufficient indications to demonstrate that they are serious about re-launching the negotiations. Whether this includes the necessary concessions remains to be seen. In any case this will have to work both ways: They know that, for example, the access of their agricultural products is very sensitive for us, just as we know that our offensive interests lie in industrial products, in services, in public procurement, and in intellectual property rights, to name just a few.

And finally: Will a trade deal with Mercosur prevent us from concluding in Doha? You have to see this in the light of our efforts on FTAs. We only negotiate such agreements, if they are compatible with the Doha Round and go much further in coverage than the Doha

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Round. I think that we can close both, the Mercosur negotiations and the Doha Round, if we are able to embrace the right compromise at the right time.

Besides negotiating Free Trade Agreements, we also need to take forward our relations with key economic players with whom we are not planning FTAs. Our relations with the US, China, Japan or Russia will do much to define five years from now whether the Union has made a real contribution to shaping rather than simply reacting to the challenges of globalisation.

This means that we will make proposals for strategic dialogues with key partners, to discuss topics such as market access, regulatory framework, global imbalances, energy and climate change, and access to raw materials, to name only a few. The immediate challenge is to re-energise the Transatlantic Economic Council with the United States and the High Level Economic and Trade Dialogue with China. These should provide a forum that delivers improved market access and helps prevent potential problems.

I see these partnerships as especially important if we want to support industries of the future, such as "green" and high tech products and services. We can do this through trade agreements and specific initiatives, but also by putting in place the right regulatory environment and international standards. In any case, what is at stake in the coming years is the capacity of trade policy to contribute to smart, sustainable and inclusive growth but also to help spreading our values in the world. Only if we succeed in doing this, we will have a chance to meet the high expectations that others have towards Europe. ■

Should the EU Support Russia's Modernisation?

Fraser Cameron is the Director of the EU Russia Centre, an independent information and expertise resource for anyone interested in the relationship between the EU and modern Russia

When EU leaders met with President Medvedev in early June in Rostov on the Don it was the first such meeting for Herman van Rompuy, the President of the European Council, and Catherine Ashton, the EU's foreign policy chief. By all accounts, the summit was constructive with Russia promising to be supportive of EU concerns regarding Iran and Afghanistan. The recent rapprochement between Russia and Poland following the tragic plane crash at Katyn also helped improve the atmosphere.

Rompuy hailed the talks as "friendly and fruitful", while Medvedev stressed they marked a "change in atmosphere" from past summits. But difficult issues were not ignored. Rompuy brought up the question of human rights stating that the situation for human rights defenders and journalists in Russia was of "great concern to the European public." He also pointed to Russia's violation of a 2008 deal to pull back its troops in Georgia to pre-conflict lines and hoped that Russia would play "a more constructive role" in neighbouring countries.

But the summit came as the EU faces deep internal divisions over the Greek debt crisis and a sagging euro - issues that Medvedev said had not gone unnoticed by Russia, which holds nearly half its reserves in euros. "I remind you that about 40 percent of our reserves are in euros and we don't have the smallest reserves," Medvedev told reporters. In an apparent answer to EU worries over Russia offloading its euro reserves, he said Russia would refrain from "hysterics about whatever problems pop up in other corners of the world, such as now in the European Union." Another concern was a decline in bilateral trade – down some 30 percent last year. According to the EU, the bloc's exports to Russia fell from €105 billion in 2008 to €66 billion in 2009.

"Against this background, Medvedev has sought to highlight the need for a thorough political and economic modernisation of Russia"

The main issue on the agenda, however, was the so-called "modernisation partnership" between the EU and Russia. "We want to be Russia's partner in modernisation," the EU president said. "With Russia we do not need a reset, we want a fast forward. President Medvedev's ambition to place Russia's modernization in the 21st century of democratic values by building a modern diversified and dynamic economy is a significant development for Russia," Rompuy stressed.

Russia openly recognises the need for modernisation although there is no consensus in Russia as to the extent of such a process. The EU is willing to help Russia but there are voices urging that any EU assistance should be conditional on fundamental reforms to the political as well as economic system, and a more cooperative Russian attitude towards its neighbours.

According to the summit statement, the priority areas of the *Partnership for Modernisation* will include: expanding opportunities for investment in key sectors driving growth and innovation, enhancing and deepening bilateral trade and economic relations, and promoting small and medium sized enterprises; promoting alignment of technical regulations and standards, as well as a high level of enforcement of intellectual property rights; improving transport; promoting a sustainable low-carbon economy and energy efficiency, as well as international negotiations on fighting climate change; enhancing co-operation in innovation, research and development, and space; ensuring balanced development by addressing the regional and social consequences of economic restructuring; ensuring the effective functioning of the judiciary and strengthening the fight against corruption; promoting people-to-people links; and enhancing dialogue with civil society to foster participation of individuals and business. This list of areas for cooperation is not exhaustive. Other areas for cooperation can be added as appropriate.

Impact of the global financial crisis

The global financial crisis hit Russia badly. Until the autumn of 2008 it thought it could escape relatively unscathed. But GDP declined almost 9% last year and income from energy sales dropped over 25%. Growth prospects for 2010 are low. Inflation and unemployment are both rising and there are increasing demonstrations against the government. As the oil price rose during Putin's term he was able to ensure pensions and wages were paid on time. But he completely failed to encourage investment in new industries, technologies or infrastructure. Now Russia is facing crunch time. The funds that were accumulated during the good years are running out. Top companies like Gazprom are close to bankruptcy and face huge problems due to the lack of investment in the energy sector. State controlled conglomerates and banks have been propped up by the state but SMEs, essential for future growth, have been neglected. Much of Russia's infrastructure is crumbling. There are hundreds of mono-cities without a future. There is a massive rich-poor gap and an even bigger gap between the regions. Even the elite do not believe in the future of Russia. They do not keep their money in the country and they send their children abroad to be educated.

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What does modernisation mean?

Against this background, Medvedev has sought to highlight the need for a thorough political and economic modernisation of Russia. He has described Russia as "a primitive and chronically corrupt economy based on raw materials" fixated on the old habit of relying on the state to solve its problems. Russia's democratic institutions were weak and the media environment "extremely challenging." Russia had to change course if it does not want to end up as a third world country.

Igor Shuvalov, first deputy prime minister, has given similar warnings. He recently told investors that although Russia had suffered its worst recession in a decade, it would be transformed into a "new country" by 2020 through innovation and investment in "human capital." He said the investment climate would be significantly improved within a year through a reduction of red tape and a clean-up of the court system.

"To reassure the EU and other international partners, Russia needs to give a categorical assurance regarding its commitment to join the WTO as soon as possible"

The problem is that we have heard this rhetoric before. When Vladimir Putin moved into the Kremlin a decade ago he promised to ensure the rule of law and tackle corruption. But under his watch there was no progress towards an independent judiciary and the corrupt bureaucracy was allowed to expand and continue taking bribes. It was under Putin that assets were taken or pressure put on Yukos, Shell and BP. It was under Putin that a growing number of investigative journalists such as Anna Politkovskaya were killed with impunity. It is little wonder, therefore, that investors are sceptical about new pledges to tackle rampant corruption and diversify the economy away from a raw-materials base.

A recent report by the Institute of Contemporary Development, an influential think-tank close to Dmitry Medvedev, called for a number of reforms. To encourage political competition, the report stated that there should be a return to the system of electing governors and senators, practices that was abolished by Putin when he was president. The report also called for greater freedom in the media (the state controls over 90% of all media outlets) to help expose corruption and encourage political debate. Unfortunately, but not surprisingly, the report found zero resonance in the media. The ruling United Russia party, controlled by Putin, sees no need for change either. The Duma is a rubber stamp for the executive and most deputies are more interested in enriching themselves than controlling the government.

A further problem for President Medvedev is that he has little support for his modernisation agenda. Nor does he have a team to implement modernisation in the key areas, partly because of a lack of qualified professionals. There is no rush of well-qualified Russians returning from abroad to help fix the economy. Furthermore, Putin, supported by the 'siloviki', is resisting all but cosmetic changes. He considers that modernisation should mean making the current system more efficient - not a radical change to the political system itself.

"The absence of the rule of law not only hampers the development of a modern, civil society but also discourages Western investment in Russia"

EU views

The European Commission has put forward its own views on what the modernisation partnership should cover. Top of the list is the rule of law. This also reflects the concerns of President Medvedev who has repeatedly drawn attention to the problems of "legal nihilism" in Russia. The absence of the rule of law not only hampers the development of a modern, civil society but also discourages Western investment in Russia. The complicated legislation concerning business, open to different interpretations, is another major problem for foreign investors. Given the potential for legal disputes, many Western now insist on including a clause within contracts as to where disputes should be settled.

Interestingly, even many Russian companies chose to use English courts. In fact over 50% of Russian cases that came before the English commercial courts in 2009 did not involve English companies and two-thirds of cases included at least one foreign party.

The EU, largely through its support for programmes run by the Council of Europe, already makes some limited contribution to the strengthening of the rule of law in Russia. The EU could also assist Russia in drafting legislation providing for the safeguard of foreign investments and private property. But the main push must come from Russia itself. Change has to start at the top and rhetoric must be followed by action. Many believe that the release of Mikhail Khodorkovsky, the imprisoned former boss of Yukos who recently went on hunger strike to protest at the disregard for Medvedev's legal reforms, would be a good signal of changed attitudes. Russia's laws concerning entrepreneurial activities are in many cases more liberal than those in EU. However, fair and effective implementation of the laws and the ability to fight one's case in an independent court are essential.

Russian GDP and exports are highly dependent on energy resources. The Russian leadership has acknowledged the importance of diversifying the economy and increasing its trade. But Russia has given contradictory signals about its willingness and commitment to join the WTO and introduced a number of protectionist measures, especially non-tariff barriers, during the past twelve months. To reassure the EU and other international partners, Russia needs to give a categorical assurance regarding its commitment to join the WTO as soon as possible. Until it does so the negotiations between the EU and Russia for a new strategic agreement will not be able to progress.

One area where both sides should see added value by working together is green technology. Russia lags way behind the EU in environmental standards and is one of the worst polluters when it comes to CO^2 emissions. Helping Russia achieve greater energy efficiency would be a real win-win development. Such a move would tie in with closer cooperation in science and research where Russia is strong in a number of fields. The EU should increase funding for cooperation in science and research and facilitate Russian involvement in EU programmes. This should be linked to the modernisation partnership.

Another area where Russia could draw on EU experience is regional development. There are huge inequalities between the regions in Russia, a problem compounded by the many mono-cities (dependent on one - usually out-dated - industry). Russia would also benefit from EU experience and technology in the renewal of its outdated infrastructure.

Such an ambitious agenda requires much more trust between both sides than is apparent today. There needs to be a vast increase in people to people contacts - students, businessmen, different professions, journalists, lawyers, etc. Russia is keen to see the abolition of visas for visiting the EU. This is a fine objective but it would have a better chance of success if Moscow stopped making EU businessmen register every time they visit a separate region in Russia.

In conclusion, the EU should support Russia in the modernisation of its economy and give clear priority to the rule of law and the fight against corruption. But such support needs to be conditional on Russia agreeing on a series of concrete actions to move towards a more open and democratic society. ■

NINE COUNTRIES. TWO CONTINENTS.

ONE PERSPECTIVE

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The Myth of Jobs Shipped Overseas

Jonathan Huneke is Vice President, Communications & Public Affairs at the United States Council for International Business

In an April column in *The Washington Post*, the economist Robert Samuelson observes that, when things were going well, the United States had what many called a "Goldilocks economy," not too hot, not too cold. At the time, that led economists to downplay potential bad news like the housing bubble. But now, he writes, we suffer from the reverse, an "Oscar the Grouch economy," where good news gets discounted and pessimism is trendy.

Samuelson identifies several positive signs, and they are positive indeed. For one thing, after months and months of dismal jobs reports, the United States added some 162,000 new jobs in March. That's the largest rise in three years. For the first time in nearly two years, he notes, more big-company CEOs expect to expand their workforces in the next six months than reduce jobs. And companies that have ridden out the credit crunch and the recession are sitting on more cash than they have in a long time, which augers well for outlays on machinery, office equipment and the like.

But America can't have a decent recovery just relying on the US market. We need trade and overseas commerce. As President Obama noted recently, 95 percent of the world's consumers live outside our borders. The president has set the ambitious goal of doubling US exports within five years – something the business community supports wholeheartedly.

"... global engagement isn't a danger ... It's not even a luxury, something we can dabble in. In today's world, it's a necessity"

After the onset of the financial crisis, the global falloff in trade was precipitous – far more severe than the overall drop in income. To get trade moving again, we need to ratify the pending free-trade agreements with Korea, Panama and Colombia, and we need to aggressively begin trade negotiations with major countries in the Pacific and elsewhere, and bring the long-stalled Doha Round of global trade talks to a successful conclusion.

And yet trade is only part of the equation. To succeed and prosper in the years ahead, most officials and politicians at the local and state levels know they need to attract the most competitive industries and companies to do business in their jurisdictions. That's something the United States as a whole needs to focus on as well.

Overall, foreign investors in the United States employ over five million people, and pay their employees 32 percent more on average than the private-sector average. Governors and mayors across the country – and indeed around the world – know the importance of foreign direct investment. That's why they compete aggressively to win new plants and investments from Europe, Asia and elsewhere. They know that FDI drives the growth of many of the most successful local and regional economies.

So investment will be crucial to our economic future. But what about outbound investment? What's the image that most often comes to mind when you think about outbound investment by American companies? If you're like many people, you think of outsourcing, of shipping jobs overseas. Certainly politicians around the world have made a lot of mileage out of that idea.

But what if someone told you that the whole idea of companies "shipping jobs overseas" is a myth? Not in individual circumstances, of course. There are always plenty of dismal stories and anecdotal evidence of companies closing plants, outsourcing operations to one country or another.

But what if somebody showed that, on balance, across the entire economy, the evidence clearly shows that companies taken as a group are not shipping American jobs overseas? Well, somebody has.

In a study my organization commissioned with the Business Roundtable, and released in March, Professor Matthew Slaughter of the Tuck School of Business at Dartmouth sifted through the most recent data on company operations from the US Bureau of Economic Analysis. His conclusion? On balance, American multinational companies create new and better-paying jobs here in the United States through their participation in the global economy. What's more, Professor Slaughter shows that the overseas operations of these companies complement – rather than substitute for – domestic employment, employee compensation and investment.

Let's take a look at some of Professor Slaughter's findings. In terms of overall performance, the extent to which US multinationals outperform many other parts of the economy is undeniable – they are truly our most competitive enterprises. With just 20 percent of overall domestic employment, multinationals provide 25 percent of our domestic output, 30 percent of capital investment, 45 percent of our exports and fully 75 percent of domestic R&D.

Professor Slaughter's research also demonstrates that the additional jobs created in the United States through trade and investment abroad tend to be high-paying, and require knowledge creation, capital investment and exporting. He illustrates that US workers of American multinationals make on average about 20 percent more than their private sector counterparts. In dollar terms, that means these workers are bringing home an extra $10,000 every year on average.

This study further reveals that the worldwide operations of multinational companies are highly concentrated here in the United States, not in their overseas affiliates. The majority of their employment (69 percent), output (70 percent), capital investment (74 percent) and R&D (85 percent) take place in their domestic operations.

Slaughter writes – and this is my main point: *"We often hear that companies are shipping jobs overseas to low-income countries, but the data does not support that argument. Far from 'abandoning' the United States, as critics charge, worldwide American businesses employ more than two workers in the United States for each worker employed at a foreign affiliate."*

We didn't make up these figures. They're drawn directly from hard data collected every year by the Bureau of Economic Analysis, part of the US Commerce Department. Economists agree that this data is the most reliable of its kind anywhere in the world. In fact, part of our motivation for publishing this report is to spur other countries to provide similar data for their citizens to review.

In his study, Professor Slaughter argues quite reasonably that, given their central role in underpinning domestic economic growth and job creation, US multinationals must continue to focus on strengthening their competitiveness by actively engaging in investments overseas. And our policy makers must take steps to make it easier for these companies to grow.

He writes: *"The expansion of worldwide American companies into*

innovation@work™

"One that would have the fruit must climb the tree."

—THOMAS FULLER

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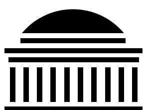
Sep 12–17	Driving Strategic Innovation: Achieving High Performance Throughout the Value Chain
Sep 13–14	Developing and Managing a Successful Technology and Product Strategy
Sep 13–14	Managing Technical Professionals and Organizations
Sep 15–16	Understanding and Solving Complex Business Problems



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international markets has long supported economic growth and employment here at home. In recent years, though, the United States has become a slow-growth market compared with much of the world. This, coupled with our current economic challenges, makes it more critical than ever for US workers and businesses to compete and succeed in the global marketplace."

Slaughter notes that some 8.5 million jobs have been lost since the beginning of the recession in late 2007. *"To fully recover from this recession and ensure long-term growth, our nation's top priority must be to create millions of jobs: and not just any jobs, but the high-paying, investment-and export-oriented jobs that worldwide American companies create. The best way to do this is to help our companies successfully tap into foreign markets."*

Professor Slaughter's findings confirm what companies operating globally have long known. First, there are major opportunities for growth and exports in overseas markets. Second, to be close to your customers, you have to have a physical presence in these markets. And third, there is an integral, positive relationship between worldwide and domestic operations at US multinationals, meaning that success overseas leads to greater success at home, including more and better jobs.

To summarize: with the vast majority of the world's consumers outside out borders, global engagement isn't a danger for us. It's not even a luxury, something we can dabble in. In today's world, it's a necessity. ■

Financial Regulation – From Micro- To Macro-Prudential Rules

Angela Knight is the Chief Executive of the British Bankers' Association

The key priority of regulation

Following the collapse of Lehman Brothers in September 2008 and the freezing of the worldwide financial system, the consequences on the banking industry have been extensive across the world. The UK government's direct intervention during the banking crisis – coordinated with action on the part of other governments – stabilised the system. But now the bill must be paid, and protections put in place to ensure such a crisis does not happen again.

Unlike the US and many other countries, in the UK the banking industry has been paying for the stabilisation already. And the three banks which were in receipt of taxpayer money are all now performing well and on course to pay that investment back in full.

" ... the European Commission has proposed an EU-wide bank levy to create a network of resolution funds – this would not provide all the answers, but has set the terms for what is likely to be a prolonged debate"

Measures to increase the resilience of the banking industry have already taken place, or are in the process of being implemented. These include banks holding more loss-absorbing capital and putting in place better liquidity buffers. Contingency planning is underway in the context of recovery and resolution plans, but very importantly improvements in corporate governance, risk management, accounting, product simplification and measures to reduce the interconnectivity of firms have already been implemented. The future needs to build on these existing measures while at the same time paying close attention to their impact on the wider economy.

To reduce the potential impact of a bank failure - and crucially to ensure the consequences are paid for by the industry, and not the taxpayer - the special resolution measures in last year's Banking Act are vital. The special resolution regime, linked to the recovery and resolution plans, will ensure that in the event of any failure in the future the authorities can act swiftly and effectively and without an automatic recourse to taxpayers' money. Other countries need to follow suit rapidly to put in place similar schemes if they have not already done so.

These changes mean that no institution need in future be viewed as too important to fail. There is clearly a debate taking place internationally about whether there should be an internationally-agreed framework, with core principles for resolution funds operated at national level. Some are also debating whether there should be a European intervention fund, which raises some important questions: how would this be coordinated; would it be pre-funded; what would be its commercial return; and, vitally, how would it tie into the regulatory capital regime? Recently the European Commission has proposed an EU-wide bank levy to create a network of resolution funds – this would not provide all the answers, but has set the terms for what is likely to be a prolonged debate.

Changes to the deposit protection scheme have also contributed to shifting the burden from the taxpayer to the banking industry. The Financial Services Compensation Scheme has in effect been transformed into an intervention fund and the limit for the protection of retail deposits has increased to £50,000.

Tax as a regulatory tool

The question of whether the financial sector should contribute more tax than it currently pays to support broader social objectives – possibly through the design of a tax aimed at correcting what are described as excessively risky or destabilising activities – raises the prospect of an internationally co-ordinated approach, possibly in the form of transaction tax. Some governments are still advocating this, to the extent that it is important to remind ourselves why these taxes are not appropriate – or practical:

- banks and financial services already make a contribution to tax receipts that are significantly higher than their proportion of GDP (in the UK last year the financial services industry paid was responsible for £61 billion in tax revenue);
- if the object is to moderate risk-taking activity, then capital and liquidity requirements are a more appropriate means of achieving this: they discourage excess and additionally ensure that the resource is there to deal with potential loss;
- a transaction tax would inevitably pass through to the customer, who is already facing increases in the cost of their financial services and new regulatory requirements come online; and
- transaction taxes significantly distort business - both in terms of what is undertaken and where it is located.

The case for macro-prudential policy

Macro-prudential regulation provides the link between stewardship

of the economy and the oversight of individual firms. It should not be allowed to divert attention from the need for economic reform in other areas, such as monetary policy, where the financial crisis has exposed weaknesses (for example, the failure to address structural issues such as the deflationary impact of China leading to interest rates being kept too low, the asymmetric use of interest rates, or the exclusion of housing costs from the UK inflation target). But looking ahead, policy tools - whether regulatory, monetary, fiscal or other - will need to complement to the need for a longer-term shift in balance in the UK economy from consumption and borrowing to savings.

Without due attention to these economic factors, macro-prudential regulation - however well designed - is unlikely to prevent another crisis. It does though offer the potential to be an important component in the prevention of future crises, although its costs in aggregate with other proposed changes need to be carefully considered.

Regulation is already being made to do most of the heavy-lifting for a wider set of problems. We would not, however, want the focus on new initiatives to address the supply side to divert attention from more uncomfortable questions about the role of monetary policy authorities in managing the demand side. Given the build-up of public sector deficits and sovereign rating concerns, the next crisis (and systemic risk) could conceivably be on the fiscal or demand side rather than originating in the banking sector.

The objectives of macro-prudential policy

Although the high-level objective of macro-prudential supervision should be the maintenance of financial stability, there is a broad spectrum of possible objectives for macro-prudential policy: at one end, protecting the banking system from the economic cycle; at the other, seeking to moderate asset price bubbles or financial imbalances more broadly.

It is probably unrealistic to make the prevention of asset bubbles the principal objective of macro-prudential policy, although it could reasonably be expected that, by moderating the exuberant supply of credit, macro-prudential policy might go someway towards mitigating bubbles. Conversely, the objective should be more ambitious than simply increasing the resilience of financial institutions in the face of the economic cycle. There is clearly, therefore a balance to be struck between these two.

This balance, and therefore the objective of macro-prudential policy, should be to protect the economy against a rising threat of financial instability and to maintain, through what might otherwise have been severe economic disturbances, the essential services banks provide to the wider economy. The targeting of asset price bubbles should be part of the regime, but not the overriding objective.

"The targeting of asset price bubbles should be part of the regime, but not the overriding objective"

From the perspective of the banking industry, a key objective for any macro-prudential model should be to ensure that it complements rather than simply adds to measures being taken in the prudential regulation and supervision spaces. It should help lead to the development of a 'smarter' regime which is based upon the level of capital held in the system, reflecting the level of risk dynamically.

Macro-prudential instruments

Choosing between macro-prudential instruments involves trade-offs. As the Financial Services Authority puts it, it involves balancing the desire to exercise leverage over credit supply decisions on the one hand, and the desire to minimise effects on the commercial decision-making of financial institutions on the other. Adjusting headline capital adequacy ratios as a means of attempting to control the supply of credit to the economy could, for example, have perverse effects. If policy makers were to increase headline capital requirements in response to concern at over-exuberance in one area of the economy, banks could respond in very different ways, including the perverse reaction of cutting lending to parts of the wider economy where returns and risk are low, while continuing to lend to sectors where returns and risks are higher. Any tool which is adopted, therefore, must be capable of targeting activity in specific segments of the economy.

This is something which perhaps the most favoured macro-prudential tool - counter-cyclical capital ratios – can do. A dynamic approach to capital requirements could be designed to be more alert to systemic stresses and more closely aligned with macro indicators in the wider economy. From an industry perspective, this would mean allowing institutions to run on lower capital ratios once bubbles have been deflated and an economy moves into the recovery phase. The danger is that capital requirements raised as a defence against periods of stress would, in practice, become permanent.

Whichever tool or combination of tools is considered, it is important to weigh the potential impact on lending to businesses, financial institutions and the competitiveness of the UK as an international financial centre. It is also important not to forget past experience. Earlier UK experience shows that multiplying the number of restrictions on banks' balance sheets was rarely beneficial. It added complexity and thus distortion without any correspondingly greater degree of control. As in a monetary policy context, this suggests there should be a strong preference for simple, targeted measures wherever possible and we should aim to avoid a proliferation of instruments.

Implementation considerations

The questions of practical implementation raised by macro-prudential regulation are formidable:

- the need to focus on a wider range of issues than simply credit supply;
- the importance of real-time feedback data;
- leakage – both across borders and sectors;
- the accountability, credibility and legitimacy of the decision making and implementation processes;
- the willingness to act; and of course
- unforeseen consequences.

The future

It is incontrovertibly the case that part of the process of addressing the causes of the economic crisis lies in reform of regulation, financial markets and the internal governance and processes of institutions and their supervisors, and that some of the answer also lies in filling the gap between the stewardship of the economy and the prudential supervision of individual institutions.

There is a place for macro-prudential policy but its development must be considered together with reform in the other areas in which the financial turmoil exposed weaknesses.

Reform of the banking industry is well underway, with new capital requirements in place, the thorny issue of pay and bonuses controlled by the regulator and a resolution scheme in place to ensure the consequences of failing banks are paid for by the industry, and not the taxpayer.

But policy makers need to consider carefully the cumulative price tag of all the demands the government is placing on the banking sector - and remember that money spent, or tied up, cannot be lent out to businesses and individuals. This will have an inevitable impact on the availability, and the cost, of loans. In turn, this will hurt the economic recovery, just when it needs support most.

In short, the UK banking industry is at the table for change providing the resulting measures are proportionate, target the right areas, build upon the analysis that has been undertaken, and that the impact on the wider economy is assessed carefully at each stage. ■

Private Air Charter: Changing Winds

Mark Briffa CV and Fast Facts

Career highlights

1994 Joined Air Partner's London Gatwick HQ as a Commercial Jets Broker
1996 Promoted to Senior Analyst
1999 Promoted to Commercial Jets Manager, UK
2001 Appointed Managing Director, UK
2006 Appointed Chief Operating Officer and joined the Board of Directors
2010 Appointed Air Partner CEO

Best part of Air Partner: the people

Motto: Success drives success.

The aviation industry has changed considerably since the heady days that preceded the 2008 economic crash and is arguably undergoing the most turbulent period in its history. Mark Briffa, the new Chief Executive Officer of Air Partner plc, speaks to World Commerce Review about the air charter industry today and how he sees it developing in the future. Air Partner is a leading provider of private aviation services to industry, commerce, governments and private individuals worldwide.

Despite tentative signs of improvements at Air Partner, one of the world's largest air charter brokers, Mark Briffa, the recently appointed CEO, is cautious on the outlook for the industry. *"I don't think we are through the recession yet"* he suggests, *"there is still too much aircraft capacity and pricing is under pressure."* Briffa goes on to explain that the boom days allowed new players to take advantage of the industry's low barriers to entry and set up brokerages. While good news at the time, today, in the midst of the worst recession in aviation history, many have closed and more will follow suit in a "changing industry."

Briffa is a hands-on CEO; he sits on the broking floor, his finger firmly on the pulse. This is a perspective that affords plenty of insight into what is driving the market: *"Commercial jet charter is experiencing such over capacity that smaller players are discounting just to generate cash and keep their businesses solvent."* While currently this negatively impacts the whole sector, Briffa believes that over the next five years the sector will shrink as smaller brokers disappear, leaving only the most established names or hardened firms to survive. He continues: *"At Air Partner we have the financial resources and requisite skills to price and pitch at levels that our peers can't sustain. As a result, we are being asked to quote more frequently. Users of private aviation are looking for change; they want to see value for money, combined with high quality standards and excellent service levels – not everyone can provide this."*

While Briffa does not believe the commercial jet sector is easy for anyone in today's climate, he points out that Air Partner gained market share in previous recessions and emerged in an even stronger position than it was before. Adding substance to his claims, he points to the financial health that Air Partner entered the current downturn in and the fact that the company, which has been trading for almost fifty years, still has significant cash reserves and no debt. He goes on: *"Air Partner is fully listed on the London Stock Exchange and has to update the market on its performance quarterly, so our financial performance is matter of public record."*

However, the downturn has been severe and even Air Partner has found it tough, but Briffa believes Air Partner's longevity and track record are unique attributes. *"With Air Partner, not only do you know that the company will still be trading when your departure date comes around, you also know you are in the best hands."*

Briffa wants the industry to step up its own levels of responsibility because *"low barriers to entry allowed unqualified players into the broking market which has made accountability very difficult"*. Looking ahead, he believes this could become even more of an issue as larger charter brokers increasingly market the best aircraft on an exclusive basis. *"In a falling market you want to make sure you are with a reputable player. There is an increasing polarisation between what aircraft are available and what you are prepared to put your CEO on."*

On the subject of the private jet sector, Air Partner has seen this market change drastically. *"Private jets were the ultimate asset to show off wealth, but today they need to demonstrate value,"* says Briffa. *"Air Partner has seen enquiries grow as those previously locked into fractional ownership schemes look for more flexible forms of jet usage. In short, the market fell and fractional owners got stuck with large stakes in jets that nobody wanted to buy."* Today, clients are much more price-conscience and looking for "flexibility and a get-out clause". Air Partner believes fractional ownership will continue to decline because *"people are no longer looking for a long term investment in aviation"* and expects its private jet growth to be driven by flexible programmes like its JetCard,

which offer pre-paid flight hours. *"These allow clients to enjoy the positives of private aviation, such as saving time and flying to tailored schedules, without owning the asset."*

Briffa also expects the charter broker market to further globalise in line with client requirements, which will lead to further work for brokers. *"The more globalised private aviation becomes the more complex the market appears and the less accountability there is. Therefore, while technology and accessibility to operators will improve over the years, nothing will replace the reassurance of a trusted team."*

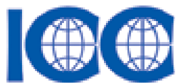
With 20 offices across the globe, Air Partner has significant experience rolling out its offer internationally. Briffa expects South America to be an area of growth for the Group. Capacity for air services between Europe and Latin America has grown by nearly 40 per cent over the last decade and the increasing business ties between the continents, combined with the growth potential of leading South American economies, mean this could be a big market for private aviation. Asia and the Middle East are also areas flagged for growth, and Air Partner's recently established Russian presence is already proving fruitful.

Finally, what does the new CEO believe the charter broker sector might look like in 2015? Answer: *"Fewer players, more globalisation, greater flexibility for clients and an increased focus on quality."* Industry observers seem to agree with this analysis and if it is proved right, Air Partner will be well positioned for tomorrow's world.

The company

Air Partner was founded in 1961 as a training school for military pilots looking to convert to civilian flying. Over the years it evolved into an air charter broker, listing on the London Stock Exchange's main market in 1995 and developing into what, today, is a global operation with a 24/7 year-round Flight Support Centre at its London Gatwick headquarters. Air Partner is the only aviation provider to hold a Royal Warrant from HM Queen Elizabeth II. Clients include royal families, governments and NGOs like the United Nations, Red Cross and World Food Programme.

The company's core divisions comprise Air Partner Commercial Jets, Air Partner Private Jets and Air Partner Freight. The Commercial Jets division charters large airliners with 20 to 500 seats for groups of every size. Over the last five decades, it has devised and executed many of the most complex air operations in civil aviation as well as thousands of routine, yet individually bespoke flights. These can be anything from large product launches to birthday weekends, Arctic troop exercises to night approaches into Basra. The Private Jets Division offers ad hoc charter and the company's unique pre-paid JetCard scheme. ■



The Outlook Remains Unclear For Trade Finance

The results of a new International Chamber of Commerce survey titled "*Rethinking Trade Finance 2010*", has revealed that prospects for strong and lasting trade recovery are mixed, with access to affordable trade finance constrained, trade protectionism still a problem, and banks facing tougher capital requirements for their trade assets.

The major trade finance survey includes the results of specific responses received from 161 banks in 75 countries, a 32% increase in the number of respondents compared with the last global survey in March of 2009. The surveys, including an interim one published in September, were commissioned by the World Trade Organization's Expert Group on Trade Finance to track developments in the industry.

"Protectionist measures should be resisted, as they curtail trade flows and add to the adverse effects of the global recession on individual country exports, economic activity and unemployment"

"The 2010 survey has confirmed that the current global financial crisis has continued to affect financial institutions and markets worldwide," the report concluded, citing a 12% drop in trade in terms of volume last year, the sharpest decline since World War II.

"This is a challenging economic environment, and trade volumes may be further impacted in the coming months. On a global basis, the predictions for 2010-2011 remain cautious; many expect that the economic turmoil will continue to predominate," it added.

Nevertheless, 84% of respondents said they anticipated an increase in demand this year for traditional trade products such as commercial and standby letters of credit and guarantees.

Victor K Fung, ICC Chairman

In terms of value 60% of respondents indicated that trade finance activity had decreased between 2008 and last year, while 43% of financial institutions reported a decrease in export letters of credit volume, slightly down from 47% in the 2009 survey. Regarding imports, 26% of respondents said they saw a decrease in import letters of credit, with 51% seeing no change from 2008.

ICC said the drop in trade was less marked in some regions, particularly Asia. It said most Chinese partners benefited from that country's fiscal stimulus package and the rebound in Chinese imports. Worldwide, exports of durable goods were most affected, while trade in non-durable consumer goods including clothing and food declined the least. The services trade was generally more resilient to the crisis than the merchandise trade.

"The survey is a continuation of ICC's long series of actions in support of international trade," ICC Chairman Victor K Fung wrote in a foreword to the report. *"In recent years ICC has emphasized the imperative of concluding the Doha Round of trade talks and on continuing the fight against protectionism."*

The report took note of the pledges to fight protectionist pressures by G20 countries following the Washington, London, and Pittsburg summits. *"Yet since the onset of the crisis, many countries have veered towards policies that favour domestic products over foreign imports,"* the report noted. *"Protectionist measures should be resisted, as they curtail trade flows and add to the adverse effects of the global recession on individual country exports, economic activity and unemployment."*

But while demand for trade finance remains strong for traditional trade finance instruments, the costs remain substantially higher than before the global recession. Some 30% percent of respondents said there had been an increase in fees for commercial letters of credit, standbys and guarantees in 2009. The increase was attributed to higher funding costs, increased capital constraints, and greater counterparty risk.

Also worrying is the intense scrutiny of documents by banks, with 34% of respondents saying they had seen an increase in the number of refusals for trade finance, up from 30% in 2009. The number of doubtful or spurious discrepancies remained high, with 44% of respondents indicating that they had experienced such cases compared with 48% the previous year, at the height of the financial crisis.

"This trend toward claiming discrepancies that effectively have little or no foundation is worrisome and may prove damaging to the integrity of the documentary credit as a viable means for settlement in international trade," the report warned.

The report raises concerns that despite the injection of US$250 billion in aid for trade finance over a two-year period, made available following the G20 summit in London in April 2009, evidence is accumulating that the implementation of the capital adequacy regime under Basel II rules is contributing to the drought in trade finance. ICC has expressed concern in the past that the proposal by the Basel Committee on Banking Supervision to increase the risk weighing of trade finance under a new framework to limit bank leverage would adversely impact the supply of cost-effective trade credit to businesses.

"It appears that low-risk trade finance instruments are being lumped together with higher risk off balance sheet items, without an appreciation of unintended consequences," the report added. ■

The full report can be found online at:

www.iccwbo.org/rethinking_trade_finance_2010

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Capital Market Regulation in Response to the Crisis

Paul Richards is the Head of Regulatory Policy and Market Practice at the International Capital Market Association (ICMA)

In response to the recent international financial crisis, there are a large number of new regulatory and supervisory initiatives, especially in Europe, which will have an impact on the international capital market, and some of which may affect market efficiency. The purpose of this article is to provide an introductory assessment of the proposals for changes in: prudential regulation and supervision; the market structure; and the market infrastructure.

Prudential regulation and supervision

Two new institutions are being created at European level, prospectively from the beginning of next year, both of which will have an impact on the international capital market. First of all, at macro level, the European Systemic Risk Board (ESRB) is being established to provide early warning of systemic risks, in response to criticism that, before the recent crisis, warnings were either not made or not sufficiently heeded. The impact of early warnings by the ESRB on the international capital market needs to be considered very carefully. Much depends on the nature and target of the warnings. If they are general and not made public, there is a risk that they will not be taken sufficiently seriously by the intended recipients. But if (in the last resort) they are made public and are sufficiently specific, the risk is that publication will bring about the very events that the warnings are designed to prevent.

To help prevent another crisis, new capital and liquidity requirements are being proposed by the Basel Committee, which will have an impact in particular on systemically significant firms operating in the international capital market. More and higher quality capital, and higher liquidity, will be required; a leverage ratio will be introduced; a countercyclical capital framework is being designed to reduce, rather than increase, the incidence of economic shocks; and more capital will be required for counterparty credit risk exposures arising from derivatives, repos and securities financing activities. These measures raise two main concerns. The first is that, if implemented too soon, they risk reducing banks' ability to lend to finance the economic recovery. Second, an important related question is how to assess the aggregate impact of the different measures proposed: they may each look sensible, if taken separately, but still impose a larger burden on the financial system than intended, when taken in the aggregate.

> **"... it is clear that the authorities' approach to supervision is changing as a result of the crisis"**

New crisis management procedures are due be introduced, in case another crisis does occur, to help resolve it at minimum cost to the taxpayer. They are likely to give national authorities the powers: to intervene early; to encourage contingency planning by market participants; and to take steps to reduce contagion from a future bank failure. The key question is whether the new measures will help to resolve the problem of moral hazard which arises when financial institutions are "too important to fail". It is clear that moral hazard does not just relate to the size of financial institutions, but to their interconnectedness through the international capital market. The introduction of a resolution regime may help simplify the complex task of winding down banks operating across borders that become insolvent in the future, but it is unclear how well the regime would work in practice in a crisis, when time is of the essence. Use of contingency capital is another possibility, though untested in a crisis so far.

A related question being considered by the IMF at global level on behalf of the G20 is whether financial institutions that are "too important to fail" should be required to pay a levy for the implicit public support on offer from the financial authorities on behalf of the taxpayer: either ex post in compensation for the cost to the taxpayer arising from the recent crisis, or ex ante in preparation for the next one. Obtaining international agreement on cross-border resolution regimes and on levies may not be straightforward. But in the absence of international agreement, there is a risk of regulatory arbitrage.

Second, at micro level, the Committee of European Securities Regulators (CESR) will be replaced by the European Securities and Markets Authority (ESMA) from the beginning of next year with more powers – in particular, powers to arbitrate between national regulators so as to help create a Single EU Rulebook. In the case of new legislation, one way of tackling national differences in future is to make more use of regulations (which have direct effect in all EU member states) rather than directives (which have to be transposed in each member state into national law). But that still leaves the problem of conforming existing EU directives (eg. the Prospectus Directive), which are currently implemented or interpreted in different ways in different member states. And ESMA's powers will, initially at any rate, be quite limited.

Nor will ESMA's powers within the EU necessarily help prevent regulatory arbitrage between the EU and the US. There are a number of difficult issues to address: front running (eg. in the case of the EU proposal on credit rating agencies, which ran ahead of the US, and where equivalence for third country ratings in the EU has still to be established); inconsistencies between the EU and US regimes (as feared in the case of the regimes planned for the clearing of over-the-counter (OTC) derivatives); and alleged discrimination (in the case of the proposed Alternative Investment Fund Managers Directive, where access to the EU from third countries and a possible link between access and equivalent regulation has still to be resolved).

Besides the introduction of new regulations, it is clear that the authorities' approach to supervision is changing as a result of the crisis, both as regards financial institutions and markets. The new approach is more "intrusive" than the old one, particularly in countries which previously had a "light touch" regime, even though it was not called this. In the case of the UK FSA, the new "intrusive" approach does not just involve assessing the systems and controls of firms it supervises, but second-guessing the management of supervised firms as well. Even though second-guessing is regarded by supervisors as necessary, it seems unlikely to be sufficient on its own. Much will depend on the quality of the management – and especially the management of risk – in supervised firms.

Market structure

In response to the crisis, the structure of the international capital market is coming under greater scrutiny from regulators in a number of ways. Regulators are giving a much higher priority than before to market transparency. At first sight, transparency looks like a "free good", but actually it involves difficult trade-offs: for example, increasing transparency in over the counter (OTC) markets (an over the counter market is one where trading in financial instruments such as stocks, bonds, commodities or derivatives is conducted off-exchange directly between two parties) may damage liquidity. Some regulators now argue that liquidity itself may only be useful up to a certain point.

Some regulators appear to be promoting the use of exchanges at the expense of OTC trading, whereas a level playing field between OTC and exchange trading is the best way of promoting competition. OTC markets are to be regulated more heavily than before, particularly OTC derivatives. This raises the question whether the new requirements being introduced in the OTC derivatives markets – relating to central clearing, regulatory reporting and transparency – will eventually be extended to the OTC cash markets as well.

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The perimeter of financial regulation is being broadened. Even though institutions (such as hedge funds) previously outside the perimeter of regulation were not one of the main causes of the recent crisis, it is proposed that they should be regulated in case they pose systemic risks in the future.

Finally, regulators are giving more attention to the suitability of financial products: not just to protect investors; but also to promote the integrity of markets. The authorities are considering whether some types of transactions in financial instruments (eg. naked short selling via credit default swaps) should be banned. But if the authorities suppress transactions in particular financial instruments, there is a risk of unintended consequences elsewhere, given the degree of integration in the international capital market.

Market infrastructure

A separate priority for the authorities in response to the recent crisis is to make the market infrastructure more resilient: for example, by encouraging liquid derivatives contracts to be cleared through central counterparties (CCPs). New EU legislation is expected to be proposed by the European Commission this summer. This raises several difficult issues.

Use of CCPs reduces the risk between counterparties, but may have the effect of redistributing the risk across the system as a whole, and creating new financial institutions that are "too important to fail". Not all transactions can be cleared through CCPs but, in the case of those that can (eg. liquid derivatives contracts), there are questions still to be resolved whether use of CCPs should be voluntary or mandatory, and if mandatory whether CCPs will be able to cope; whether CCPs should compete or become monopolies (as in the case of the DTCC in the US); and whether it matters where they should be located.

If market participants are required to record transactions not cleared by a CCP in a trade repository, the confidentiality of market-sensitive data will also need to be safeguarded.

Implications for ICMA and the capital market

This regulatory agenda has a number of implications for ICMA's work on behalf of our members as standard setter in the international capital market. We need to draw the authorities' attention to the practical implications of new measures which are likely to have an impact on the efficiency of the international capital market. In setting standards in the international capital market, we need to ensure that these standards are consistent with the new regulatory measures proposed and, when standards are set, regulators have emphasised that they expect them to be implemented. ■

The International Capital Market Association (ICMA) represents a broad range of capital market interests including global investment banks and smaller regional banks, as well as asset managers, exchanges, central banks, law firms and other professional advisers. ICMA's market conventions and standards have been the pillars of the international debt market for over 40 years.

Article reproduced from the International Capital Market Association Regulatory Policy Newsletter, April 2010.

Public Finances Taking a Heavy Toll on the Incipient Recovery

Marc Stocker is a Director in the Economics Department at BUSINESSEUROPE (The Confederation of European Business)

After a very deep, but short-lived recession, the economic recovery in Europe is underway, driven by a resurgence in global trade and industrial activity. However, an exceptional degree of uncertainty still characterises the current environment. This uncertainty has been recently accentuated by renewed instability in financial markets linked to growing concerns about fiscal sustainability in a number of European countries.

Confidence in the euro has been undermined and the substantial challenges ahead to sustain this recovery should not be underestimated.

First of all, evidence is mounting that Europe is missing out in an otherwise vibrant global recovery. The crisis has further shifted the centre of economic gravity towards Asia and emerging economies, which suffered must less severe consequences from the global financial crisis. But Europe is also losing ground in the developed world, which is expected to grow twice more rapidly than Europe this year. The US in particular will see growth of close to 3% in 2010, with significant improvement in productivity and corporate profitability while Europe is struggling to adapt and appears more affected by lingering problems in the financial sector and growing public indebtedness.

This is worrying because (1) most companies are now reviewing their strategies and might reconsider investing in Europe in such global environment and (2) without faster growth the necessary process of fiscal consolidation will be painstaking.

Finding the right policy mix will not be an easy task. But the cost of inaction would simply be unbearable. We calculate that if growth remains stuck at around 1% and governments only aim to bring their primary balance (net borrowing excluding interest payments) back to equilibrium by 2014 (with a consolidation effort averaging 1% of GDP per year from 2011 onwards), public debt in the EU would still continue to rise and reach 100% of GDP by 2017. See Figure 1.

By that time, interest payments on public debt alone will outweigh the combined national budgets on education and research. But the dislocation of productive resources will occur much more rapidly, increasing the cost of capital for companies, raising expectation of higher taxes in the future and posing a severe threat to financial stability across Europe.

To put public debt on sustainability course, we foresee that a combination of significantly higher growth, of at least 2%, and sustained primary surpluses of close to 3% of GDP will be needed. This represents a major policy challenges, both for individual countries and the euro area as a whole.

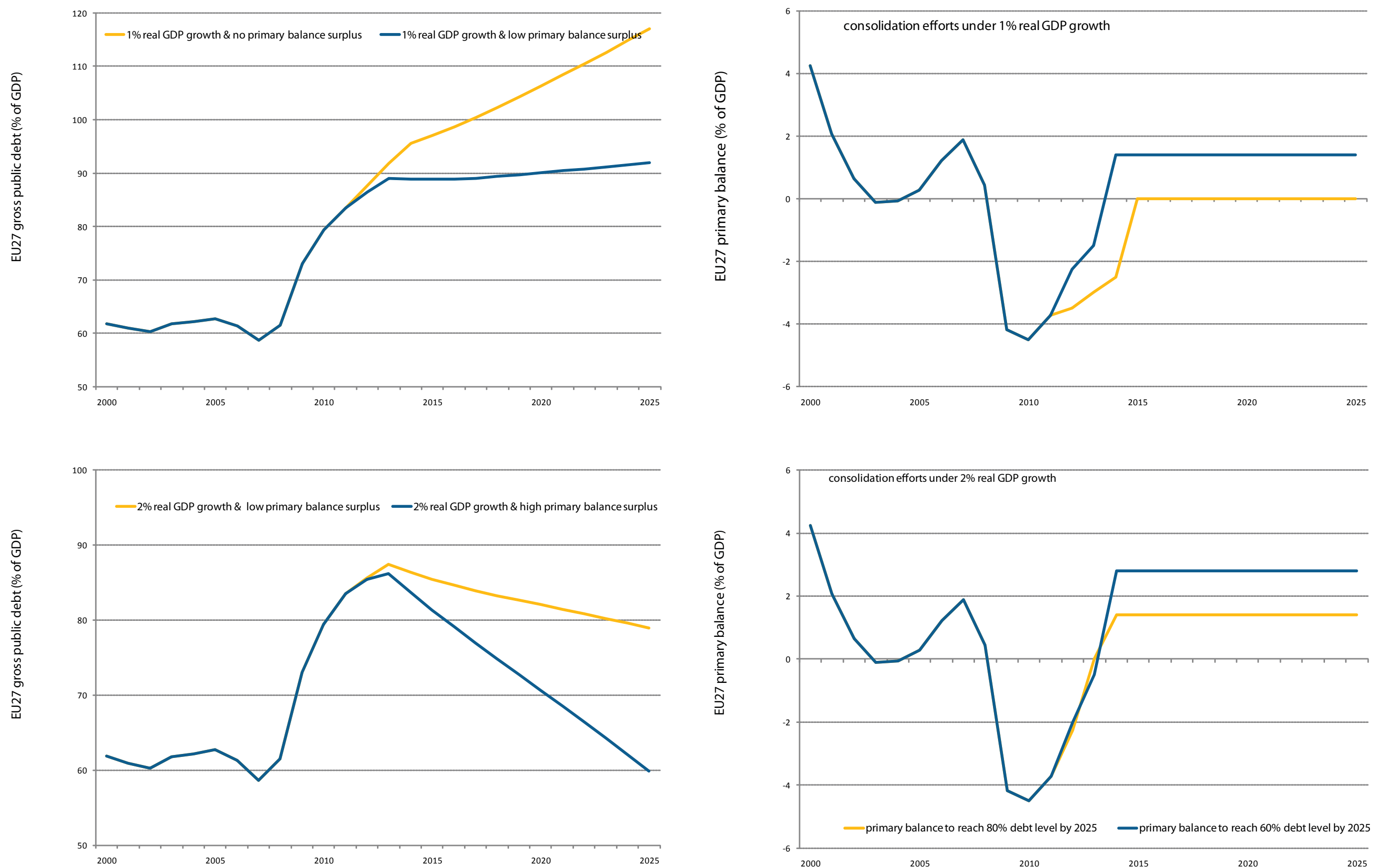
Sustainability of public finances is a major concern for businesses, as the growing financing needs of governments are hampering the availability of capital for companies, is a growing source of financial instability and raise expectations of higher taxes in the future. Beyond the immediate loss of confidence in the euro and growing uncertainty on capital markets, companies fear above all the risk of tax-driven consolidation, which would undermine their activity without supporting fiscal sustainability in the long term.

Instead, businesses advocate far-reaching reforms able to combine growth and fiscal sustainability in the years ahead.

A common European strategy is slowly taking shape, which includes in the short run the introduction of an ad-hoc crisis management framework to deal with sovereign default risks in the euro area. This obviously sets a precedent and will have consequences for its future

Figure 1. Public debt scenario

a) weak GDP growth (1%), insufficient consolidation efforts

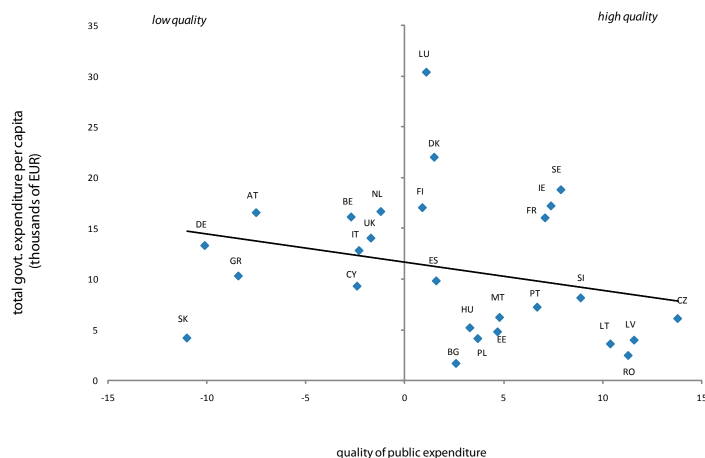


Source: BUSINESSEUROPE based on European Commission

governance, in terms of budgetary controls, greater and broader surveillance of national economic policies and crisis resolution instruments.

But the parameters of a comprehensive strategy able to combined growth and fiscal sustainability are yet to be defined. This can only be achieved through a clear reassignment of policy priorities and by mobilising resources where it will matter most for future growth and job creation.

Figure 2. Quality of public expenditure does not necessarily depend on amounts spent



Sub-components of quality-indicator: general government gross fixed capital formation, productive spending (transportation, R&D, education, health)

Source: BUSINESSEUROPE based on European Commission and Eurostat

The business community proposes a two pillar approach. On the one hand, an exit strategy should comprise credible commitments towards fiscal sustainability with tighter fiscal rules and institutions, greater efficiency of public administrations, credible cost cutting measures, greater recourse to markets and reforms of pension and healthcare systems.

This should be combined with an entry strategy based on renewed commitments to achieve excellence in education, training and research systems, allow for the effective deployment of new technologies and modern infrastructures, and adopting growth enhancing tax reforms.

This will require both public and private funding. Developing true European markets for venture capital, innovation and infrastructure financing and making greater and more targeted use of the European Investment Bank would make a lot of sense in the present environment.

Furthermore, raising the growth potential of the European economy would require the adoption of growth-enhancing tax reforms that minimize the deadweight loss created by taxation, reduce tax-related allocative distorisions, and enhance economic efficiency, both from a supply and demand side.

Besides, tax regimes remain highly fragmented across the EU, so that in order to unlock the full potential of the internal market, it is necessary to eliminate double taxation, tax obstacles to cross-border business operations, introduce cross-border tax relief mechanisms, reduce administrative burden for businesses, reform VAT rules, and simplify electronic invoicing procedures.

But recent developments during the sovereign crisis have also

demonstrated the need to review the governance structure of the European Monetary Union.

This should mean in particular greater national commitments towards fiscal sustainability and competitiveness, better enforcement mechanisms at euro-area level and a stable system to address sovereign debt crisis in last resort situations.

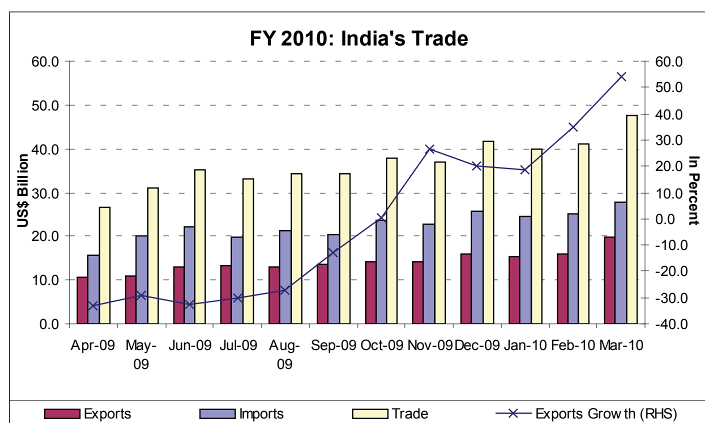
To conclude on a positive note, the euro area has a tremendous upward potential if its member states are committed to undertake the necessary reforms of product, labour and capital markets. The benefits would far outweigh the impact of the crisis for companies and citizens alike. These reforms were making slow progress in a benign environment. Maybe this crisis, which has shaking the euro area in its foundations; will be a trigger for more radical change and will provide a boost to those willing to embrace it. ■

The Rising Rupee Is a Concern for India's Exporters

Pritam Banerjee is the Head of Trade and International Policy at the Confederation of Indian Industry

India's merchandise exports for the fiscal year 2009-10 declined by 4.7%, from around US$184 billion at the end of 2008-09 to US$176.5 billion at the end of 2009-10. The decline in exports is primarily attributable to the global meltdown, which had engulfed the world economy during the last quarter of 2008 and had continued unabashed throughout 2009. As a result of the global crisis India's export shipments destined to Europe and North America had reduced significantly, resulting in negative exports growth for thirteen consecutive months, from October 2008 to October 2009.

Since November 2009, exports have again started showing signs of revival and have grown steadily since then. During March 2010 exports grew at the fastest ever rate of 54% over the same month last fiscal. Exports is an important sector for the India economy, since it accounts for a share of around 20% in the country's Gross Domestic Product (GDP) and is also among the largest employers.



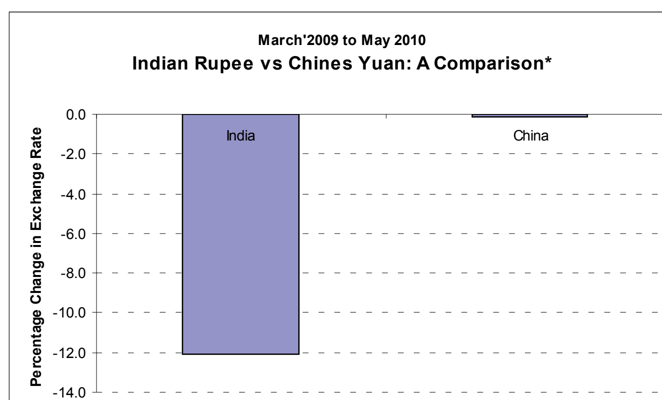
Source: CMIE

The Government of India has set a target to grow India's exports by 15% during 2010-11 to US$200 billion. With visible signs of broad-based recovery across the globe the target looks feasible, and is further supported by a recent forecast by the World Trade Organisation (WTO), which expects the world trade to grow by 9.5% during 2010-11.

However, the continued poor performance of some of the key export sectors and the appreciation of Indian rupee may adversely impact the prospects of India's exports in coming months.

Sectors like engineering, readymade garments, leather, carpets, oil meals, petroleum products and gems and jewellery, which together account for about 70% of India's exports, have either shown no or negative growth in recent months. While India's engineering goods exports has been adversely effected in the US, gems and jewellery exports, and chemicals and related exports have been more unfavourably affected in the EU market. Handicrafts, including carpets, which were badly affected even in 2008-09, performed even worse in 2009-10 in both EU and US market, with a negative growth averaging more than 30 per cent.

On the other hand, appreciation of the Indian rupee against the US dollar in recent months is putting increased pressure on the margins of Indian exporters. Indian rupee has appreciated more than 12% against the US dollar during the period from March 2009 to May 2010, compared to Chinese Yuan, which appreciated, by 0.1% during the same period.



Source: Pacific Exchange Rate Service

** Negative value indicates appreciation of the currency against the US dollar*

Appreciation of Indian rupee against the US dollar may be explained by the surge in foreign capital inflows into India. Seeking higher returns on their investment, the international investors borrow funds in dollar markets, where liquidity is ample and interest rates are low because of anti-crisis measures, and invest in equity, debt and real estate in emerging markets like India, where returns are much higher.

As of May 18, 2010, FII's invested close to US$11.3 billion in the Indian debt and equity markets during 2010. The balance of payments data, recently released by the Reserve Bank of India (RBI), indicates that net portfolio investment inflow during April-December 2009 amounted to US$23.6 billion, as compared with an outflow of US$11.3 billion during April-December 2008.

Since the rupee appreciation causes the dollar value of the country's exports to rise, the current bout of rupee appreciation along with high inflation is eroding the competitiveness of Indian exporters in international markets.

While the exact impact of rupee appreciation on the exports sector may be difficult to gauge, it adversely impacts export products like textiles and garments, which are indigenously produced in India by raising the dollar price of these goods in international markets. On the other hand it favourably impacts export product that are produced using imported inputs procured from international markets by

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Practical Steps In Changing Economic Conditions

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Transfer Pricing: A Challenge for Developing Countries

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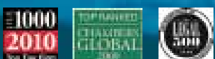

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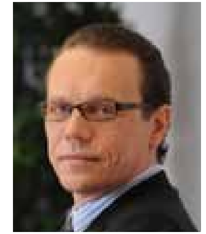
The Role of Taxation in Rebuilding Europe's Economy



Algirdas Šemeta is the European Commissioner for Taxation, Customs, Anti-fraud and Audit

Europe has experienced a period of severe economic turbulence, and the very basis of member states' economic policies has been drawn into question. As governments design and implement their exit strategies, they must go back to the drawing board and decide how their fiscal policies can really meet their needs and objectives for the 21st century. The quality of revenue will be just as important as the quality of spending in exiting this crisis and ensuring long-term fiscal sustainability. Taxation, if well designed, can play a crucial role in helping member states to rebuild their economies in a way that is growth-enhancing, job-promoting and preserves the fundamental principles of the European social model. The question is, are the taxation policies that have been followed up to now sufficient in meeting the goal of rebuilding a strong, sustainable economy in Europe?

I believe that the time has come to re-think taxation in Europe: to make it work better for member states, businesses and citizens. While the revenue-raising aspect of taxation is naturally the first consideration, it cannot be the only one. We cannot underestimate the potential that tax policies have to encourage employment, attract investment, support research and development, and promote a greener society. This can be done through incentive-based taxes, or by shifting some of the burden away from less growth-promoting taxes (such as capital and labour) towards more growth-friendly ones (environmental and consumption). Long-term consolidation will require member states to adapt the structures of their tax systems and adjust the provisions of individual tax bases, maximising their incentive effects and minimising distortive effects, in particular on growth, investment and jobs. Generally, each member state will have to decide its own approach to best fit its national needs.

" ...the time has come to re-think taxation in Europe: to make it work better for member states, businesses and citizens"

If there is one thing this crisis has made clear, it is that member states' economies are inextricably linked. EU coordination on economic policies has never been more important. Recently, the issue of tax coordination, in particular, as a means of ensuring fiscal sustainability has come increasingly into the limelight. The European Commission's proposal on Reinforcing Economic Policy Coordination and Professor Mario Monti's report on *A New Strategy for the Internal Market*[1] both specifically refer to the need for further coordination in tax matters for greater economic stability within the EU. Member states are closely following each other's moves in their consolidation efforts, aware that their neighbour's tax strategy has an impact for them too. As European Commissioner for Taxation, I will take all appropriate measures to ensure that member states' tax policies complement, rather than disrupt, each other's overall economic objectives. This will include the establishment of a Tax Policy Group, composed of high level government representatives, which will be a forum for key strategic discussions on tax issues of common interest. Through this group, we will ensure that improving tax policies through a coordinated approach remains high on the EU and national agendas.

Rebuilding a strong European economy will also rely heavily on a strong internal market. And, the strength of the internal market relies, amongst other things, on how smoothly our taxation policies function.

At the moment, there is certainly room for improvement. There are still too many tax obstacles - double taxation, discrimination, unfair competition and high compliance costs – which act as barriers to fruitful cross-border activity. If we take the example of double taxation, it is clear that it creates huge financial problems for many citizens and deters businesses from reaping the full benefits they could enjoy from a Single Market. I am determined to tackle this problem, and have already taken the first step. In April, the Commission launched a wide public consultation to gather feedback from businesses and citizens on the double taxation problems that they have personally encountered. These first-hand accounts will ensure that the next steps in our work to address this problem will be properly focussed and well-targeted – pre-requisites for success.

Another initiative which could make a real and positive difference to business in the internal market is the common consolidated corporate tax base (CCCTB). When it comes to corporate taxation, we are far from a functioning single market at the moment. Companies have to deal with 27 different rulebooks, resulting in high compliance costs, administrative burdens and complex re-adjustments. Common EU rules for establishing the taxable base of companies would eliminate large costs and complexities for European enterprises and make the EU a more attractive market for foreign investors. Likewise, the review of the VAT system which I intend to begin over the next 12 months, will seek simplify, clarify and modernise our rules in this area, creating a better environment for business within the EU.

Growth-friendly tax policies, a coordinated approach and measures to remove tax obstacles to the internal market are all essential aspects in ensuring that taxation fully contributes to re-energising the European economy. But, no matter how good the tax policy, its purpose is diminished if member states are unable to collect the revenues that they are due. Tax fraud and evasion can do real damage to a national economy, as has become all too evident in recent months. The EU has worked hard to combat such illegal practices, enshrining the principles of transparency, fair competition and information exchange at home, and promoting those same principles abroad. We have been a forerunner in the international good governance campaign, and a strong partner to the OECD in its work to tackle tax havens and establish fair and effective tax enforcement globally. Our work in this area must not only continue - it must be intensified, if we are to reclaim the billions lost from national budgets every year through tax fraud and evasion. And as European Commissioner for anti-fraud, as well as taxation, this issue will remain high on my agenda throughout my mandate.

Taxation has a major role to play in overcoming the current crisis. For too long, it has been seen as a constraint, a necessary inconvenience. But we are now seeing a shift in attitudes, and the re-establishment of taxation as a central element of economic policy at both national and European levels. Quality taxation can help in raising the revenue needed to rebuild our economies and meet our key policy objectives, without imposing unnecessary burdens on businesses and citizens. For this coordination is the key word. ■

1. http://ec.europa.eu/bepa/pdf/monti_report_final_10_05_2010_en.pdf

Transfer Pricing: A Challenge for Developing Countries

Caroline Silberztein is Head of Transfer Pricing Unit, OECD Centre for Tax Policy and Administration

A lot of debate about tax and developing countries nowadays tends to focus on how to reduce revenue leakage through offshore tax havens. But there is another hot issue called transfer pricing which developing countries have to be mindful of, particularly if they want to avoid the risk of losing out on tax revenue from cross-border transactions carried out by multinational enterprises. How does it work?

A large proportion of world trade is accounted for by cross-border trade taking place within multinational enterprises, subsidiary's results. The higher the royalties paid by the French subsidiary, the lower the taxable profits in France. The French tax authorities will be satisfied if they see that the royalties paid by the French company to its headquarters in Mexico are not higher than those that would be paid to an independent enterprise for a similar transaction. But if the royalties are too high, there is a possibility that profits are being shifted out of France to reduce tax liabilities there. The "arm's length principle" is used to address such issues.

Under the arm's length principle, one compares the remuneration from cross-border controlled transactions within multinationals with the remuneration from transactions made between independent enterprises in similar circumstances. The "arm's length principle" has become the international norm for allocating the tax bases of multinational enterprises among the countries where they operate. All OECD countries use this principle, as do an increasing number of non-OECD countries, such as Argentina, China, India, Russia, Singapore and South Africa.

Different methods

The question is how to determine an arm's length price for cross-border transactions within MNEs. The OECD lists as many as five methods for approximating arm's length outcomes and these are explained in detail in the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ("OECD Transfer Pricing Guidelines").

First, the Comparable Uncontrolled Price (CUP) method compares the price charged for property or services transferred in a controlled transaction within a multinational enterprise to the price charged for property or services in a comparable transaction on the open marketplace, or so-called "uncontrolled" transaction. In theory, this is the most direct way to apply the arm's length principle and where it can be reliably applied, it is regarded as preferable to all other methods.

The trouble is that in many industries, few uncontrolled transactions in the marketplace satisfy the comparability requirements needed for this method to work reliably. In effect, a seemingly minor difference in the property transferred in the controlled and uncontrolled transactions could materially affect the price and the reliability of the comparison between the two. For this reason, the CUP method is mostly used for trading commodities.

The resale price method is most useful for buy-and-sell operations. It starts from the price at which products purchased from an associated enterprise are resold in the market place. A resale price margin is applied to cover sale and other operating expenses, work out an appropriate profit given the functions performed by the reseller, its assets and its risks, and find an arm's length price for the original property transfer between the associated enterprises. The cost plus method starts from the costs incurred by the supplier of property or services in a controlled transaction. An appropriate mark-up is then added to these costs, for the supplier to make an appropriate profit corresponding to its functions, assets and risks. The method is mostly used for contract work in manufacturing and back-office services.

The same reasoning can also be applied to net profit margins. The net margin taxpayers make from controlled transactions can be compared to the net margin earned by the same or other taxpayers in similar uncontrolled transactions in the marketplace. This is the so-called transactional net margin method or TNMM.

Finally, the division of profits in the controlled transaction can be compared to the one that independent enterprises would have expected to realise from similar transactions, in what is known as the profit split method. This profit method is mostly used in cases where both parties to the transaction contribute valuable intangibles.

Historically, OECD countries have tended to treat the profit methods – that is, both TNMM and the profit split method – as last resort for when the other traditional transaction methods do not work. In practice however, profit methods are now widely used in many countries. The transactional net margin method is actually proving easier to use than traditional transaction methods, being less sensitive to minor product differences for instance. The profit split method is also spreading, partly because of the growing importance of intangibles in today's business transactions, in the e-world or in financial products, for instance, for which comparables can be scarce. As a result, the OECD is now considering removing the "last resort" status of profit methods, and putting the emphasis on the selection of the most appropriate method for a particular case, and taking account of the respective strengths and weaknesses of the various methods. Public comments have been gathered and new guidance is being prepared (see www.oecd.org/ctp/tp/cpm).

In practice, one key difficulty in applying transfer pricing methods is to find open market transactions between independent enterprises that are comparable to the controlled transactions within a multinational enterprise. This is an issue for developed as well as developing countries, although it is magnified for developing ones due to the smaller size of their economies and smaller number of independent enterprises operating in their markets that can be looked to for comparisons.

Business restructuring

One major OECD on-going project that developing countries need to follow is to reach consensus on how the arm's length principle applies to business restructurings involving the cross-border redeployment of operations by a multinational enterprise. Such restructurings can have dramatic effects on the allocation of the profit (or loss) potential among the members of the multinational enterprise and affect the corporate income tax paid in each of the countries where the group operates. The arm's length principle and the OECD Transfer Pricing Guidelines can help to lay out the appropriate questions and point to solutions.

For instance, what operations does the restructuring involve? Have valuable intangible assets, such as patents and trademarks, been moved? Who should bear the termination costs that may follow from such restructuring: the restructured entity itself, the parent company that made the decision to restructure, or the entity to which the operation is being relocated? How does the arm's length principle apply in such cases? The OECD has been working with the business community and stakeholders since 2005 on this issue. A draft report was released for public comment in 2008 (see www.oecd.org/ctp/tp/br) and is expected to be finalised in 2010.

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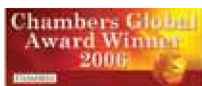

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No method is perfect, and the inherent risks for disputes are not hard to spot. It is little wonder that a survey by Ernst and Young in 2007-08 found that 74% of parent and 81% of subsidiary respondents in MNEs believed that transfer pricing will be "very important" or "absolutely critical" for their organisations over the next two years.

Take our example of the Mexican beverage company and its French affiliate. In case of a dispute with the French authorities on the arm's length price for the royalties, the risk for the firm is that the same amount of profits will be taxed twice – once in Mexico and once in France. The Mexican enterprise will want to avoid such double taxation. But Mexico and France will each rightly want their legitimate share of the firm's profits. It is therefore critical to reach a consensus on the arm's length price that the Mexican and French authorities, as well as the taxpayer, can use to arrive at an agreement.

Generally, under the OECD Model Tax Convention, double taxation can be resolved between the states concerned by following the Mutual Agreement Procedure (or MAP for short) which caters for an increasing number of complex international tax disputes, including tricky transfer pricing disputes (see Manual on Effective Mutual Agreement Procedures at www.oecd.org/ctp/memap). The OECD Model Tax Convention now includes compulsory, binding arbitration procedures for cases left unresolved after two years of Mutual Agreement Procedure.

Developing economies are keenly aware of the challenges posed by transfer pricing. Their goal is the same as for OECD countries: protecting their tax base while not hampering foreign direct investment and cross-border trade. The arm's length principle can help them achieve that goal. The key is to tailor the legislative measures and administrative effort to the strategic needs and resources of each country. Applying the arm's length principle can become complex and resource-intensive, though policymakers should bear in mind that most OECD countries started modestly and built their transfer pricing legislation and practices gradually over several years. Indeed, they are still in the process of improving them. Tax authorities in developing countries who wish to implement transfer pricing legislation may focus on the most common types of transactions and sectors in their economy first, for instance the exploitation of natural resources, manufacturing, or service activities. Enforcement objectives should be realistic, given the available capacity, and compliance requirements made reasonable for taxpayers in light of the size of the cross-border trade. So-called "safe harbours" are sometimes used to simplify compliance by small taxpayers, or to deal with small and less complex transactions carried out by multinational enterprises.

Given the global and sometimes controversial nature of transfer pricing, it is important to develop internationally shared principles to help each country fight abusive transfers of profit abroad, while at the same time limiting the risk of double taxation of those profits. This is what the arm's length principle is for. As more developing countries apply it, new lessons will be learned. This is a key step on the road to building a stronger, cleaner and fairer world economy. ■

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The Use of Hybrid Legal Entities in International Tax Reduction Strategies, Part III

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In WCR December 2009 we have shown how a Dutch "Cooperative Association" might be used in a hybrid form to a foreign tax payer's advantage via international tax planning and in WCR March 2010 a similar article was devoted to the potentially hybrid Dutch limited liability companies NV, BV and SE. This month's contribution deals with hybrid Limited Liability Partnerships (LLP's)

Dutch LLP's: Dutch corporation tax act allows tax payers to freely choose between a "tax entity" or a "tax transparent limited partnership"

Article 2 of the Dutch Corporation Tax Act contains a definition of which Dutch legal or contractual entities are subject to Dutch corporate income tax. As far as Dutch LLP's are concerned, this article subjects to tax the so-called "open limited partnerships". In doing so the law apparently distinguishes between open limited partnerships and closed limited partnerships. The latter category is not subject to Dutch corporate income tax.

A Dutch LLP is known in the Netherlands by its abbreviation in the Dutch language: CV (*Commanditaire Vennootschap*). This is the notion we will use below for such Dutch entities.

A CV has at least one general partner and one limited partner. Limited partners are liable only for the debts of the CV up to the amount of their partnership contribution. General partners are fully liable for the debts of the CV and are therefore usually limited liability companies, also in other jurisdictions.

The question whether a CV is "open" or "closed" has been dealt with in legislative history and case law. An "open CV" is any CV which is not considered "closed". A "closed CV" is a Dutch limited partnership which has quite severe limitations to the access of new partners and the voluntary transfer of a partnership share from one partner to another partner. Only in case such accessions and transfers are subject to the express approval of ALL partners, is the CV a Closed CV and transparent for Dutch corporate income tax purposes. In such a case the partners are subject to corporate income tax in the Netherlands themselves if they are Dutch residents and if they are foreign residents, in case they operate a Dutch permanent establishment or own Dutch real estate.

By playing with the CV's "articles of establishment", tax payers are therefore entirely free to choose whether to set up a CV which is taxable for Dutch CIT by itself or to create a CV which is transparent for Dutch CIT purposes. All will depend on the founding documents, especially those concerning admission of new partners and transfer of partnership interests between existing partners.

The foreign tax denomination of a Dutch CV will invariably be

dependent on foreign tax rules (foreign entity tax classification rules), so a tax mismatch (good or bad) can rather easily occur: a Closed CV may well count as a Dutch tax entity abroad even if it is not subject to Dutch corporate income tax and an Open CV may well be seen as a tax transparent partnership abroad even if it is subject to Dutch CIT itself. CV's are therefore "tricky" entities to work with, from an international tax perspective. One may run into double taxation before one knows it, but the opposite (no taxation at all) is also possible. This implies, as always, that one cannot really ignore the tax rules because if one does, things may go terribly wrong, with double taxation as a result.

Foreign LLP's under Dutch corporate income tax principles

The Netherlands, like any other country, uses its own criteria to determine if foreign LLP's must be considered taxable entities in which case they are seen as "participations" which qualify for the participation exemption, or as transparent entities in which case they should be seen as a foreign branch office of the Dutch participant/ limited partner, subject to the Dutch foreign branch income exemption. It should be noted that the two Dutch tax exemptions, one for income from and capital gains realised with participations and the other one for branch income, differ markedly from each other so changing the one exemption for the other may make considerable financial difference. The foreign tax criteria (like the question "is the LLP subject to tax itself under foreign tax law?") play no role in the Dutch entity tax classification process either.

The Dutch Ministry of Finance offers tax payers guidance in the "Dutch tax classification of foreign entities" process via a so-called Resolution, dated 18/12/2004, which contains the following criteria:

1) Can the foreign joint venture, under its own legal system, own the assets with which the joint venture is conducted?
2) Is there at least one participant in the joint venture who is liable for the debts of the joint venture without limitation?
3) Does the joint venture have a capital dividend into shares?
4) Can new participants access the joint venture or can participant transfer their share in the joint venture to other participants without the unanimous acceptance by all participants?

The answers to the above four questions will basically determine whether from a Dutch corporate income tax viewpoint the foreign joint venture qualifies as a tax entity or as a tax partnership. In case the foreign joint venture is legally comparable to a Dutch CV (which is the case if questions 1) and 2) above have been answered affirmatively, the foreign LLP is a "CV lookalike" in which case criterion 3) loses its significance and criterion 4) needs to be looked at in detail, in which case a set of additional Dutch rules apply, as follows:

a) the foreign joint venture conducts an enterprise in its own name;
b) there is at least one general partner and one limited partner;
c) the general partners are liable for the debts of the joint venture without limitation (although they might be LLC's themselves);
d) the limited partner is only liable up to the amount of his capital contribution;
e) the limited partner does not act towards third parties as representing the joint venture.

These Dutch criteria are not part of any foreign entity tax classification rules, so a mismatch between the Dutch and the foreign tax take of a foreign LLP can also very easily occur. A good example of this would be the German KG: This entity very much resembles a Dutch CV (the words even mean the same in the two languages), so from a Dutch corporate income tax viewpoint, German KG structures where a German limited liability company acts as the general partner ("GmbH & Co KG" structures) are "CV lookalikes". It will then depend on the internal rules in the KG as concerns the access of new partners and the transfer of partnership shares between partners, whether the German KG is seen as a tax entity ("Open KG" from a Dutch tax viewpoint) or as a tax transparent entity ("Closed KG"). Regardless of the fact that under German law a KG is always tax transparent!

The Dutch distinction between Open CV's and Closed CV's, in use to distinguish foreign LLP interests in "foreign participations" and "foreign branch offices", based on the internal LLP rules concerning their accessibility to new partners and to the transferability of partnership interests between partners, is a rather unpractical one. Obtaining consent from all other participants for each and every change in the partnership composition is in fact unworkable in partnerships with more than just a few partners. However, this implies that foreign LLP's which resemble their Dutch CV counterparts will usually be regarded as "Open LLP's" in which case they are treated as "participations" of the Dutch limited partner who participates in such a joint venture even though abroad they are treated as tax transparent. A mismatch between the Dutch and the foreign tax treatment of LLP's is therefore often unavoidable.

Examples

- In case a foreign LLP is considered a "participation" (ie. a "subsidiary") from a Dutch corporate income tax viewpoint whilst the foreign jurisdiction, considers it tax transparent, like in a KG situation, the following might happen:

  a) The Netherlands will normally exempt any and all income from such a foreign LLP from Dutch corporation tax under its "participation exemption" (eg. interest payments);
  b) The foreign tax authorities may equally exempt the Dutch share in what they see as a tax transparent LLP from local profits tax; this would especially be true in case the LLP share does not constitute a permanent establishment of the Dutch limited partner in the foreign country under foreign tax law;
  c) Even if the foreign tax authorities would consider the Dutch limited partner taxable in their country, eg. for operating a permanent establishment there or for owning real estate, they may allow for tax deductions for a variety of expenses (especially under a tax treaty with the Netherlands which resembles the OECD Model Tax Treaty's article 7-3, which is true for 99% of the Dutch tax treaties). However, such foreign tax deductible items may not picked up in the Netherlands as income (by reducing exempt foreign branch income), as a result of which a "double dip" in expense deduction may easily occur: certain expenses incurred by the Dutch "partner" for the KG will be tax deductible in both countries;
  d) It may even become possible for the tax payer to create a tax deduction in the KG without income pick-up elsewhere in the group for internal expenses in the Dutch group which owns the KG interest. For instance, for mortgage interest which the Dutch participant in the KG must pay to its Dutch parent company that finances the mortgage loan from equity. The above KG example also works for many other countries;

- In case a Dutch LLP is considered a taxable entity in the Netherlands ("Open CV") whilst abroad it is seen as a tax transparent partnership, and the foreign jurisdiction is where the "parent" of the Dutch CV is, the following might happen:

  a) Upon a transfer of intangibles against book value from the foreign parent to the Dutch CV, depending on the "foreign entity tax classification rules" to which the parent company is subject, which will likely deviate from the Dutch rules, there might not be a gain recognition abroad; after all, the parent transfers intangibles to itself (ie. its foreign branch office). However, the Netherlands may consider the CV as a taxable entity (Open CV) and will, upon the tax payer's request and based on a transfer pricing report, recognize a transfer against fair market value and the intangibles may then be shown for their fair market value in the tax balance sheet of the CV and be depreciated over their useful lifetime (with a five year minimum depreciation period). This will create sometimes very substantial tax deductions, within a multinational group without pick-up elsewhere in the group.

Conclusions

Like Dutch NV's, BV's, SE's and Cooperative Associations, Dutch LLP's are open to so-called hybridization, in which case they are treated differently under Dutch corporate income tax law than under foreign corporate income tax law of their parent company. The same is true for LLP's in which a Dutch tax payer participates. This may easily lead to double taxation (for which a tax treaty may not offer any solution). However, the opposite is possible as well: LLP's, both Dutch and

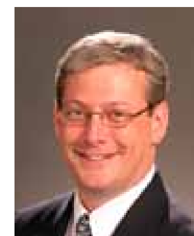
foreign, may give rise to double non-taxation, or to "double dipping" or to the tax deductibility of expenses in one country without income pick-up elsewhere in the group in another country.

Tax authorities show little or no interest in aligning their tax rules ("entity tax classification rules") with those of other countries. They will therefore – albeit unintentionally - continue to subject tax payers to double taxation and in such cases, tax treaties offer no help at all. Is it then strange if tax advisers do the opposite and advise their clients to deliberately enter into certain hybrid entity structures whereby double taxation does not only disappear, but even turns into double non-taxation because part or even all of their corporate income disappears from the tax radar screen? The one comes with the other, in my view.

Working with foreign joint venture formats is never easy from a tax perspective, in any country. Still, this is the way in which business deals unavoidably develop. Tax payers doing business abroad usually have no choice than to work with a foreign joint venture format. Tax payers are therefore well advised to take a thorough look at their home country tax definitions of any foreign joint venture and to take nothing for granted, to avoid nasty surprises. But it is good to know that often, with some more tax planning, a possibility might exist to turn these tax risks into tax benefits. This can be achieved by deliberately opting for a foreign joint venture format which causes a mismatch between the home country and the investment country's tax systems, so part of corporate income may fall "between the ship and the shore" or certain business expenses might become tax deductible in both tax jurisdictions.

Next time we will take a closer look at "hybrid financing" where one country sees a loan for tax proposes whilst the other country defines the financing arrangement as the provision of equity. ■

A Seat at the Table: The Importance of Import Compliance in the Post-Recession Economy



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With supply chains stretching to squeeze efficiencies and costs to remain competitive, companies that incorporate trade compliance professionals within their global sourcing decisions and internal control processes are able to achieve a competitive advantage – saving duties, avoiding delays, identifying and mitigating risks, and better prepared to address inevitable government audits and scrutiny.

Companies seeking to expand into new markets, identify low cost sourcing channels, manage tax burdens, and capitalize on increasingly sophisticated supply chains face challenging new realities. While export control concerns, trade security initiatives, and product safety requirements force new paradigms in the way companies prepare for trade, communicate product and shipping information, and seek to manage an uninterrupted supply chain, import compliance remains a primary focus for identifying and perhaps controlling costs and cannot be neglected within a comprehensive supply chain strategy.

This article will focus on two fundamental import compliance issues: tariff classification and valuation, and the benefits of an effective trade compliance program toward duty savings, reduced risks in government audits and mitigation of potential civil penalties that could shatter carefully constructed product margins and profit expectations. In particular, this article will explain an importer's obligations with regard tariff classification and valuation of imported product, and provide support for integrating Trade Compliance within supply chain decisions and the competitive advantages that follow.

While import compliance requirements are often complicated and require dedicated professionals to help effectively manage them, the secret to an effective trade compliance program is **communication**. If trade compliance professionals are included in sourcing discussions, supplier reviews, product development decisions, pricing discussions and other fundamental business planning - if they are provided a "seat at the table" - they can raise their voice to educate companies on obstacles and opportunities in cross-border transactions. They can highlight duty savings opportunities, preview compliance obligations and identify gaps or risks so that effective solutions can be developed in advance to avoid future risks, delays, and penalties. Those companies who are able to integrate trade compliance effectively are able to capitalize on opportunities and mitigate or avoid risks, allowing trade compliance to contribute tangible financial benefits while adhering to legal obligations inherent to international trade.

Post-recession reality – the current trade compliance environment

Government revenues are shrinking and many countries are increasingly turning to customs duties and fees as an additional or reinvigorated revenue source. Countries generally are not moving to increase duty rates or otherwise dramatically change existing import regimes, rather customs services in various jurisdictions are increasing their audit and verification activities to enforce existing laws more aggressively and affirmatively ensure that importers are depositing the correct amount of duties, fees, and taxes legally due at the time of entry.

The success customs services are having in connection with audits and investigations that readily identify import compliance violations and result in recovered duty and tax revenue, along with the collection of civil penalties, reinforces that continued government review is warranted – and revenue enhancing. Companies that are proactive in managing their trade compliance will be better able to avoid the "gotcha" of penalties and will continue to support the goal of an uninterrupted supply chain.

Most government import audits focus on one of two import compliance areas: (1) tariff classification (ie. what is it?) or (2) valuation (ie. what is it worth?). All countries require that importers accurately report this information at the time of importation, and each element is essential to the determination of duty and tax liability due.

Communicating on tariff classification: what is it?

Tariff classification is the process of assigning a unique code to imported merchandise to identify a specific product. The Harmonized Commodity Description and Coding System, an internationally standardized system coordinated by the World Customs Organization (WCO) and utilized by more than 190 countries, have defined classification rules and, in most cases, the Harmonized System (HS) has been formally adopted within each country's legal requirements.

The process of classifying imported merchandise and determining the correct HS tariff classification is often complicated, requiring training and experience. It is almost never cookie-cutter and will always require detailed knowledge of the product, its use, material, and composition. An analysis of relevant rules and product specifications is needed to establish the correct tariff classification and to demonstrate reasonable care in support if challenged by customs. No matter the jurisdiction, principal liability for the accurate tariff classification and deposit of duties rests with the importer of record.

The tariff classification of merchandise is the fundamental step for determining the applicable duty rate at the time of importation. In addition, a product's tariff classification may also indicate whether other trade restrictions apply, such as antidumping or countervailing duties, permit requirements (eg. for food, pharmaceutical or medical products), or quantitative limits. Tariff classification may also be utilized by countries to collect international trade statistics used in trade negotiations, establish the country of origin of imported product or determine eligibility for duty preferences under applicable Free Trade Agreements (FTA). Given its direct relationship to the collection of revenue and product admissibility, tariff classification is a primary focus in any customs service audit or verification.

Fundamentally, the incorrect tariff classification can result in the erroneous assessment of duties. Misclassification may result in companies paying more than necessary, or in an under-tender that may prompt future investigations and penalties if identified by customs.

A best practice incorporates within existing internal control processes defined gates through trade compliance for new product development (NPD), along with the establishment of material master data requiring tariff classification assignment prior to purchase or shipment. Trade compliance's involvement in the NPD process and coordination with engineers and product managers will enable a company to more accurately establish the landed cost associated with imported product. Coordinating product development with trade compliance professionals will also help identify trade impediments in advance, including antidumping duty liability or other non-tariff barriers related to import permits or license requirements.

"Supply chain management's commitment to integrating trade compliance within cross-border sourcing decisions will allow for greater transparency in anticipated duty liability and the implementation of internal controls to capture and report required information"

Because tariff classification is in many instances tied to FTA eligibility, coordination with trade compliance professionals in connection with any new product sourcing or change in product sourcing will allow time for analysis of FTA qualification and, if appropriate, coordination with the foreign vendor to ensure required FTA supporting documentation is available. In this same vein, failure to communicate sourcing changes can inadvertently destroy FTA eligibility. A sourcing change to lower the landed cost of a subassembly may inadvertently destroy the FTA duty-free qualification of the finished product, nullifying any savings and perhaps destroying sales commitments for FTA-qualified product.

Communicating on valuation: what is it worth?

While a product's tariff classification determines the duty rate or other assessment that may be due upon importation, the other part of the import equation is the value of the imported product. In other words, if a product is subject to 10 percent duties, the next logical question is 10 percent of what?

Tariff classification is designed to answer the question: "What is it?" – to determine the corresponding duty rate. Import valuation establishes: "How much is it worth?" – to determine the value against which any ad valorem duty or tax is assessed. Like tariff classification, defined valuation principles are applied by World Trade Organization (WTO) member countries to determine the correct appraised value of imported merchandise, with minor variations between countries in interpretation and enforcement.

The primary method of appraisement for imports is "transaction value," generally defined as the price actually paid or payable for merchandise when sold for exportation. Transaction value is typically the invoice price upon which payment is made in an arm's length transaction, and must be used unless the importer is otherwise prohibited from its application.

The transaction value of imported product should include all payments made as a condition of sale for the imported goods by the buyer to the seller, or by the buyer to a third party to satisfy an obligation of the seller. While transaction value may be used for related-party transactions, an importer must be prepared to demonstrate that the company's transfer price includes all costs plus a reasonable profit.

Communicating required additions to transaction value

Although transaction value is generally reflected by the invoice price against which payment is made, there are several required additions:

(1) the value of any assists (eg. materials, equipment, or foreign engineering and design used to produce imported product that is provided free of charge or at a reduced cost);

(2) packing charges;

(3) selling commissions paid in connection with the imported product;

(4) royalty or license fees the buyer pays as a condition of the sale for importation (eg. royalties on patent rights held by the foreign supplier); and

(5) proceeds of a subsequent resale of the imported product remitted to the foreign seller (eg. profit sharing arrangement with the seller).

If any of the above additions occur and are not otherwise incorporated into the invoice price of the imported merchandise, they must be added to the declared value of the imported merchandise and applicable duties, fees, and taxes tendered thereon.

Most import compliance issues arise due to the inability to timely capture and report "assists" or additional payments related to the products' production. For example, communication between trade compliance and supply chain is essential to identify and capture the movement of capital equipment or tooling from one supplier to another where the buyer retains ownership of the asset, or with regard to the provision of raw materials free of charge to a foreign supplier, such as toll manufacturer, for use in the production of imported product. These "assists" must be captured and reported as part of the value of the corresponding imported product.

Similarly, it is not uncommon for suppliers to separately invoice tooling charges, set-up fees, engineering costs, or other production expenses. Where these costs are excluded from the invoiced value of the imported merchandise, they must nevertheless be added to the declared value of the imported product. Trade compliance personnel need to be made aware of key supplier contracts and integrated into supply chain decisions to enable identification and consideration of all required additions to import value.

Another area ripe for customs service scrutiny is foreign research and development costs that are necessary for the production of imported merchandise. Increasingly, companies are developing "centres of excellence" (COE) globally for the development of engineering, research, software or other production-related costs. Where COE efforts are provided to foreign manufacturers free of charge, the value of these foreign development costs may be deemed an assist required to be reported upon importation of the corresponding product that incorporates COE development, with applicable duties, fees and taxes due.

Supply chain management's commitment to integrating trade compliance within cross-border sourcing decisions will allow for greater transparency in anticipated duty liability and the implementation of internal controls to capture and report required information. This improved communication will also mitigate the risks associated with customs service scrutiny or review.

The import process should begin prior to the placement of a purchase order. Communication should be integrated within existing internal controls processes, such as new vendor or vendor change processes, NPD processes, capital acquisition processes, and review gates during purchase order placement or material master set-up. With a seat at the table, trade compliance personnel can educate and communicate, and provide transparency to landed cost analysis while mitigating future risks.

Communicating transfer pricing risks

Because tax strategies drive transfer pricing policies, companies often overlook customs valuation issues. Given the inherent differences between tax and customs on transfer pricing requirements, however, many customs service authorities are increasingly focusing on transfer pricing – making it a risk area for importers.

As a general rule, transfer pricing for tax planning focuses on an entity's overall profit in a particular jurisdiction, since there is generally a single tax rate to be applied by the tax authorities. In contrast, transfer pricing for customs purposes is narrowly focused at the commodity level, since duty rates generally vary from product to product. The analogy often used to explain these differing perspectives is the difference between a snowball (tax) versus a snow flake (customs).

Tax strategies also do not take into consideration certain required additions to customs value, such as assists noted above. In other words, the value of raw materials provided free of charge from one party to a related manufacturer may have no direct tax implications so long as the manufacturer recovers its production costs and makes a reasonable profit for the services provided and risks incurred. Under customs value laws, however, the value of the raw material provided free of charge must be reported as an assist and applicable duties tendered. Where the invoice fails to reflect these costs because the transfer pricing policy does not require their inclusion, internal controls and processes must be established to enable their reporting.

Retroactive transfer price adjustments within a global transfer pricing strategy may also need to be reported to the customs authorities, as these adjustments necessarily impact the values previously reported to customs at the time of importation. Given the recent economic stress and shrinking tax revenues, customs authorities have an increased incentive to investigate transfer pricing issues in an effort to raise tax/duty revenue. Trade compliance must coordinate with supply chain, tax and finance to communicate retroactive transfer price adjustments and address the customs duty and reporting obligations that may necessarily follow.

Increasingly complex tax and supply chain strategies related to intellectual property ownership and assessment of inter-company royalties or the establishment of cost-sharing agreements to allocate global research and development costs also should be communicated to trade compliance to enable the reporting of required additions or adjustments to transaction value. Royalties paid to a related party that directly relate to imported merchandise, or cost-share payments made for global R&D expenses, often must be reported in connection with the imported merchandise. Cross-functional communication is essential to capture these costs, determine their financial impact upon import, and avoid costly audits and penalties that result if these costs are identified by customs service authorities before they can be reported.

Conclusion

As international trade increases, and government revenues decrease in the current economy, customs services worldwide are more likely to audit import transactions to ensure that government revenues are protected. Those companies with senior management commitment to integrate trade compliance professionals into supply chain and sourcing discussions to facilitate cross-functional communication will enable a more efficient, predictable supply chain – one that translates to (1) avoiding unnecessary overpayment of duties, (2) identification of opportunities to reduce duties and fees, (3) preparedness for inevitable government scrutiny, (4) management of risks inherent with international trade, and (5) greater transparency to the company's supply chain and import processes. Given these advantages, it is time for companies to make room for another seat at the table. ■

Taxation in Ukraine: Major Developments In 2010

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It has become a tradition in Ukraine when approval of the annual state budget law is followed by amendments to Ukrainian tax laws. This process usually takes place in late December each year. This year, however, the state budgeting process was completed only in April in the wake of presidential elections, formation of the new parliamentary coalition and appointment of the new government.

The Ukrainian parliament adopted the 2010 state budget law on 27 April 2010. The law amending certain aspects of dividends taxation was adopted on the same day. A follow-up law amending the major Ukrainian tax laws (the "Amendment Law") was adopted on 20 May 2010. As of 28 May 2010, the Amendment Law has not been signed into law by the President of Ukraine and, accordingly, its final text has not been made publicly available. Below we provide our comments, inter alia, on certain major changes expected to be introduced by the Amendment Law should it become effective. Our comments are based on the most recent publicly available text of the draft Amendment Law which may differ from its final text.

The recent tax amendments are mainly targeted by the government to collect more taxes and combat tax evasion techniques.

A. Corporate profits tax ("CPT")

The standard CPT rate is 25%. CPT liabilities are self-assessed by taxpayers. CPT is payable on a quarterly basis. The taxable profit is determined based on adjusted gross income reduced by tax deductible costs and tax depreciation. For CPT purposes, adjusted gross income means gross income (ie. a company's world-wide income) received (accrued) during the reporting period either in cash, in kind or in an intangible form. Gross income includes total income from the sale of goods (work, services), fixed assets and receipt of gratuitous transfers.

Ukrainian tax law generally allows reasonable business expenses to be tax deductible, although there are certain expenses explicitly disallowed or restricted by the law.

Tax losses

Ukrainian CPT payers should account for tax losses on a cumulative basis (ie. subject to certain exceptions, irrespective of the type of activity which results in losses). Under applicable law, the accumulated tax losses may be carried forward indefinitely. The Amendment Law is expected to change that rule and limit the carry forward of tax losses accumulated as of 1 January 2010. If the Amendment Law takes effect, companies will be able to utilize only 20% of such losses in 2010.

According to the Ukrainian government, the aggregate tax losses accumulated by Ukrainian companies amounted to UAH[1] 75 billion (approximately US$9.5 billion) as of 1 January 2010. Ukrainian officials claim that UAH 10 billion (approximately US$1.3 billion) of this

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figure was illegally declared by taxpayers as a result of tax evasion schemes. Interestingly, the aggregate tax losses accumulated by Ukrainian banks owing solely to favourable tax legislation (ie. full tax deductibility of the insurance reserves and application of the "cash method" in assessment of tax liabilities) amount to UAH 25 billion (approximately US$3.2 billion).

Taxation of dividends

The tax laws require that a taxpayer makes 25% CPT prepayment in respect of the dividends being distributed by such taxpayer. The 25% CPT is payable in addition to dividends and is not withheld from the amount of dividends. The so-paid CPT may be further offset against taxpayer's subsequent CPT liabilities.

"Now all amounts of dividends distributed by Ukrainian companies within the amounts of dividends received by these companies from their subsidiaries are exempted from CPT prepayment"

Pursuant to the previous version of the CPT law, the Ukrainian holding companies receiving more than 90% of their income as dividends from their Ukrainian subsidiaries were eligible for exemption from the above-referred CPT prepayment.

The lawmakers extended the above exemption. Now all amounts of dividends distributed by Ukrainian companies within the amounts of dividends received by these companies from their subsidiaries are exempted from CPT prepayment.

Also, the new law exempts from 25% CPT the dividends received by Ukrainian companies from their non-resident subsidiaries (except for non-resident subsidiaries registered in the blacklisted jurisdictions). Previously, such dividends were subject to CPT.

For the purposes of the above exemptions, a Ukrainian company should be deemed to have a "subsidiary" if it owns at least a 20% stake in the charter capital of such legal entity.

Mandatory dividends

The state budget law has amended Ukrainian corporate laws to provide for mandatory payment of dividends by Ukrainian joint stock companies to their shareholders in 2010. These companies should pay dividends in the amount of 30% of their respective net profit for the reported financial year and/or undistributed profit.

The fiscal aspect of the said amendments is that, as a general rule, payment of dividends requires 25% CPT prepayment from the amount of dividends.

However, the relevant corporate laws were amended in a way that creates room for discussion as to whether the mandatory dividends requirement applies to all types of Ukrainian joint stock companies (ie. public and private joint stock companies existing under the new Ukrainian Joint Stock Companies Law ("JSC Law"), as well as open and closed joint stock companies which for the time being continue to exist under the "old" companies law pursuant to an official clarification of the Ukrainian Securities Commission).

The 2010 state budget law amended both the JSC law and the "old" companies law. Pursuant to these amendments, the old law was subject to minor changes, while the actual 30% mandatory dividends requirement was included in the JSC law. Therefore, an argument can be made that open and closed joint stock companies, which continue to be governed by the "old" companies law, are not required to pay 30% mandatory dividends.

Limitation on deductibility of reserves

Under CPT law, banks and certain types of non-banking financial institutions are entitled to tax deductibility of the so-called insurance reserves, ie. reserves formed by these institutions in respect of possible losses from loan transactions. The insurance reserves are formed by the banks and some other financial institutions pursuant to methodology and criteria set down by the National Bank of Ukraine and other Ukrainian authorities.

The current version of the CPT law entitles the banks to 100% tax deduction of their insurance reserves. Other eligible financial institutions are permitted to make tax deduction in the amount of 80% of their insurance reserves.

Pursuant to the Amendment Law, a bank will be permitted to declare tax deductible insurance reserve in the amount of up to 40% of its total lendings for the period until 1 January 2011, up to 30% until 1 January 2012 and up to 20% from then on. A similar threshold of up to 10% will apply to non-banking financial institutions.

The apparent reason behind such a dramatic shift are multibillion tax deductions previously declared by Ukrainian banks as a result of huge amounts of insurance reserves formed during the peak of financial crisis in respect of bad and risky debts. So, disregarding the amounts of insurance reserves to be formed by the banks in 2010, their tax deductibility will likely remain substantially limited.

Taxation of banks' income

The Amendment Law is also expected to affect Ukrainian banks by requiring them to declare taxable income upon accrual of loan transactions income (eg. interest payments), rather than upon actual receipt of such income. However, the banks should still be entitled to declare taxable income upon actual receipt of their loan transactions income which was accrued starting from 1 January 2009 and was not received until 1 January 2010.

B. Value added tax ("VAT")

VAT is levied at the rate of 20% on the supply of goods and services in the territory of Ukraine, and on the import of goods and services to Ukraine. VAT payable to the state budget is determined as the difference between VAT collected from customers (output VAT) and VAT paid to suppliers (input VAT).

All supply of goods and services in Ukraine, as well as import of goods and services is within the scope of VAT (subject to specific exemptions).

The VAT law distinguishes between the following major types of transactions which are:

- subject to 20% VAT. This applies to all goods and services apart from the exceptions listed below;
- subject to 0% VAT. Such transactions primarily include sales of goods outside Ukraine (export of goods);
- non-VAT-able transactions, such as insurance and reinsurance, social and pension insurance, most banking services, etc.; and
- VAT-exempt transactions: certain educational and healthcare services, etc.

VAT refund

According to official statistics, the aggregate state debt to Ukrainian businesses in respect of VAT refund was UAH 21.8 billion (approximately US$2.8 billion) as of 1 January 2010. The 2010 state budget law has finally offered a solution to the VAT refund problem by introducing VAT reimbursement mechanism with domestic government bonds. This mechanism was introduced as an extra option for taxpayers.

The Ukrainian government applied securitization of VAT refund indebtedness back in 2004, and that experience is generally regarded as quite successful. As a practical matter, at that time taxpayers were able to sell the bonds at a 20-30% discount, thus receiving the VAT refund immediately. This year the VAT bonds are also expected to attract many investors, primarily financial institutions and foreign companies.

The 2010 VAT bonds issuance is planned to follow the 2004 scenario. As in 2004, the bonds should be issued in a book-entry form and will have a five year maturity. It is planned that the bonds will be redeemable in five equal annual instalments each comprising 20% of par value. The VAT bonds are expected to bear 5.5% annual interest. The aggregate amount of the bonds to be issued is yet to be determined, and it is expected not to exceed UAH 20 billion (approximately US$2.5 billion). The government has recently announced its plan to set a ceiling on discounts at which VAT bonds may be traded.

> **"The Amendment Law is ... intended to increase the share of excise in prices, which, according to the government, is generally lower than in other European countries"**

VAT recovery limit

VAT law imposes certain restrictions on VAT cash refund. In particular, the amount of taxpayer's input VAT that is not offset by its VAT liabilities in a tax period (a month) should increase the amount of input VAT in the subsequent tax period. The so-called "transferred" input VAT may be declared for VAT cash refund provided that it is not offset by VAT liabilities in this subsequent tax period.

To make a taxpayer eligible for VAT cash refund, inter alia, such taxpayer's VAT-able transactions for the 12-month period preceding submission of the claim for cash refund must not be less than the amount of such claim. Otherwise, the amount of the so-accumulated input VAT (the "Accumulated Credit") should be transferred to the next tax period.

As regards the latter, the Amendment Law is expected to impose a temporary prohibition from declaring the Accumulated Credit (which does not entitle to cash refund) as input VAT of the next tax period. This prohibition should remain in force till 2011.

The government explains that the above measure is needed in order to audit the amounts of Accumulated Credit accrued by Ukrainian taxpayers and remove the tax effect of the illegal Accumulated Credit.

C. Excise taxes

Currently, Ukraine imposes excise taxes on the following groups of goods:

- alcohol and alcoholic beverages, including wines and beer;
- tobacco and tobacco products;
- motor vehicles and vehicle body frames, bicycles and motorcycles;
- motor fuels and other oil products.

The rates of excise tax are divided by the method of their calculation into ad valorem, specific, combined and mixed rates. Ad valorem rates are based on goods turnover and are set as a percentage thereof. Specific rates are determined as fixed payments for a unit of commodity. Combined rates simultaneously provide for percentage of turnover and fixed payments. Mixed rate is also a combination of ad valorem and specific rate, where tax is levied under ad valorem rate, but not less than the specific rate set for the respective goods.

The Amendment Law is expected to increase tax rates for most excise goods. These changes are a part of the government's action to cover state budget deficit. They are also intended to increase the share of excise in prices, which, according to the government, is generally lower than in other European countries (eg. 11% in prices of fuels, as compared to 43% in Lithuania and 54% in Poland; 32% in prices of cigarettes, as compared to 60% in Lithuania and 68% in Poland; 34% in prices of vodka, as compared to 42% in Lithuania and Poland).

Pursuant to the Amendment Law, the expected increase in excise rates for most alcohol products varies from 15% to more than 140%. For example, the tax rate for fortified and strong wines will increase from UAH 0.50 to UAH 2.00 (approximately US$0.25) per litre. Following entry into effect of the Amendment Law, the brewing industry will find itself under even greater impact of tax rates increase, where the effect of increase of excise rates for beer from UAH 0.31 to UAH 0.74 (approx. US$0.09) per litre will be combined with increase of duties on water supply.

The Amendment Law will also influence excise rates for fuels and oil products. In particular, the excise on motor spirits with octane number (RON) of 92, 95 and 98 will be charged at €132 per ton instead of the current €110 per ton. The excise on light distillers and other special fuels, which is now charged at EUR 20 per ton, will be raised to €132 per ton.

The Amendment Law is also expected to change tobacco products taxation. Ad valorem for cigarettes with filters will be increased by 5%, and specific rates will grow from UAH 69 to UAH 90 (approx. US$11.36) per 1,000 cigarettes. The change should increase the share of excise in the price of cigarettes to 37%.

D. Other taxes

Pension fund charge

An important development is that the 2010 state budget law will cancel 0.5% pension fund charge applicable to foreign currency sale and purchase transactions. This charge will not apply starting from 1 July 2010.

Exploration tax

The use of deposits of natural resources is subject to exploration tax provided such deposits were previously explored at the state budget expense. This tax is charged based on the volume of extracted resources and, generally, is deductible for CPT purposes. The tax rates established by the government are multiplied by the coefficient stipulated by the law since 2008. The 2010 budget law increased this coefficient from 2.17 to 3.19.

Water tariffs

The Amendment Law is expected to increase the tariffs for water used in production of beverages. Such tariffs will be increased from UAH 3 to UAH 21.60 (approx. US$2.73) per 1 m^3 for surface water and from UAH 3.5 to UAH 25.20 (approx. US$3.18) per 1 m^3 for underground water.

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1. UAH is the abbreviation of Hryvnia, the Ukrainian national currency.

Cyprus: New Option for Transfer-In Companies

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Cyprus has made it possible for companies to transfer their registered offices into and out of that country, a move that is expected to bring to Cyprus relocations from jurisdictions permitting transfers out. This article examines the enabling legislation and the competitive advantages it offers.

Enabling legislation

The enabling legislation permits a company registered in a foreign jurisdiction (provided the laws of such jurisdiction permit the transfer and continuation of companies elsewhere) to transfer its registered office to Cyprus, de-register from the jurisdiction of incorporation and obtain a certificate of continuation in Cyprus. Conversely, the legislation also permits Cyprus registered companies to transfer their registered office and continue in jurisdictions where transfers and continuations are permitted. However, in view of the competitive advantages of Cyprus as a jurisdiction, the movement is expected to be predominantly inward rather than outward.

Previously, the transfer of a company to another jurisdiction often entailed significant tax consequences, essentially deterring cross-border corporate immigration. A migrating company would often be deemed to be liquidated in its jurisdiction of incorporation, inevitably leading to taxable disclosure of its hidden reserves. The principle of freedom of establishment enshrined under the EC Treaty and more significantly, the wide interpretation given to this principle by the European Court of Justice (ECJ), have gradually changed this. The ECJ has unequivocally supported a choice of forum approach and has emphasized the principle that companies registered in one member state should be able to carry out their activities throughout the EU without being subject to the burdensome incorporation rules of the host member state.

"Cyprus has a number of advantages which place it in a unique position from which to invest, trade, restructure or hold underlying assets"

Pending the implementation of the Fourteenth Company Law Directive which deals with the cross-border transfer of registered office of limited companies, a number of member states, including Cyprus, have adopted legislation to facilitate cross-border transfers of corporate seat.

Advantages of legislation

The advantages of this facilitative legislation are two-fold: (i) a company may "forum shop" for the most convenient jurisdiction in which to continue its activities whether in tax, organization, market demand or other terms; (ii) a company is permitted to effect such a move without having to endure liquidation or winding-up proceedings in its jurisdiction of incorporation. Such a transfer should produce the same effects as a cross-border merger, which in accordance with the Merger Directive, are tax-free.

Tax-free exits were already supported by ECJ case law. In the case of Hughes de Lasteyrie du Saillant, the ECJ, prompted by the referral of the French Conseil d'Etat invalidated a French statute which taxed the unrealized appreciation inherent in corporate stock held by a French resident upon transfer of his tax residence from France to Belgium. The interpretation of the ECJ reinforced the freedom of cross-border establishment: a jurisdiction of incorporation cannot impose exit taxes deterring corporate entities from making a rational decision as to the suitability of a jurisdiction's corporate and tax regime to their particular needs.

Competitive advantages of Cyprus

Cyprus has a number of advantages which place it in a unique position from which to invest, trade, restructure or hold underlying assets. At 10%, Cyprus can boast the lowest corporate tax rate within Europe. Its participation exemption for dividends has no minimum holding period. It does not tax capital gains other than on the disposal of immovable property situated in Cyprus or the disposal of shares representing immovable property situated in Cyprus (and then only proportionately to the property-holding shares) and specifically exempts the trading in shares, stocks or debentures from any taxation.

Cyprus does not tax outgoing dividends paid to non-resident shareholders wherever they may be situated. Moreover Cyprus has an extensive and growing network of double tax treaties many of which feature highly attractive (often nil rated) withholding tax rates from the contracting jurisdictions to Cyprus. To give a simple example, the typical Dutch Sandwich (where a Netherlands Antilles company is parent to a Dutch BV) yields a net exit tax of 8.3% (for a shareholding of 25% or more of the share capital or voting rights). If Cyprus were to replace the Netherlands Antilles in the present structure via a transfer and continuation of the Netherlands Antilles company to Cyprus the net exit tax would be 0%.

Cyprus has also transposed the European Company Statute allowing public companies the option to convert into a Societas Europaea (SE), which is a European public limited company. The statute provides four ways to form an SE, by merger, formation of a holding company, formation of a joint subsidiary, or by conversion of a public limited company previously formed under national law. In short, companies which transfer-in to Cyprus can reap all the tax and regulatory benefits without incurring any taxation.

Transfer-in procedure

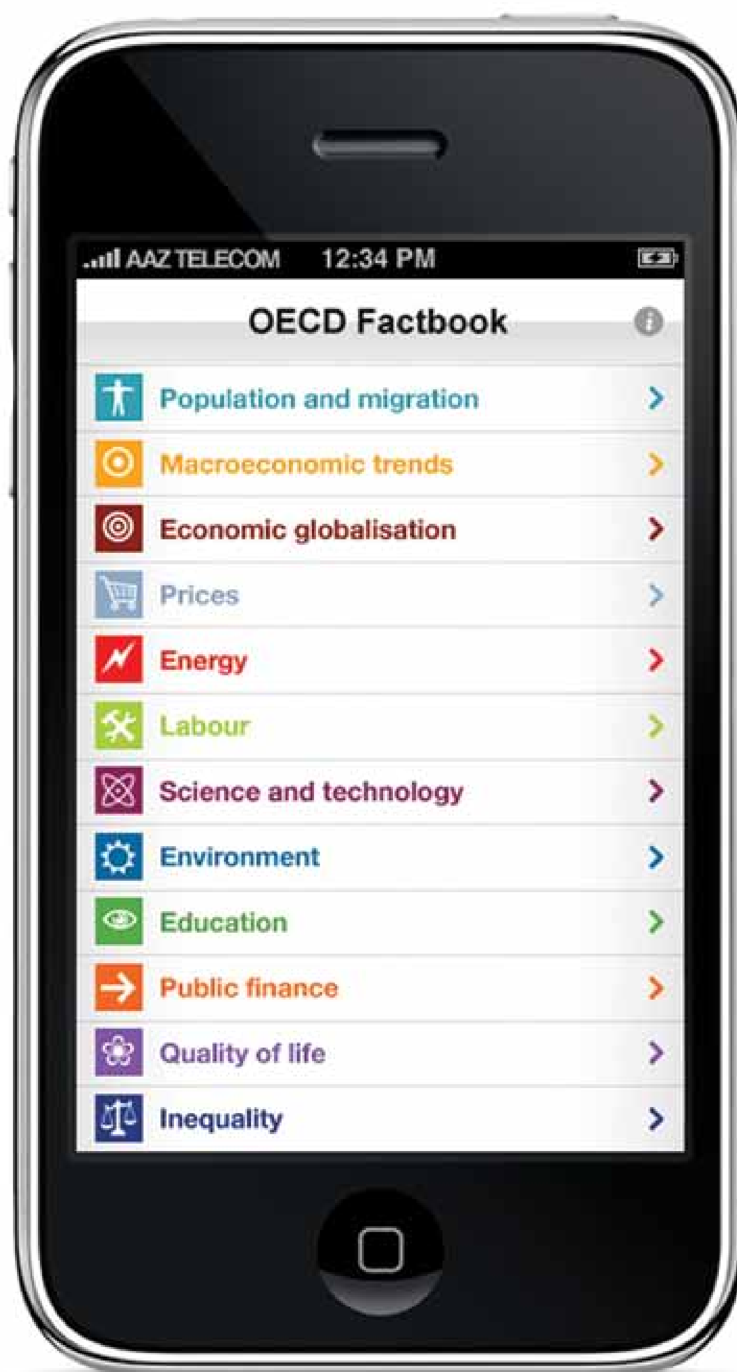
A foreign company wishing to register in Cyprus must apply to the Registrar of Companies and submit the relevant documentation which includes among other things the certificate of incorporation, a certificate of good standing and the corporate resolution authorizing the transfer-in and continuation in Cyprus. If the company is carrying out a licensed activity it will also need to satisfy local licensing criteria for the relevant activity.

When the relevant documents are submitted the company will be issued with a certificate of temporary continuation and will be considered a legal person for the purposes of the law. Within six months, the company must submit to the registrar proof that it has been "deregistered" from its transfer-out jurisdiction, following which it will be issued its permanent certificate of continuation.

Conclusion

Cyprus' unique tax and regulatory advantages have brought it to the forefront of "vehicle" jurisdictions for financing, restructuring, holding, investment and trading. In conjunction with the possibilities offered by complementary EU legislation such as the Merger Directive and the European Company Statute, it is expected that the much-awaited transfer of registered office legislation will further bolster the popularity of the Cyprus company.

For more information on this subject including the specifics of the transfer-in process, contact Emily Yiolitis at: emily.yiolitis@harneys.com.



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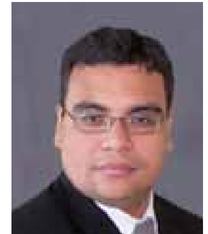
The Nicaraguan Tax Law Reform and Its Effects



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Introduction

Tax legislation in Nicaragua has always been subject to periodic changes through the years. Until November 2005, Nicaragua lacked a Tax Code to rule basic tax notions. Previously, these matters were ruled by the Common Tax Law. The new code established the general considerations regarding concepts, entities and terms for prescription and all assorted matters dealing with the tax world.

However, the more important aspects of taxes in Nicaragua have been ruled by the Tax Equity Law since May 2003 and its bylaws and amendments. The law encompasses more specifics than the Tax code and it rules application of the major national burdens which are mainly value added tax, income tax and selective tax to consumption.

In late 2009, this law became the top commented item in the country. The impact of a change to the established body of law was deemed troublesome for most sectors for many reasons, mainly a heavy hit on tax payers in an underdeveloped country. But foreign aid was thinking of withdrawing support to the government, and the national budget for 2010 needed to find funding. In response, the government aggressively pursued a reform to the law during the second half of 2009.

Increasing revenue

During the second quarter of the second year of the current administration, it was made evident by foreign donors that they were a bit weary of the elected government. Several countries, foreign institutions and NGOs that normally provided donations to the country were thinking of withdrawing their support.

By June 2009 it was announced that the government was pulling for a reform of the Tax Equity Law, one whose main objective was to collect as much revenue as possible in order to allot resources for 2010 and 2011 budgets.

The government did not initially provide the full text but rather held different presentations to the general public using presentations through the Chambers of Commerce. The presentation consisted in 44 PowerPoint slides which explained how the change opted to increased revenue by taxing income heavily and aimed to diminish exemptions as much as possible such as those provided to Free Trade Zones, one of the largest sectors as calculated by employed workers. The project was not a mere reform to the Tax Equity Law but almost a complete overhaul of the current tax system aimed to increase revenue as much as possible.

As expected, several sectors, if not all, of the Nicaraguan economy strongly opposed this new law. The majority of the general populace thought that the overhaul proposed by the government could have potentially damaged commerce and investment more than it would have helped the government make ends meet.

For years Nicaragua had been a thriving and exciting option for foreign investment due to its location and available work force. Some believed that due to the new tax legislation, Nicaragua would have eventually succumbed to unemployment, as well as lack of promotion of new investment. All this under a global economic crisis with no sign of improvement, eventually the government sat down with the different main sectors of Nicaragua's economy and private businesses and began to slightly modify its proposal.

End of the year rush

By the end of October and middle of November 2009, the government and the private sector had met numerous times and it was commonly known that albeit there was no real explicit consensus, the government was making efforts to listen to the sectors and reach an understanding. Nevertheless some smaller sectors were upset as they claimed that their complaints went unheard whereas those expressed by the local banking companies and big companies were top priority. Some believed that most of the burden of collection was set against the individual and small tax payer as opposed to larger tax payers.

However it was still just a month and a half before year's end, and the government through their legislative branch had only until the first two weeks of December to approve the reform to the tax equity law and the 2010 budget. There was little time to lose discussing the reform. Eventually, the law was finally approved on December 3rd, published on the 21st in the official journal and was set to become in effect on January 1st, 2010.

Small changes at key sectors

Although in the end the reform did not change as much as it was originally presented to do, and to some the end result was what the government initially expected, those dispositions which were modified were received with some resistance. Even as late as March some sectors filed unconstitutional resources against it, but as a law put in effect the companies affected had to adapt to the new conditions.

The major changes and dispositions established by the reform were as follows:

Income tax

Among the principal modifications to the national tax legislation, and quite possibly the biggest change applied, there is the imposition of the minimum payment of 1% on gross income, in substitution to the 1% tax on assets and of 0.6% on deposits of the financial sector. This provision is a modification to article 28 of the Fiscal Equity Law, which established that the minimum payment would be calculated based on the monthly average of the total assets of the year to be declared.

What this entailed for companies was that each month they had to pay said 1% in advance, calculated from gross income whereas before there was no advance payment and was paid yearly.

What this causes is a bigger income tax recollection. Before, the law allowed that the tax was applied to the net income, which meant the gross income, minus deductions, profit, costs and expenses. As the advance payment is calculated over gross income, the tax is applied to a bigger sum (income tax is set at 30% for corporations). Some companies whose tax period was not set at year end (ie. January 1 to December 31st) had to advance payment regardless of their period adding to the revenue needed for the first month of 2010.

After the reform some exemptions to income tax application were eliminated. In accordance with this reform, the interests earned, received or credited on deposits placed in financial institutions situated in Nicaragua shall be taxed with 10% income tax. Previously, only the interest earned on deposits with an average monthly balance greater or equal to US$5,000.00 are taxed.

Additionally, interests received from Nicaraguan source by Nicaraguan resident and non-residents (except financial institutions legally established in the country); the dividends or participations of utilities paid by companies that they may or may not pay income tax, to their shareholders or partners; as well as prizes of games such as raffles and the earnings form bets greater than C$25,000.00 shall be subject to a definitive 10% withholding tax. Income received from a

Nicaraguan source by a Nicaraguan non-resident would be taxed with a 20% withholding.

Likewise, with the above mentioned reform, interests earned from short, medium and long term loans, granted by foreign banks or financial institutions to national financial institutions and to national persons and enterprises shall no longer constitute non-taxable income.

In matters of property transfer subject to registration before public offices, previously this was understood as occasional gain and subject to a 1% tax withholding. With the reform, when transferring personal property or real estate subject to registration before a public office, a withholding of the annual Income Tax will be applied according to the taxable value of the good, in accordance with the following tariff:

- From US$0.01 up to US$50,000.00 > 1%
- From US$50,000.01 up to US$ 100,000.00 >2%
- From US$100,000.00 or more >3%

In addition, with the reform to article 21 of the Law, a progressive tariff is established for the payment of income tax in case of employees which increases the minimum amount that may be taxed from C$50,000.00 to C$75,000.00.

In regards to casinos and game rooms, the monthly tax to those game rooms with less than 101 slot machines was raised from US$18 to US$25 for each machine, those with more than 100 but less than 301 slot machines paid US$20 and this was raised to US$35. Finally those with over 300 machines used to pay US$25 per machine and this was raised to US$50. The law also states that the authorities can only authorize game rooms with a minimum of 10 slot machines on towns with a population of 30,000 whereas on towns with bigger population the minimum would be 25 slot machines. Casinos would pay a monthly tax of US$400 per game table. All these taxes are counted as income tax.

Selective Tax to Consumption (ISC)

With regards to the ISC (selective tax to consumption), in the fiscal reform the non accreditation of the ISC is applied to the sale of the goods derived from the petroleum.

Likewise, in case of the agricultural stock exchanges, transactions shall be subject to a definitive withholding of 1.5% income tax for primary agricultural goods, in comparison with the 1% that is currently withheld.

Additionally, in the above mentioned reform, it is stipulated that the following sumptuary goods shall never be exonerated from taxes: alcoholic drinks, products that contain tobacco, jewellery stores, perfumes, cosmetic products, yachts and other recreational and sport ships and boats, and aircrafts, all of private use.

International considerations

Surprisingly, the reform focused very little in dealing with hot topics regarding international taxing such as transfer pricing. During the first presentation of the reform projects this was actually an emphasized point during the government's addresses to the public and private sector. The government's proposal to deal with transfer pricing or their actual stance on the matter was never explicitly stated. The government merely gave the idea that it was being considered for reform. In the end, the dispositions dealing with price transferring were not modified heavily.

Currently, the Tax Equity Law bylaw does establishes that if evidence is found of relation between a foreign exporter and a national importer, the difference of the price as compared to the price in the current market, would be understood as taxable income. The reform did not change this strongly. It is not known if the Tax Authority and the government will begin to apply this disposition widely although there are reports indicating that as far as mid 2009, the government was providing workshops to the Tax Authority employees to better understand transfer pricing.

One of the main and probably biggest concerns from companies or individuals that have participation in Nicaraguan companies, is the 10% withholding applied to dividends. Although this is not uncommon in other jurisdictions, the change did bring about preoccupations as expected. In prevention of this matter, some companies decided to pay accrued dividends to their shareholders before year end, both locally and to foreign shareholders.

In regards of double taxation, Nicaragua currently has no tax treaties in effect with any country. The tax reform did not address this matter at all.

Unconstitutionality and the tax reform

During the first few months of public consensus regarding the law in 2009, there were some controversies regarding the changes applied. One of the first red flags raised by tax experts was that in the case of employees, it was said that income tax would be applied to gross income instead of net income. This would mean that salaries would be affected by income tax before the social security quota was applied, which by constitutional law should be net from taxes. By taxing with income tax before the social security quota, it affects the amount grossed for social security. Eventually the government did not include this; however, it did not stop other sectors to file resources against the law and even at 5 months of being in effect, there is still controversy over the reforms and their position against the Nicaraguan constitution. Some sectors have already filed unconstitutional pleas before the Supreme Court against some aspects of the reform. Nevertheless, the outcomes of the please have yet to be publicly disclosed.

Conclusion

The Government has yet to release official numbers for the revenue obtained from the first 5 months of 2010. It has been informed by independent media that there is a slowdown in recollections dealing with income tax, as opposed to the Government's expectations. Although it has been reported that, value added tax recollections, a tax which affects sales of goods and services, is surprisingly on the rise.

Before the reform was approved, some believed that the increase in efforts to collect income tax would eventually lead to tax evasion due to the harsh collection modes established. However as of the writing of this article, it appears most companies have been in compliance with the new rules.

Some sectors of the economy continue to lobby with the government in order to appease the effects of the reform to their sector and some have managed to obtain minor changes in the bylaws. The Law's bylaws as opposed to the law, is issued by the executive power and therefore does not need approval by the parliament. This allows certain flexibility in changing some of the items tackled by the reform.

However, this also creates uncertainty as the bylaws are periodically reformed and makes it difficult to anticipate what a year end situation might be for the country and the government.

As of the first half of 2010, the Nicaraguan economy, although affected by the global economic crisis, still manages to survive. The government's focus on investment is heavily set on getting more business to the country in order to accommodate a growing unemployment rate. It's still early to have seen the effects the reform had in the economy and although there have been many downsizing and business closings; it is not commonly attributed to the reform but rather the state of the economy as a whole. As the government puts extra effort on collection and revenue, including trying to recuperate any long standing debts by tax payers, it still remains to be seen how would the end of 2010 fare as compared to previous years, not to mention the projections for 2011, during which the following elections are to be held. ■

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The Polish Tax System Is Beneficial For Foreign Investors

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When considering investing in and entering a particular market, a number of factors need to be analyzed, such as location, access to other markets, existing infrastructure, stability of the economy, as well as the number and weight of administrative and legal obligations and burdens imposed on entrepreneurs. The existing tax system plays an important role among the analyzed factors of the economic environment of the particular country.

Poland is generally seen as a safe choice for investors. It applies the same economic standards as other western European countries, also in terms of public obligations. The structure and complexity of the Polish tax system is considered similar to those of most of other European countries. After numerous changes and amendments made over several years, the Polish tax system in its current shape seems to be relatively consistent and stable.

Apart from some restrictions in sectors such as construction or maintenance of highways, foreign investors are treated equally in Poland along with domestic entrepreneurs. Every entrepreneur who has a fixed establishment in Poland through which it operates, is obliged to settle income taxes, ie. CIT or PIT and indirect taxes such as VAT or excise duty.

Preferential tax rate on corporate income (CIT)

The CIT rate in Poland amounts to 19% and is amongst the lowest in Europe.

The amount of CIT due is calculated on income minus deductions, reliefs and tax-deductible costs. Consequently, the level of the effective tax rate, ie. the ratio of the amount of tax due to the value of the tax base, amounts in Poland to 17.5%[1].

To the advantages of the Polish CIT law belong in particular quite a broad spectrum of tax deductible costs and flexible tax depreciation rules, which reduce the tax base and in consequence can lead to lowering the effective tax rate indicated above.

Moreover, the CIT rate in Poland is identical for both: income of a general nature and the so-called capital gains and amounts to 19%.

Possibility of choosing between progressive and linear rates of personal income tax (PIT)

Persons undertaking economic activities in Poland may choose between a progressive PIT rate (18% and 32%) or a linear one of 19%. Linear taxation is beneficial for small businesses that gain substantial income.

In addition, Poland has concluded agreements on avoidance of double taxation with more than 60 countries. The above can substantially decrease the tax burdens in case of cross-border payments.

Value added tax (VAT)

Tax on goods and services is in its core harmonized at the EU level. Poland implemented all of the Community directives related to tax on goods and services, including three directives of the so-called VAT package, introducing, inter alia, the possibility to apply for a refund of VAT paid in another member state through the national tax office.

The basic VAT rate in Poland amounts to 22%, but there is also a reduced rate of 7%, applied to quite a wide range of goods and services. Moreover, it is possible to apply the VAT exemption eg. for the provision of certain categories of services including financial, educational or cultural.

VAT can be settled on a monthly or quarterly basis. Moreover, the possibility to settle the input VAT due on import in the tax return was introduced last year to the Polish VAT law. Such possibility can positively affect the company's financial liquidity in case of importing goods to Poland.

Business and Technology Parks and Special Economic Zones

Business Technology Parks and Special Economic Zones were established in Poland in order to speed up economic development and increase the use of new technology solutions.

In the case of investing in Special Economic Zones, an entrepreneur can benefit from exemption from corporate income tax with regard to costs incurred in the process of establishing the new investment and creating new workplaces. In some cases, entrepreneurs may also receive an exemption from local taxes (upon the decision of the local authorities).

Foreign entrepreneurs investing in Business and Technology Parks can count on relief, as well as EU subsidies and tax benefits to the same extent as their Polish counterparts. Help offered while investing in the parks and zones may also comprise of advice for a foreign entrepreneur on the specifics of the Polish tax system and social security obligations, aimed for instance at identifying specific tax reliefs and exemptions that may apply to the particular business.

Application of the law by tax authorities

In the past, there were allegations concerning the excessive fiscal approach of the Polish tax authorities. This approach, however, has radically changed over the last few years. It should also be noted that Polish administrative courts in recent judgments often rule in favour of the taxpayers. This follows from the taxpayer-friendly interpretation of the ambiguous tax law provisions and subsidiary application of the EU law and rulings in similar cases.

In addition, over the last few years the approach presented by the tax authorities while conducting tax audit evolved. It seems that tax controllers while conducting tax audit try to remain minimally burdensome for companies and do not interfere with normal business operations. ■

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1. *Project for the EU Commission TAXUD/2008/CC/099, Report 2009. Effective tax levels using the Devereux/Griffith methodology, Centre for European Economic Research (ZEW), Mannheim and Oxford, October 2009, http://www.pedz.uni-mannheim.de/daten/edz-h/gdz/10/etr_company_tax.pdf*

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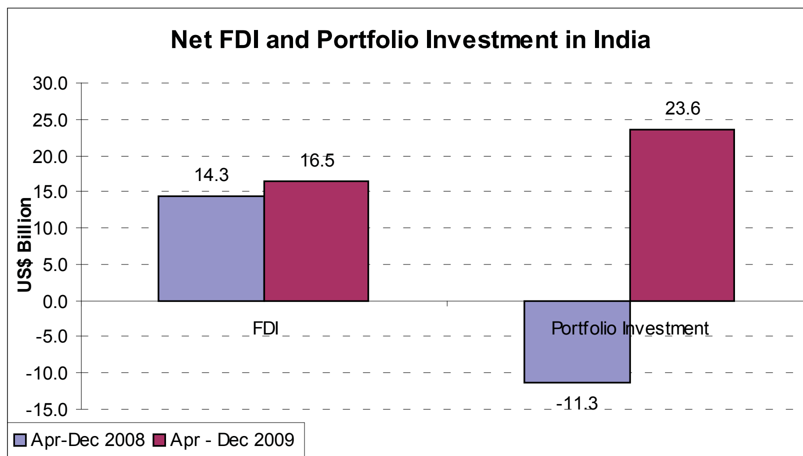

Source: RBI

reducing the dollar price of such inputs.

According to various news reports, the appreciation of the Indian rupee against the US dollar is forcing more and more small and medium enterprises, especially in the textile sector, to lay off workers or close down. According to a few industry experts in the southern textile hubs of Tirupur and Bangalore, a factory closes every week.

Garment exporters from Tirupur explain that exporters had booked current orders when the dollar was worth Rs 48-49 and it has dropped to Rs 44 since then. Since the garment exporters cannot pass on the resultant increase in dollar costs of their products to consumers in the US, out of the fear of losing out to China or Bangladesh, they have to operate on reduced margins hoping to make up through high volumes.

Appreciation of the Indian rupee has also adversely affected the outsourcing industry in the country. This is because, while the local costs of the industry have increased due to rising staff salaries, appreciation of the rupee has reduced their revenues. Since, two-thirds of the outsourcing business in India comes from the US, appreciation of the Indian rupee vis-à-vis the US dollar is worrisome for the industry.

What next?

The RBI has resorted to open market operations and purchased dollars in the past in the past to ensure the competitiveness of India's exports. However, this time with domestic inflation in double[1] digits in recent months, the RBI may have a tough balancing act to do. This is because if the RBI tries to arrest rupee appreciation by purchasing dollars from the market, it would lead to increased money supply in the system, which would fuel inflation. On the other hand, if the RBI aggressively tries to tame inflation by raising key policy rates (repo and reverse repo) and hence interest rates in the economy, it would further encourage FII's to park more funds in the Indian markets, given the fact that the future of economies in Western Europe and North America continues to be uncertain.

Nevertheless, with India's balance of payments statistics pointing towards high and persistent trade and current account deficit in recent years, any process, which renders exports more expensive in dollar terms and imports cheaper in rupee terms, cannot be ignored. ■

1. During the month of April, inflation was at 9.59%

Privatization of Public Enterprises in Saudi Arabia: Why the Process is Slow

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Effective implementation of the privatization strategy of Saudi Arabia entails some challenges that need to be addressed carefully. A number of lingering issues related to the implementation of the privatization strategy of the Kingdom include: valuation of public enterprises under imperfect capital market, the debt issue of public enterprises, land use restrictions and labour issues, securing efficient tendering process, and a corporate governance system that direct and control the behaviour of management after privatization.

However, by the end of 2010 almost six years have passed since the announcement of the privatization strategy of Saudi Arabia, and thereafter identification of the public facilities to be privatized. So far none of the firms slated for asset privatization have been privatized fully (enterprises slated for privatization include domestic aviation services, education services, the Saline Water Conversion Corporation, The Saudi Electricity Company (SEC), SABIC, Sewage Services, certain banking and telecom services, railways, and sea ports the Saudi Arabian Mining Company {Ma'aden}, Saudi Arabian Airlines, and also include state-owned shares in joint Arab and Islamic companies).

The pace of the program is slow, even though lately some steps have taken place in service privatization, as opposed to asset privatization. The strategy does not provide a time framework for the completion of the privatization program. An indicative timetable for privatization with a set of goals for each stage of privatization would send strong signals to investors and create confidence in the authorities' commitment to an effective and goal-oriented privatization program. A rapid and well planned privatization is to be preferred over a slow and ill-conceived privatization program. A slow and ill-planned privatization program can demoralize workers and managers in the public sector. The management of enterprises may engage in capital depletion if they have no stake in privatization or fear job losses upon transfer of ownership to the private sector.

Capital market anomaly and valuation of assets

A successful privatization program requires a developed, fairly competitive, and efficient capital market, including a market for corporate control. When the flow of information for investors in existing capital markets is imperfect and incomplete, and firms'

accounting records and auditing standards are poor, as well as, when investors lack access to accurate material information and reliable data about firms due to delays in the publication of annual reports, it becomes difficult to check insider-trading and malpractice in the capital market. In such situations resorting to local stock market for securities valuation may not yield fair values. Under imperfect capital markets the assets and liabilities of public enterprises should be valued by a selected accredited accounting firm using more than one valuation approaches which are subject to review by the authorities, and if necessary, to be re-valued by another selected accounting firm. The authorities should provide the valuation report and other relevant documents, or prospectus, including three years' financial and performance data of the firm to potential buyers. The authorities should try to ensure that there is no collusion between the accounting firm and the potential buyers. When the authorities allow buyers to sell privatization bonds in the capital markets to raise funds to buy enterprise, commercial banks should underwrite or purchase bonds issued to finance the leverage buyout of the public enterprise. In essence there should not be any state subsidy to the buyer of the enterprise. The private owner must assume full financial and managerial responsibility for running the enterprise.

"Dealing with the long-term debt of public enterprises is a major challenge for the implementation of the privatization program"

Debt issues and terms of sale

Dealing with the long-term debt of public enterprises is a major challenge for the implementation of the privatization program, as there is no provision of that type included in the privatization strategy of the Kingdom. One option to be considered in this respect is that the buyer should assume the long term liabilities for the firm upon transfer. The short-term liabilities, such as claims of workers and income taxes should be assumed and be written-off by the state.

If the value of the assets exceeds bank loans, the buyer will have to pay the excess amount either in cash or within one year along with a simple premium rate reflecting time preference of money.

Short-term and long-term liabilities have to be clearly defined prior to privatization. A clear and consistent demarcation of liabilities needs to be established and upheld. The privatization strategy should also state clearly that the buyer shall assume full legal responsibility for all pending court cases against the enterprise. There should be no scope for renegotiating the terms and conditions of privatization after the sale.

When the price is not paid in cash, the buyer should be required to provide a bank guarantee. But a guarantee from a bank with poor asset quality, low profitability, and poor management is worth very little. If the bank guarantee is issued by state owned bank, then ultimately it is the state that assumes the responsibility for the buyer's credit. Such a guarantee can have adverse effects by creating an incentive to default. Indeed, the state bank's guarantee may be contrary to the objective of privatization as the public indirectly ends up assuming the burden if the buyer defaults.

If the bank guarantee is issued by private commercial bank with a record and propensity for insider loans, such a guarantee be of little value. Bank guarantees are to be accepted when the bank can assume the responsibility for default and has the financial ability to meet its obligations without recourse to the state exchequer. Only guarantees from financially solvent banks are reliable and trust worthy.

If the authorities sell enterprises partly on credit, a strong mechanism for credit collection is required. Discipline in the banking and non-banking financial system is necessary for the success of the privatization program, because otherwise there will be both incentives and means for rent-seeking, as buyers may borrow from banks against collateral of little value, and refuse to pay bank loans, or try to delay payment to the state.

Land use restrictions

The privatization strategy of the kingdom does not stipulate the land use for industrial purposes. A provision restricting the land use for industrial purpose deters buyers from buying the enterprise for its land value rather than for operating the given enterprise as a manufacturing unit. A provision of bundling land use with an enterprise may reduce sale price of an enterprise, as there is a trade off between the sale price of public enterprise and whether the surrounding property is unbundled.

Unbundling the surrounding property and then selling the property at the market price is motivated by the desire to raise higher revenue from privatization. The benefits of unbundling the property is that it creates a good number of new industrial estates with considerable market value, because of a booming real estate market and the scarcity of suitable industrial plots in Saudi Arabia at the current time. The demerit of unbundling the adjacent property from the enterprise is that it restricts the scope for future expansion.

Securing an efficient tendering process

The privatization strategy of the kingdom also lacks specific procedures to be followed when implementing privatization transactions. A well-prepared and decisive tendering process is essential for enhancement of the implementation of the program. The market price reflects the value of the firm, provided that it is being valued in a well-functioning and informed market place composed of a rather large number of buyers. In the absence of a competitive environment there is scope for under valuation, particularly in a small group oligopoly market where the numbers of potential buyers are few and there may be structural features that enable collusive behaviour.

A benchmark number has to be determined regarding the number of competitive bidders at which to accept the highest bid price when the amount offered is less than the net worth of the firm. In the case when the number of bidders is less than the acceptable competitive number of bidders but the price is lower than the net worth of the firm the tender needs to be repeated again. In the second round of tendering, irrespective of the number of bidders the highest bid price has to be accepted even if it is lower than the net worth of the firm.

When the tendering process is weak, a more effective mechanism for the disposal of firms can be made by using a wide variety of practical and feasible auction techniques. The authorities can also establish an appropriate reservation price for the firm to be privatized. If the bid price is lower than the reservation price the authorities can convert the public enterprise into a joint stock company and sell its shares. When a strategic buyer, who is willing to pay above the reservation price, is not forthcoming, the state can use initial public offer or private placement schemes. Experience in the EU, where the tendering process throughout the union is subject to a series of EU Directives, indicates that good practice covers the following aspects of tendering:

A -Transparency in selecting potential awarding contractors, secured by the use of objective selection criteria which must be known beforehand and by the requirement to publicize any contract whose estimated value exceeds specific threshold.

B - Indication of which of the permissible award procedures have been chosen:

i) An open procedure, in which any firm may tender;
ii) A restricted procedure, in which only firms that have been invited to tender by the contracting authority may do so;
iii) A negotiated procedure, in which the contracting authority consults selected firms and negotiate the contract terms with one, or more of them.

C - Compliance with explicitly stated technical requirements standards.

Labour issues

The existence of highly productive manpower is a critical factor in the success of the privatization program. In order to enhance skills and competitiveness, enterprises targeted for privatization should be required to develop appropriate training programs to retrain their workers as part of the enterprise restructuring program prior to privatization. As firms downsize under private ownership many jobs will be lost and some workers will be laid off. As a result unemployment will increase, in particular during the first years of the sell-off of public enterprises. To alleviate the impact of the adverse effects of privatization on the labour market the proceeds from privatization may be used for addressing the unemployment problems arising from the privatization program. Thus funds from privatization can be used for:

1- Workers compensation (ie. severance payments).
2- Labour training and relocation programs.

Corporate governance

The privatization strategy of Saudi Arabia states that the principal objectives of privatization are to improve the capacity of the national economy and enhance its competitive ability. These objectives can hardly be achieved without having a sound and effective corporate governance system that direct and control the management of enterprises after privatization. The literature on corporate management and control includes extensive research on corporate governance.

Charkham (1994) defines two basic principles of corporate governance:

(i) Management must be capable to lead the enterprise forward, free from constraint caused by government interference, or fear of displacement.

(ii) This freedom must be exercised with a framework of effective accountability.

Good corporate governance is thus concerned with correctly motivating managerial behaviour towards improving the business, as well as controlling the behaviour of managers. The system of governance operating in Saudi Arabia relies on the board of directors and shareholders voting at the AGM to provide the mechanism of governance. If shareholders have little incentive to provide monitoring and the board of directors does not operate as an effective mechanism, there is little, other than resorting to the market for corporate control (which in itself can be inefficient), to ensure that good corporate governance practices prevail.

The nature of Saudi system of corporate governance owes much to the nature of the ownership and control of registered companies in Saudi Arabia, with ownership being highly concentrated and the majority of equity being held by institutions that have necessarily focused solely on the long-term performance of companies. The nature of share ownership in Saudi Arabia is essentially long-term. This is not to say that all shareholders own their holdings for long-periods of time, but shareholders in general perceive their holdings as investment vehicles whose purpose is to provide income (either in the form of dividends, or capital gains) rather than as ownership stakes in Saudi companies.

Mayer (1994) and Frank and Mayer (1996) distinguish between insider and outsider systems of ownership. In outsider systems those with ultimate power (the shareholders) are essentially arm's length investors, whereas in insider systems those with the ultimate power are closely connected to the company. An essential distinction between the insider and outsider systems is the extent to which the corporate sector is involved in the ownership and control of companies. Franks and Mayer (1995) argue that insider and outsider systems may be appropriate in different contexts. The former may be best suited to corporate activities with longer term pay-offs, but may be slow in undertaking necessary corrective action. The latter may be better suited to riskier investments requiring large amounts of new capital investment, where it involves well-diversified public owners, but corrective action may be taken prematurely.

Riskier investments may require closer active and responsive monitoring if they are to come to fruition. Outsider systems may fail to provide sufficient monitoring. Insider systems may provide monitoring but fail to exit from unviable projects in a timely fashion. These suggest a need for firm/situation specific corporate governance in which there is a sufficient means to monitor the behaviour of managers.

Cadbury (1992) sets out seven recommendations in an attempt to control and monitor the behaviour of managers:

(i) The role of chairman and chief executive officer should be separated. However, if both posts are held by one individual, there should be strong and independent set of non-executive directors on board.

(ii) The majority of non-executive directors should be independent of management and free from any business or other relationships which could materially interfere with the exercise of their independent judgment.

(iii) Executive directors' contracts should not exceed three years without shareholders approval.

(iv) Full disclosure of the remuneration of the chairman and highest paid director should be provided.

(v) Executive directors' remuneration should be subject to the recommendations of a remuneration committee comprised of wholly or mainly non-executive directors.

(vi) Boards should establish an audit committee of at least three non-executive directors.

(vii) Directors should report on the effectiveness of the company's system of internal control, including mechanisms for risk assessment and management and confirm that the business is a going concern.

Conclusion

We address here a number of challenges facing the implementation of privatization program of Saudi Arabia. Valuation of public enterprises needs to be treated with special care since under imperfect capital markets reliance on local capital markets may not yield fair valuation of enterprises. When public enterprises operate under capacity level, valuation via cash flow techniques may also result in under pricing of assets.

The issue of public debt of enterprises under privatization should also be dealt with some delicacy. Long-term debt usually transferred to the buyer of the firm as the buyer pays the net asset value, whereas short-term liabilities, such as claims of workers should be assumed by the state. Such options require a clear demarcation of short-term and long-term liabilities from the very beginning of the privatization process. It is also important when selling public enterprise setting up a payment mechanism that ensures effective credit collection system. Under imperfect capital markets (with weak corporate governance system) reliance on local banks' guarantees may entail insider loans practice.

The paper also discusses the merits and demerits of bundling and unbundling the land use with the enterprise. In the absence of a competitive environment there is scope for under valuation, particularly in a small oligopolistic market, as a result the tendering process is also another challenge. The paper presents a view on how to secure an effective tendering process. Since transfer of public enterprises into private ownership is not the end objective of the privatization program, we highlight the importance of establishing good corporate governance system that correctly motivates managerial behaviour towards improving the business, and at the same time controlling the behaviour of mangers. ■

Antigua A Serious and Progressive Financial Centre

Brian Stuart-Young CAMS, is CEO of Global Bank of Commerce, a position he has held for several years, and has supervised the growth and development of the institution. He manages the Bank's corporate head office at Global Financial Centre, Friars Hill Road, St. John's, Antigua. He also has senior executive responsibility for the Bank's investment Division, GBC Wealth Management Ltd., located at the head-office. His extensive private and public experience includes a current board position with the Caribbean Association of Indigenous Banks (CAIB) and earlier positions as a Director of the Caribbean Association of Industry and Commerce (CAIC), Director of the Eastern Caribbean Investment Promotion Services (ECIPS), Chairman of the Eastern Caribbean States Export Development Agency (ECSEDA), and Director of the founding board of the Centre for Management Development at the University of the West Indies (CMD-UWI). He is a Charter Professional Member of the Association of Certified Anti-Money Laundering Specialists (ACAMS). He is also a Fulbright Scholar, and was educated in the United Kingdom and the United States, and is a regular contributor to various leading publications on financial services.

Brian Stuart-Young, Chairman and CEO of Global Bank of Commerce Ltd, discusses developments in the Caribbean banking sector in an interview with Tom Page

How has the world economic crisis affected the international banking sector in the Caribbean and Antigua in particular?

The Caribbean is a favourite destination for both tourism and international financial services. However, it is not unscathed by issues relating to the world financial crisis nor by the closure of the Stanford International Bank in the jurisdiction of Antigua and Barbuda as well as other regional failures. Most of the Caribbean banking sector has experienced a snowball effect resulting from these events, even though its financial institutions had no direct exposure to the toxic sub-prime mortgage debt that triggered the crisis.

First, the regional economy, which is largely dependent on tourism, suffered from the financial constraints experienced by most travellers by sea and air. Second, international clients using the banking services of international financial centres experienced credit restrictions in their home markets and were forced to disrupt their wealth management portfolio to address their personal financial circumstances; some had significant losses from the depressed stock markets and needed to dip into their savings to purchase more shares in stocks at the reduced values; and then there were other clients who identified exceptional opportunities in real estate values and used their savings to purchase properties. Third, several hotels in the region had to reduce employment levels to respond to the downturn in visitor arrivals. Antigua also had a major dislocation in employment from the closure of the Allen Stanford owned Bank and his group of companies was considered as the largest private employer after government.

Notwithstanding the challenges of the prevailing environment, the Caribbean banking sector supervised by multi-jurisdictional banking Acts and Regulators has responded well to various legislative and regulatory updates to meet international standards. In the case of Antigua and Barbuda, both its government and banking sector are strongly committed to ensuring an infrastructure which can respond to the special business needs and financial services of not only Caribbean clients but also international client relationships.

How have Caribbean banks stepped up their internal compliance regulations in response to the heightened scrutiny on Caribbean banks with regard to preventing money laundering and terrorist financing?

A key issue for Caribbean banks, and all banks who have no parent offices located in major financial centres, has been the maintenance and strengthening of correspondent banking relationships. These banks require relations with other banks through which they can conduct international cash clearing and transfer services, and are entirely reliant on such correspondent facilities from other banks that provide intermediary services. Given the various international issues that have caused heightened scrutiny over correspondent relations, and the global demands to prevent money laundering and terrorist financing, the Caribbean Association of Indigenous Banks (CAIB) undertook to advocate on behalf of its member banks for stronger relationships through establishing a code of principles by which the member banks would demonstrate their compliance with international standards. It is an initiative that has been encouraged by correspondent banks currently conducting business with Caribbean banks.

In keeping with the principles espoused by the Wolfsberg Group of eleven major banks that provide international correspondent banking services, CAIB's Advocacy Committee has developed the Caribbean Principles, which establish risk management standards for

members and comply with related international standards to support the reputation and operational integrity of Caribbean banks.

In October 2009, the CAIB Board of Directors formally launched *The Caribbean AML/CTF Principles for Correspondent Banking*. These Principles, with associated AML/CTF Guidelines, are a core set of standards to which member banks will subscribe by having their Board of Directors agree to adopt and ensure the compliance of their institution. CAIB will also promote the Caribbean AML/CTF Principles to the several regulatory and supervisory authorities for AML/CTF matters in the Caribbean region, so that member banks' compliance with these standards will also be observed during regular bank examinations.

Subscribing banks to these Principles, including those from Antigua, are identified on the CAIB website www.caribbean-principles.com, and Caribbean Principles will establish a registry to host certain bank information that will assist third parties, including correspondent banks and customers, to review the compliance of banks with international standards and expand their trust and confidence in Caribbean financial institutions.

The offshore sector often suffers from a reputation for encouraging tax evasion. How does Antigua ensure that it is not considered a tax haven?

Antigua's jurisdiction has a robust mutual legal regime which facilitates a transparent process under which information may be exchanged. It will not allow itself or its banks to be used as a secret tax haven and recognizes the requirements for tax compliance and anti-tax fraud policies. It was one of the first Caribbean jurisdictions to establish a Tax Information Exchange Agreement with the United States, and has held tax treaties with the United Kingdom and the Caribbean Commonwealth Community for many years. It successfully completed more than a dozen tax information exchange agreements (TIEAs) by the last quarter of 2009, which made it fully tax compliant with the OECD requirements and was placed on the OECD's "white list". Not satisfied with holding the bare minimum to meet the qualifying criteria for the "white list", Antigua continued to negotiate additional TIEAs and by May 2010 the number of TIEAs that have been ratified by its Parliament had risen to twenty, placing the jurisdiction in significant compliance with the OECD requirements for tax transparency.

International Financial Centres are often accused of maintaining secrecy laws that prohibit cooperation between the jurisdiction and external authorities. How does Antigua manage mutual legal assistance services?

Antigua has ratified mutual legal assistance in anti-money laundering and anti-financing of terrorism matters as provided for under its Mutual Assistance in Criminal Matters Act (MACMA). The MACMA provides for mutual assistance for all countries that are members of the British Commonwealth, the United States of America and for other countries for which Antigua and Barbuda has signed mutual legal assistance treaties (MLATs). There is no legal or practical impediment for rendering assistance where both countries criminalise the underlying offence. The jurisdiction also benefits from being a member of the Egmont Group through Antigua's supervisory authority, Office of National Drug and Money Laundering Control Policy (ONDCP), which assists communications between Financial Intelligence Units to prevent money laundering and the financing of terrorism. The governing legislation for the management of its international financial centre is regularly updated to ensure compliance with international standards.

In May 2010, the government announced in the Parliament of Antigua and Barbuda that the Antigua Court-appointed Receiver for the Stanford International Bank (SIB) had reached a mutual assistance arrangement with the US-based SEC-appointed Receiver over the SIB assets, with the intention of providing the best cooperation between the interested parties in order to address the circumstances and assist the SIB's account holders. Antigua is firmly committed to mutual cooperation and the preservation of a safe financial sector environment.

Will the imposition of global regulations affect banking regulations in Antigua?

The regulatory environment of banks providing international financial services is strongly supervised for the safe and ethical depository of foreign currencies and the delivery of wealth management solutions. The jurisdiction undergoes regular peer evaluation by the Caribbean Financial Action Task Force as well as reviews by the World Bank and

the IMF, all of which give enhanced scrutiny to the operations of the financial centre.

The supervision of banks is divided with domestic commercial banks under the Eastern Caribbean Central Bank, and international service banks are licensed and regulated by the Financial Services Regulatory Commission (FSRC) and must maintain internal policies to govern compliance with international standards. These requirements include annual third-party audits of their anti-money laundering (AML) and anti-terrorist financing (ATF) practices which must be submitted to the ONDCP and the FSRC for review. Following the collapse of the Stanford Bank, there was a major review of the FSRC undertaken by experienced bank examiners drawn from the region and Canada and assisted by the Financial Action Task Force (FATF). With these actions, the jurisdiction has been aggressively emulating the actions being taken worldwide to strengthen the regulatory oversight of all financial systems.

The FSRC has already adopted stronger levels of supervision for its annual examination of all international service banks, including the requirement that all bank investments be independently confirmed to the regulator, thus obtaining a secondary confirmation to the one provided for audit purposes and ensuring an up to date analysis of the assets carried by the institution. Annual financial audits are mandatory and are conducted by resident offices of well recognized auditing firms including PricewaterhouseCoopers, PKF and KPMG. The impact of the financial crisis and the closure of the Stanford International Bank has transformed Antigua into one of the safest and most strongly regulated jurisdictions in the world.

What are some features that Antigua offers which make its international banking and business sector attractive to international investors?

The combination of well-regulated financial services, world class communications, an English-speaking and skilled workforce and strong professional resources offers a positive environment for electronic and international business services. Antigua provides ideal support for information technology services and internet-driven business opportunities that demand more sophisticated financial services.

The Antigua & Barbuda Investment Authority established by the Government assists the investment process and identifies related incentives for certain investment categories. Modern financial services include Internet banking, telephone banking, wire transfers in major currencies, corporate and trust administration, pension and fund management, payroll services, electronic commerce facilities that allow online sales of international services and products, and the development of multi-functional prepaid debit cards. These are powerful financial tools that enable business people to compete in an international and open market environment. The remarkable growth of the internet is impacting economies around the world, and Antigua is no exception.

Is Antigua positioned to provide international financial services to companies operating across borders?

As an independent nation, Antigua is well positioned to attract international business for electronic commerce. The government has passed the relevant legislation to govern e-commerce, the Electronic Transactions Act, and also to control abuse of electronic systems and protect the safety of online activity. The government is also committed to operate as an e-government and has positioned Antigua to become a leading Caribbean IT centre.

In addition, Antigua has become attractive to international investors from Latin America, Europe and the Far East seeking private banking services and wishing to balance their portfolios with certain commodity and foreign exchange trading services, and who may be interested in property investment in the jurisdiction. Increasingly, investors have been purchasing properties in Antigua and Barbuda as vacation and second homes. These investments also qualify them for Permanent Residency, and they can obtain advice from any of the major accounting firms with offices in Antigua such as PricewaterhouseCoopers, PKF, KPMG or their own advisory resources for tax planning arrangements. Several major real estate developments are being undertaken in Antigua & Barbuda, and interest from international investors has been significant. The resident banks have been supportive to investors pursuing local real estate and tourism projects.

Is credit card default the next crisis in the making?

The management of credit within the Caribbean banking sector is very different to that as established in major financial centres. Old fashioned Caribbean bankers will tell you that they are happy to lend you once they hold your family jewels. In general, the lending practices are very well secured. Even in the case of credit cards, the credit is usually related to pre-approved credit limits tied to pre-established collateral requirements. With respect to international clients, the credit is based on cash deposit securities equivalent to at least 100 percent of the credit limit. Whilst credit card default may well become the next major wave of the financial crisis, it should not have a direct impact on the Caribbean banking sector.

How do you see the financial sector in the Caribbean in general and Antigua in particular over the next 12 months?

The economy of the Caribbean is largely dependent on the well being of the economies in North America and Europe. Some green shoots are beginning to appear in these markets and it is expected that the improved regulatory environment will further assist this growth. The Caribbean jurisdictions have kept pace with the various improvements in regulatory and auditing oversight, and all the jurisdictions comply with the International Financial Reporting Standards (IFRS) and financial institutions are audited in accordance with these standards. The regional banks, including those providing services from international financial centres, expect that the major markets will see some recovery shortly due to their strategies, and the Caribbean should see the first waves of this recovery over the next 12 months.

Antigua's financial centre has learnt from the issues resulting from the Stanford International Bank, and, from a regulatory and audit compliance position, is well restructured to better serve its domestic and international banking clients. There is also modern legislation to govern the operation of various types of formal structures required to support wealth management strategies, including the establishment of trusts and foundations and the incorporation of international businesses and limited liability companies. There is a fully experienced and professional sector comprised of attorneys-at-law and licensed company providers that can assist in the clearing of names, registration of corporate entities and referring clients for bank account relationships in the jurisdiction.

This professional and legislative landscape will greatly support the financial institutions operating in the jurisdiction, and strengthen the business opportunities for Antigua to perform as a serious and progressive Caribbean financial centre. ■

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Listing Your Fund on the Cayman Islands Stock Exchange

Jonathan Culshaw is a Partner at Harneys' London office and Jonathan Law is a Partner in the Cayman Islands' office

Introduction

The Cayman Islands is the world's leading offshore domicile for investment funds and the Cayman Islands Stock Exchange (CSX) has developed a stream-lined, flexible and progressive regime for listing a variety of investment funds. Since its inception CSX has listed over 3,000 securities with the aggregate market capitalisation of listed securities being in excess of US$160 billion. CSX permits the listing of every type of fund vehicle whether a company, unit trust or limited partnership. Various fund structures including closed and open ended, stand-alone and master-feeder structures are all permitted to apply. Additionally, there is no restriction to Cayman-based funds. In this article, Harneys partners Jonathan Culshaw and Jonathan Law examine the benefits of listing and also offer some guidelines on how to get listed on the CSX.

Reasons for listing

- Broaden investor base – a listing can increase the marketability of funds since institutional and other investors in numerous jurisdictions are prohibited from investing in unlisted fund securities or securities which are not listed on a recognised stock exchange. In addition, CSX has an automated electronic NAV reporting system and it has dedicated pages on both the Bloomberg Financial Markets Information Service and Telekurs, allowing each listed fund's net asset values and investment profiles to be accessed from over 80,000 terminals worldwide.

- Third party review and oversight - CSX officers undertake a qualitative review of each fund at the time of listing, vetting the initial listing documents and reviewing the suitability of each fund issuer's directors, investment manager, administrator and other service providers. Funds with unsuitable or inexperienced managers will be refused a listing, so a successful application and listing should indicate to investors that a fund is bona fide and managed appropriately.

- Flexibility - CSX remains proactive and competitive in the funds space adapting its listing requirements to address the particular needs of new fund structures and products. In determining listing requirements CSX seeks to strike a pragmatic balance, avoiding the imposition of any regulatory requirement that unnecessarily increases a fund's costs and reduces investor returns. Unlike some competing exchanges, there are no specific applicable investment policy restrictions.

- Timing, professionalism and cost - CSX is committed to providing initial comments on any draft listing document within five business days and a document turnaround time of three business days thereafter. The listing process is quick, usually taking three to six weeks to list an investment fund and disclosing all relevant information without imposing unnecessary conditions. CSX listing fees are extremely competitive with a typical fund listing costing just US$2,000 per annum.

- Status of Cayman and CSX - as a white-listed OECD jurisdiction, the Cayman Islands is fully compliant with the international standard for exchange of tax information. With its financial regulator the Cayman Islands Monetary Authority as a full member of IOSCO and CSX an affiliate member, there is some assurance that the jurisdiction and the exchange meet the highest internationally accepted standards of securities regulation.

General eligibility

Every issuer must be able to satisfy some basic eligibility conditions including:

- The directors of the fund or its controlling entity having adequate experience and expertise in the management of funds.

- The transferability of the securities to be listed

- The appointment of an independent auditor to audit the fund's financial statements as well as a registrar and transfer agent in the Cayman Islands or another approved jurisdiction.

Getting Listed

The listing agent

The first step for any proposed issuer is to appoint one of the Cayman Islands law firms which has been approved by CSX to act as an approved listing agent who is then responsible for advising the issuer on the requirements of CSX's listing rules and acting as the liaison point between CSX and the issuer.

The listing document

Once the prima facie eligibility of the issuer is determined, a listing document will need to be prepared. It may take the form of the fund's existing prospectus and needs to include all information necessary to enable an investor to make an informed assessment of the activities, assets and liabilities, financial position, management and prospects of the issuer, its profits and losses and the obligations, rights, powers and privileges of such securities. There is a host of specific requirements and disclosures in relation to funds including:

- a description of the investment objective, policies and restrictions to be followed by the fund

- a detailed list of all material risks associated with investing in the fund such as material counterparty, custody or settlement risks

- a summary of the principal contents of the service providers' contracts, identifying particulars of the dates and parties, terms and conditions, fees or remuneration to be paid to such service providers

- a statement of all material fees to be paid by the fund

Continuing obligations

Once listed, an investment fund must continue to comply with its ongoing obligations, as specified in the listing rules. In particular, CSX must be notified of any major new developments in the fund's activities which are not public knowledge and which may lead to a substantial movement in the price or net asset value of the shares.

Summary

The listing rules are flexible, pragmatic and straightforward and throughout the listing rules the emphasis is towards transparency, not inflexible prescription. The rules serve to ensure that every relevant piece of information is disclosed to investors, giving them enough information to enable truly informed decisions as to whether to invest in a particular fund without seeking to impose onerous and arbitrary requirements as to the management and operation of funds. In essence, a CSX listing is an inexpensive and effective way to add transparency, profile and reputation to any fund offering. ■

For more information about listing your fund on the Cayman Islands Stock Exchange, a more detailed version of this article is available at:

http://www.harneys.com/publications.php?npindex=457

Alternatively you can contact:
Jonathan Culshaw at jonathan.culshaw@harneys.com or
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Bermuda is highly regarded as one of the most sophisticated e-Business jurisdictions in the World. According to Economist Magazine's eReadiness survey, out of seventy countries assessed, Bermuda has consistently ranked among the Top 21, and in 2009 was in the top 10 overall for business environment and connectivity. Not coincidentally, Bermuda's business continuity and data recovery services compete head-on with others in larger business centres, with great efficiency. We are here and eReady to help your business maximise its potential, whatever the challenge.

GOVERNMENT OF BERMUDA
Ministry of Energy, Telecommunications and E-Commerce
Department of E-Commerce

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ICT in Bermuda: Measured Progress

A growing consensus has taken hold that the development of information technology systems has produced change in our lives of a magnitude akin to that of the Industrial Revolution. Early adopters of the new technology have tended to be found in the private sector. Many governments have limited their role to encouragement from the sidelines, the installation of limits (on speed, content and online practices) and, increasingly, the sourcing of revenue from online activity. This despite the US Government's implacable demand that the web remain uncensored and "free" in spirit.

It is refreshing, therefore, to look at the work of the Bermuda Government in not merely supporting, but in leading the ICT sector. The Bermuda Government was itself one of the earliest adopters of ICT. Realising that the island's traditional remoteness would be changed by the advent of the web, the Bermuda Government decided that it should lead, rather than follow, the private sector.

As early as 1999, ICT had its own Ministry and thus a representative in meetings of the Bermuda Government's Cabinet. An electronic code of conduct was published that year and has been upgraded since to ensure that it remains relevant. Government itself is driving rapidly towards the goal of offering all its services online, and is a world leader in that regard. Although the project is not yet complete, the way in which the governed interface with their Government in Bermuda has become increasingly electronic, in the payment of taxes, vehicle licensing and registration, and a hundred other ways.

The traditional adversarial approach between government and the public does not apply to Bermuda's e-commerce efforts. The Ministry of Energy, Telecommunications and E-Commerce (METEC) is responsible for regulating the IT sector, but does so in a conciliatory and consultative manner that does not downplay its role as monitor and regulator, but which has allowed the sector to develop in a sensible and meaningful manner. Similar public-private partnerships lie at the heart of Bermuda's success as an international financial services centre, and nowhere is that partnership better evidenced than in the area of e-commerce.

"The traditional adversarial approach between government and the public does not apply to Bermuda's e-commerce efforts"

From time to time, the Ministry takes actions that some elements of the ICT sector might prefer it did not, but on the whole, an understanding exists that the Bermuda public, corporate and individual, is hungry for connectivity at an affordable price. Cell phone usage, for example is as high in Bermuda as it is anywhere in the world, and this has been made possible by sensible Ministry policy and law, enacted only after consultation with all the service providers to ensure that every angle of progress is considered before rules are laid down. METEC, and especially the Department of E-Commerce, is strictly utilitarian in its outlook: what is best for the greatest number wins the day.

The Hon Michael Scott JP, MP, Minister of Energy, Telecommunications and E-Commerce

Thus questionable activities such as gambling and pornography may not be hosted from Bermuda's domain; parents are offered practical advice on shielding their children from the most damaging sites that a "free" internet has to offer; every student in Bermuda is offered practical advice and encouragement in the area of telecommunications; an annual Tech Week highlights what is available and where improvements have been made; annual Technological Innovation awards (which this year attracted some 150-plus entries) celebrate ICT advancements; and overall, the Department of E-Commerce works at what, by government standards generally, is warp speed, reflecting the incredible rate of development that the online world takes for granted.

In 2008, METEC received Cabinet approval for its *"Telecommunications Regulatory Reform Policy"*. The new policy will change the telecommunications regulatory regime from one that is currently a managed competition to an open and fully competitive landscape under the regulatory oversight of a fully independent regulator.

Industry has participated in the development of this new ethos, which will see the introduction of two pieces of ground-breaking legislation: the Electronic Communications Act 2010 and the Regulatory Authority Act 2010. These changes are intended to act as an enabler of ICT on the island and, through competition, to provide a level of innovation in telecommunications that is expected to contribute to the further diversification of Bermuda's economy.

Recently, METEC's energetic Minister, The Hon Michael Scott, JP, MP, summed up his Government's intent thus: *"The Department of E-Commerce will carry on its efforts to promote, support and instigate the continued growth and advancement of technology, technology-related business, opportunities, legislation, e-skills and access, so that Bermuda continues to be recognised as a prime and sophisticated jurisdiction in which to live and conduct business electronically."*

Could Bermuda's commitment to IT be more plain?

Worldwide recognition

Bermuda's progress in the IT area has made headlines around the world. The Economist Intelligence Unit, in its annual surveys, routinely rates Bermuda in the top tier of countries worldwide in terms of e-readiness. The World Information Technology and Service Alliance (WITSA) held its Global Public Policy Summit (GPPS) in Bermuda late last year, and the event was a resounding success. Hundreds of attendees travelled to Bermuda from more than 40 countries for the event.

The Secretary General of WITSA, Dr James H Poisant, summing up the conference, said: *"WITSA is extremely proud that the Bermuda Chamber of Commerce, working in collaboration with the Bermuda Government, succeeded in hosting the best-ever Global Public Policy Summit in WITSA's history. The programme content, speakers, venue and operations were world-class."*

The Bermuda GPPS event culminated in the issuing of a Bermuda Declaration, the objectives of which included the articulation of broad goals for the future direction of policy within the global ICT industry. Mr Dan E Koo, Chairman of WITSA, also referenced the Bermuda Declaration as being a precursor to the development of the Declaration of Amsterdam, adopted at the closing ceremonies of the WITSA World Congress on Information Technology (WCIT 2010) held in Amsterdam, from May 25 to 27 this year.

In Amsterdam, as a result of the success of the Bermuda GPPS conference, the Bermuda Government was given a special award

by WITSA, its ICT Industry Development Award, which recognises governmental efforts to encourage the development of the global ICT industry.

The intention of this pre-conference was to enable several emerging countries in that region to participate, which would not otherwise have been able to do so; to provide meaningful sessions on growing and maturing ICT industries; and to enable the participants to network with their global peers and benefit from the 2009 GPPS.

The wired island

In May, METEC released the third and final annual report on The State of Information and Communication Technology in Bermuda. The research, carried out by an independent agency, was based on a carefully selected representative sample of more than 400 households and in-depth interviews with 200 small, medium and large businesses. The report established a benchmark view of Bermuda's technological competence, as well as local attitudes towards technology issues. The report's conclusions serve as a window into ICT development in Bermuda and its acceptance among the corporate and individual communities. The report's findings were grouped into three areas of insight: attitudes towards technology; access to technology, and ICT literacy.

The general view in the past decade has been that the Bermuda population is a sophisticated user of ICT. The report bears this out, both in corporate and individual terms. To a degree unimaginable not long ago, Bermuda residents' use of and reliance on their electronic access to the world defines the nature of Bermudian society.

Corporate ICT usage

Bermuda is home to about 15,000 local and international companies. As might be expected, almost all own and use computers, the report stated. Among other findings:

- Essentially every company that owns a computer has access to the internet, with the majority having a broadband connection.

- The average employee spent 30.4 hours a week using a computer at work in 2009, up from 27.1 hours in 2008.

- Seventy-eight percent of Bermuda businesses have a company website. About a quarter offer online payment facilities. About 40% have an internal intranet.

- Common servers are used by 81% of companies, just about all of which are secure. Three-quarters of companies with a common server have remote access.

- The existence of defined technology security policy increases with the size of the business. Such policies exist at 89% of large firms, 59% of medium firms and 46% of smaller firms.

- About 85% of Bermuda businesses have a disaster recovery and business continuity plan.

- More than half of all Bermuda companies offer formal technology training.

Personal internet use

Among the more important findings of the report:

- Nine out of every 10 residents (89%) have internet access, the great majority with a high-speed connection. Similarly, 90% of residents own a computer, suggesting that virtually everyone who owns a computer has internet access.

- Ownership of laptops increased from 55% in 2007 to 68% in 2009, with a corresponding decline in desktop ownership from 76% to 63%.

- Residents were more knowledgeable about technology products and more interested in learning about new technology in 2009 than they were in 2008 and 2007. Residents also declared themselves more likely to want to be early adopters.

- The incidence of residential computer networks is increasing. About three-quarters (73%) of residents who own more than one computer have such a network, up from 54% a year earlier. Exactly three-quarters of residential network owners have a wireless network, of which 81% are secure.

- Cable internet access is growing at a rapid clip. Cable access increased from 7% in 2008 to 17% in 2009.

- Residents spend about 11 hours a week using a computer at home. About three-quarters of Bermuda residents are on the internet more than half the time they are using their computers at home.

- Online banking has caught on in Bermuda in a big way. About three-quarters of residents (73%) bank online. Similar percentages use the internet for news and travel information, online shopping and e-mail.

- Sixty percent of residents buy online from overseas suppliers, while 21% use the internet to buy from local suppliers. Given the island's small size and narrow retail sector, overseas online purchasing was always likely to be popular.

Cell phones

The report found that an overwhelming 94% of Bermuda residents own a cell phone or mobile device. Excluding the very young and very old, just about everyone in Bermuda uses a cell phone or mobile device.

- All aspects of mobile usage are on the increase. The use of Blackberry Messenger, for example, increased from 12% in 2008 to 31% in 2009. Internet browsing on cell phones rose to 42% in 2009 from 25% a year earlier.

- The use of text messaging is also increasing significantly, with more than half of all Bermuda residents texting daily in 2009.

> **"The Bermuda population is a sophisticated user of ICT"**

Conclusion

The findings of the survey confirm that a government that is actively committed to improving access to, and understanding of, ICT is seeing its efforts rewarded.

Bermuda's embrace of ICT is critical to its remaining at the forefront of the global community, yet Bermudians are famously resistant to change. Part of their willingness to embrace ICT can be traced to the high level of employment in the service sector, where office computers are ubiquitous, and part to Bermuda residents' exposure to telecommunications and computer technology when they travel, which they do with regularity.

Credit must also go to the Ministry of Energy, Telecommunications and E-Commerce for fostering interest in the wired world among Bermuda residents and for consistently putting a human face on technological developments. Had METEC not existed, it would have been necessary to invent it, yet the Bermuda Government's early acceptance of the need for ICT in all Bermuda's economic activities has ensured that the island has been able to be a full player in the digital revolution.

The internet has certainly changed the way Bermuda works and plays. The traditional complaint that Bermuda is too remote to be current no longer applies. Bermudians are as tech-savvy as anyone in the world, thanks to their natural inquisitiveness, ability to adapt when circumstances demand, and a Government that saw the future ahead of many of its peers and has taken enormous steps to ensure that the growing acceptance of ICT worldwide does not leave Bermuda isolated. ■

Special Economic Zones in Poland

Olga Zajączkowska-Drożdż is a Senior Associate at Kubas Kos Gaertner

The Polish economy is developing dynamically. It is an example of an economy in transition, in which structural changes have been effectively implemented since 1989.

In order to free the market and promote competition Poland introduced legal regulations, a privatisation program, currency exchange market regulations, income tax breaks for enterprises and opened financial markets. Poland has also opened up to foreign greenfield investment.

The Polish governments' efforts are aimed at increasing investment in the Polish economy, as well as promoting an increase in employment through new investments, both domestic and foreign. This has resulted in legal solutions aimed at promoting the Polish economy and creating conditions for investment development. One solution is the creation of Special Economic Zones (SEZs).

The basis for creating SEZs in Poland is the Act of 20 October 1994 on Special Economic Zones (hereinafter: the "Act on SEZs") which indicates the rules and manner of establishing and managing of economic zones, as well as conducting business activity on the territory of the special economic zone. The detailed rules of the functioning of the zones are indicated in the legal acts regarding the individual economic zones. Pursuant to Article 4 of the Act on SEZs a zone shall be established by means of a regulation of the Council of Ministers, issued upon request of the Minister of Economy.

From the point of view of the law, special economic zones constitute an administratively separate territory of the state, in which a special system of legal norms, the objective of which is to enable or facilitate the completion of the state's economic tasks and objectives, is in force.[1] The interested entities may conduct business activity on preferential conditions in comparison to conducting business activity outside the SEZ.

Fourteen Special Economic Zones have been created in Poland: EURO-PARK Mielec, Suwałki, Katowice, Legnica, Łódź, Wałbrzych, Kamienna Góra, Kostrzyn-Słubice, Słupsk, Starachowice, Tarnobrzeg, Pomeranian, Warmia-Mazury and the Krakow Technology Park.

As it follows from Article 3 of the Act on SEZs, a zone may be established in order to accelerate economic development of a part of the country's territory, particularly by means of:

- developing certain areas of economic activity,
- developing new technical and process solutions and their implemention in the national economy,
- developing exports,
- increasing competitiveness of goods produced and services rendered,
- developing the existing industrial assets and economic infrastructure,
- creating new places of employment,
- developing unused natural resources subject to environmental regulations.

Entities carrying out investments in special economic zones may use public aid in the form of income tax exemptions on account of the costs of new investments as well as the creation of new job opportunities. The intensity of the aid is varied and in the case of investments in the Lubelskie, Podkarpackie, Warmińsko-Mazurskie, Podlaskie, Opolskie, Świętokrzyskie, Małopolskie, Lubuskie, Łódzkie and Kujawsko-Pomorksie Provinces amounts to 50% and in the remaining provinces - 40%. Warsaw is an exception, in the case of which the extent of aid is at the level of 30%[2].

Entities intending to commence business activity in the special economic zone and to take advantage of public aid should obtain a permit to conduct business activity in the special economic zone, which is issued by the entities administrating the zones, in the manner of conducting a tender or negotiations. The administrators, pursuant to Article 6 of the Act on SEZs may be only a joint stock or limited liability company, in which the State Treasury or province government unit holds a majority of the votes to be cast during a General Meeting of Shareholders or a Shareholders' Meeting.

The rules regarding the conduct of tenders and the detailed standards on the manner of their conduct are regulated – separately for each economic zone in the relevant regulation of *the Minister of Economy and Labour from 2004 on tenders and negotiations as well as criteria for assessing plans for business ventures which are to be taken by entrepreneurs on the territory of the zone.*

"... the significant role which special economic zones play in the Polish economy must be emphasized"

As an example, it may be noted that the administrator of the Krakow Technology Park, created by the Regulation of the Council of Ministers of 14 October 1997 in the matter of establishing a special economic zone in Krakow (Journal of Laws no. 135, item 912 as amended), is Krakowski Park Technologiczny Sp. z o.o. (Krakow Technology Park Ltd) with its registered seat in Krakow. By means of the Regulation of the Minister of Economy on 2 July 2009[3], the Krakow Technology Park Ltd, as the administrator, was entrusted with granting permits for conducting business activity on the area of the zone on behalf of the Minister of Economy (hereinafter: "Regulation").

In order to participate in the tender or negotiations and to obtain a permit for conducting business activity on the area of the Krakow Economic Zone, the criteria set forth by the zone administrator should be considered, specifically the subject of the assessment is the relevant level of technology innovation. The invested amount cannot be less than €100,000, the interested entity should declare their participation in the creation and modernisation of the special economic zone infrastructure and the possibilities of cooperation with universities and colleges in research and educational projects. The subject of the assessment in the procedure for granting permits is also the previous activity of the interested entity as well as the planned development of the investment in the area of the economic zone[4]. The information regarding the invitation to the tender or the negotiations - pursuant to Article 4.1 of the Regulation – the administrator places (such information) through an announcement in a daily national newspaper and on the web page of the zone in Polish and one of the languages commonly used in international trade. The invitation may also be announced in the foreign press.

Has the creation of special economic zones in Poland brought the expected effects and has the objective in the form of accelerating economic development of areas constituting special economic zones been achieved?

A positive response to the above question found its expression in the amendment to the Act on SEZs, which was adopted on 30 May

2008 (Journal of Laws No. 118, item 746). The amended act at issue increased, among others, the area of the zones in Poland from 12 thousand to 20 thousand hectares. Next, on 27 January 2009, the Council of Ministers established a plan for the completion and further development of special economic zones by adopting the document entitled *The Concept of the Development of Special Economic Zones*[5], the main assumption of which is the manner of developing additional areas designated for SEZs established through the amendment of 30 May 2008.

As it follows from the analysis of *The Concept of the Development of Special Economic Zones* in the assumptions lying at the basis of the further development plan of the zones a catalogue on investments desired from the point of view of the Polish economy has been distinguished. It was recognized that the investments which should achieve priority support in the framework of the economic zones regard the following sectors:

- automotive,
- aviation,
- electronics,
- machinery,
- biotechnology,
- small tonnage chemistry,
- R&D activities,
- innovative services,
- industry manufacturing equipment aimed at the production of fuels and energy from renewable sources.

From the data of the Ministry of Economy indicated in the Report on Special Economic Zones status as at 31 December 2008[6], approved by the Council of Ministers, it follows that the intended development of the economic zones should be assessed positively and conducting business activity in economic zones enjoys the interest of foreign investors. As it follows from the data of the Ministry of Economy[7] c.70% of the capital invested in the zones comes from five countries: Germany, Poland, the United States, Japan and Italy. Companies with German capital were indicated as holding the leading position in the capital investment structure. The leading investors in the special economic zones are:

- General Motors Manufacturing Poland Sp. z o. o. (Katowice SEZ);
- Toyota Motor Manufacturing Poland Sp. z o.o. (Wałbrzych SEZ);
- MICHELIN POLSKA S.A. Olsztyn (Warmia and Mazury SEZ);
- FIAT -GM POWERTRAIN POLSKA Sp. z o.o. (Katowice SEZ);
- Volkswagen Motor Polska Sp. z o.o. (Legnica SEZ).

The analysis of the effects of the functioning of the special economic zones as at the end of Q3 2009, published on the web page of the Ministry of Economy[8] leads to the conclusion that the value of the completed investments in the special economic zones has achieved a joint level of PLN 63,719.9 million, has created 148,762 new jobs and maintained 54,506 jobs.

A question arises in the context of the above data as to how the situation presents itself in the Krakow Technology Park.

On 30 March 2009 the Krakow Technology Park celebrated the 10th anniversary of its operation. This is a good time to make a conclusion. The Krakow Special Economic Zone, covering an area of 528.84 hectares, is located in the Małopolska and the Podkarpackie Provinces. This zone is the only special economic zone in Poland which also plays the role of a technology park[10]. Already in 2010, the Krakow Technology Park issued a permit for conducting business activity to six companies, and up to that time, a total of 86 permits have been issued for conducting activity in the economic zone, 6,290 jobs have been created and the total incurred expenditures amount to PLN 1,450 million[11]. The development of the economic zone should be assessed positively. The Krakow Technology Park carries out the accepted assumptions, is attractive for investors and is one of the most dynamically developing areas of business.

In summary, the significant role which special economic zones play in the Polish economy must be emphasized. After several years of operation of the special economic zones, a large investor interest in conducting activity in the zone has been seen, which is attested to, first and foremost, by the number of issued permits for conducting business activity as well as the value of the completed investments. One may only hope that the long-term undertaking, which was the introduction of special economic zones in Poland, limited however by the date of their operation until the end of 2020, will encourage new investors to locate their activity in the special economic zones. ■

Effects of the functioning of special economic zones as at the end of Q3 2009[9]

Zone	No. of permits	Value of the completed investments in million PLN	New jobs	Maintained jobs
Kamienna Góra	40	1,406.7	3,763	265
Katowice	183	15,503.7	31,454	8,991
Kostrzyn-Słubice	104	3,186.1	10,302	5,287
Kraków	49	1,410.2	5,953	2,367
Legnica	55	4,208.4	7,948	265
Łódź	115	6,977.5	14,109	6,369
Mielec	118	4,090.9	11,880	3,432
Pomeranian	65	5,051.8	14,012	3,146
Słupsk	46	742.0	1,665	744
Starachowice	73	1,150.3	3,153	3,352
Suwałki	51	1,355.4	4,741	133
Tarnobrzeg	110	5,335.0	16,448	6,382
Wałbrzych	139	10,692.3	18,503	8,954
Warmia-Mazury	57	2,609.5	4,830	4,819
Total sum	**1205**	**63,719.9**	**148,762**	**54,506**

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1. Michał A. Waligórski "The Administrative and Legal Reglamentation of Business Activity in the so-called Special Economic Zones" Legal Studies 1997/132 p. 15
2. Ministry of Economy, www.beta.mg.pl
3. The Regulation of the Ministry of Economy of 2 July 2009 on entrusting the granting permits for conducting business activity on the area of the Krakow Technology Park and carrying out control on the completion of the terms of the permit to the Krakow Technology Park (Journal of Laws of 15 July 2009).
4. Information provided in the web page of the Krakow Technology Park, www.sse.krakow.pl
5. The web page of the Minister of Economy, www.beta.mg.pl
6. Published on the Ministry of Economy web page, www. beta.ms.gov.pl.
7. Report on Special Economic Zones – status as at 31 December 2008. Published on the web page of the Ministry of Economy, www.beta.ms.gov.pl
8. As above.
9. The analysis of the effects of the functioning of the special economic zones as at the end of Q3 2009, published on the web page of the Ministry of Economy, www. beta.ms.gov.pl
10. Source – data published on the www.paiz.gov.pl/strefa_inwestora/sse/krakow web page as well as the web page of the Krakow Technology Park www.sse.krakow.pl.
11. Data published on the web page of the Polish Information and Foreign Investment Agency SA www.paiz.gov.pl, current status as at May 2010

Poland: In the Heart of Europe... And of European Investors

Michal Bielinski is a Senior Associate with Raposo Bernardo

Lisbon-based Raposo Bernardo law firm opened its office in Warsaw in early 2009, materialising a plan that had been in the forge for three years and demonstrating our trust in the Polish economic strength and future potential.

As in almost any other jurisdiction, navigating the legal challenges of doing business, especially for a foreign investor, may be hard. Although nowadays the Polish law does provide the legal tools to normally set up and conduct any type of business, there is room for improvement and streamlining. The appropriate legal partner, with a strong experience in internationalization plans and top European quality standards, will help overcome those challenges and drive forward the success of the enterprise in a growingly competitive and sophisticated market.

Considering all the factors surrounding the Polish economy, the outlook is positive and Poland is now one of the most attractive investment destinations in Europe.

Poland's political and economic developments over the last 20 years, and especially since the EU accession, have put the country in the forefront of CEE economies, also offering Western Europe added business and investment opportunities.

"Poland's political and economic developments over the last 20 years, and especially since the EU accession, have put the country in the forefront of CEE economies"

According to preliminary data from the National Bank of Poland, FDI inflow to Poland in January and February 2010 was over €2.2 billion. In 2009, at peak global economic crisis, Poland saw FDI inflows fall by just 16 percent, reaching €8.4 billion – a figure demonstrating the crisis did not decrease Poland's FDI inflow to alarming levels and that the country performed better than expected. Actually, Poland's 2009 1.6% GDP growth was Europe's highest.

Looking back on pre-accession forecasts, and despite the present downturn affecting virtually all economies of the world, it is clear Poland has surpassed expectations and is now one of the most thriving economies in Europe. Although not challenge free, as any economy, Poland is politically and economically stable and benefits from a highly motivated and qualified labour force as well as a confident and vast internal consumer market.

Indicators such as GDP, industrial production, productivity, consumer spending, education levels, are growing faster than in most EU-15 countries. The sheer size of the internal market, EU funds, eased bureaucratic barriers and investment incentives, offer investors added competitive conditions and positive grounds to expand on. In the future, further reforms will hopefully curb public spending and cut budget deficit – and enable the economy to smoothly enter the eurozone.

Poland's population of over 38 million people provides for a vast market, and it is needless to say that demand for many products and services is huge. Poles comprise over one third of the citizens of the new EU member countries and country is the 30th largest market in the world, with its position being strengthened year after year by rapid economic growth and the subsequent increases in rates of pay.

The location of Poland at the very heart of Europe makes it easy for investors to enter markets in Germany, Russia as well as most of former Soviet satellite countries. Poland attracts by some of the lowest labour costs in Europe and a highly qualified, young and motivated labour force.

High levels of optimism, motivation and confidence in the institutions of the economy are continuously stated in different surveys of the Polish population, ahead of all other CEE countries in the same surveys. In a time of deep disbelief and pessimism adding to the hard consequences of the downturn, this is also a factor to be taken into account by any investor.

In the EU 2007-2013 financial framework Poland may benefit from a substantial financial support. Out of the overall amount of €307.6 million designated by the EU to achieve the goals indicated in the European cohesion policy, Poland is supposed to receive €80 million (including 67.5 million from structural funds). The funds will help develop the economy in two ways. First of all, the funds will be used to improve the existing business environment ie. transport and IT infrastructure, environment protection strategies. On the other hand the funds are going to be directed to small and medium-sized enterprises in order to boost both development and practical implementation of innovation and modern technologies. Undoubtedly, the European Football Championships to be organized by Poland and Ukraine in 2012 are among the major stimulating factors, especially for the construction, service and tourism sectors.

The favourable image of the Polish economy is also influenced by inflation, or rather the fact that it is consequently kept under control. A low rate of inflation has been noticeable since the early 1990s. Another result of the positive economic changes is the falling level of unemployment, which does not alter the obvious fact that Poland still has substantial reserves of well-qualified workforce.

Investors that are already present on the Polish market, or just entering it, can count on excellent conditions for investment and also gain direct support. Apart from investment incentives provided through Gmina (local authority) councils and various forms of aid, eg. within the Special Economic Zones, firms can also receive assistance from the EU structural funds. Between 2007 and 2015 our country will jointly receive over €67 billion from EU's budget. These funds are intended to raise the economic competitiveness, among others, through of a thorough transport infrastructure reform. The country's Eastern regions and the rural areas are the priority of the modernisation policy for the near future.

The largest part of the capital is going to be allocated for improvement of infrastructure – the transport, environmental and energy infrastructures. Thanks to the structural funds there will be improvements in both the state and number of express routes and motorways, rail connections, airports and their passenger terminals as well as sea ports. Furthermore, EU funds will be utilised for the improvement of water quality, construction of modern rubbish dumps and for the building of a flood prevention infrastructure. The EU funds may also be used for ecologically friendly activities. All the above-mentioned investment will be possible as a result of the Infrastructure and Environment Operational Programme, which is one of several operational programmes specifying goals for the spending of funds.

Under the framework of the Innovative Economy Operational Programme (IE OP), Poland is going to receive EU support in such areas as research and development and the development of exports. The anticipated results will be scientific laboratories of the highest standards that will be able to work in cooperation with business, ultra modern technology among firms, Poland's aviation industry among the world's elite, numerous workplaces for programmers and biotechnologists. Support on the basis of IE OP will be provided to firms, business institutions and scientific entities cooperating with business, which are carrying out programmes in Poland. The IE OP, like all the other programmes is divided and prioritised in a particular way describing the principles for granting the EU funds. The various priorities support scientific research, the modernisation of Poland's educational structure, the broad sphere of innovation in business, promotion of the Polish economy and tourism worldwide, services to foreign investors and computerisation of the economy and administration.

"Over the period of 2007-13 Poland will be the largest beneficiary of EU funds among all the member states. The programmes being prepared by Poland are the largest not only in the contemporary financial perspective, but often in the history of the EU"

Also, the Human Capital Operational Programme runs until 2015 and comprises the financing of training for the unemployed, raising professional qualifications for employed, modernisation of the educational system, minimising barriers related to finding work, improvement the effectiveness of public administration dealing with unemployment and supporting innovative faculties in higher education. The concept of the programme is to create an educational system, which could ensure training in the professions and trades that are needed for the labour market. Due to this we can expect that in the near future, Polish personnel will be competing with the western Europeans mainly according to their improved qualifications and not only for lower paid positions.

The EU has also taken into account the development of the poorest regions of the Union, within which there are five Polish voivodships. The Development of Eastern Poland Operational Programme (EPD OP) is to decrease the gap that divides the poorest voivodships in Poland from the wealthier EU regions. Under the EPD OP, financial support will be provided to firms that increase attractiveness for investment in Eastern Poland and promotion of the Region. It has to be underlined also that each of the 16 voivodships has its own operational programme (Regional Programme), which provides support for entrepreneurs for investments, the infrastructure within the gminas (local authorities), or for internet development in the region.

Over the period of 2007-13 Poland will be the largest beneficiary of EU funds among all the member states. The programmes being prepared by Poland are the largest not only in the contemporary financial perspective, but often in the history of the EU.

The EU grants may be allocated to projects from virtually all sectors of the economy. Poland is scheduled to be the largest beneficiary of EU funding in the coming years. In order to successfully control their distribution and use, Operational Programmes, Regional Operational Programmes and the Operational Programme for European Territorial Cooperation, have been established.

The Innovative Economy Operational Programme (IE OP) plays an important role among various forms of granting state aid to enterprises in Poland. Small, medium-sized and large enterprises involved in projects in Poland may apply for grants under the Programme.

Under IE OP the grant amount varies from 15 to 70% of eligible costs. Aid granted under IE OP may be combined with state aid from other sources, provided that the state aid limit available to an investor for a project is not exceeded.

Eligible costs within the framework of investment activities are practically all investment related costs, including: the acquisition price or production cost of tangible and intangible fixed assets; and two years' salary costs for new employees. Support is granted to new projects, meaning that a project may start no earlier than after a grant application is lodged and accepted in writing by the respective authority. From this moment on, costs incurred may be eligible (refundable). Moreover, a granted investment should be sustained for at least five years (three for SMEs) after the end of the project.

The country offers a wide range of investment incentives. Investors are invited to locate their projects in 14 Special Economic Zones (SEZ). ie. special zones where economic activity may be run in favourable conditions. Polish SEZs offer attractive tax exemptions, employment incentives and well-prepared investment lots.

A special economic zone is a separate, uninhabited part of the country's territory where business activity may be conducted under preferential conditions defined in the Act on Special Economic Zones of 20 October 1994.

Special economic zones were created, in particular, to accelerate the economic development of regions; manage post-industrial property and infrastructure; create new jobs and attract foreign investors to Poland.

The basic benefit of investing in a special economic zone is the possibility of obtaining a tax allowance consisting in a corporate income tax exemption. Currently, the corporate income tax rate in Poland is 19%. The maximum income tax exemption is related to the value of state aid available to an individual investor for a particular investment project. This value depends on the investment location, the size of the enterprise and the amount of investment expenditure (expenditure for purchase of tangible assets, or two years' labour costs).

In addition, the exemption is available when: conditions set out in the zone permit are fulfilled, ie. a defined amount of investment expenditure is incurred within a specified time, a defined number of new jobs are created within a specified time, the investment is finished within a specified time limit; the investor does not carry over the ownership of any assets related with investment expenditure – for a period of five years from the date of their entry into the tangible and intangible assets register in the meaning of the income tax provisions, or, in the case of small- and medium-sized enterprises, for a period of three years; the investor pursues the economic activity related to the investment for a period of at least five years, or, in the case of small- and medium-sized enterprises, for at least three years; the investor maintains newly created jobs for a period of at least five years or, in the case of small- and medium-sized enterprises, three years (where aid for new job creation is granted). ■

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New Long-Term Funding Options for Brazilian Financial Institutions

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In the midst of a global financial crisis, Brazil has finally become a real alternative for investors worldwide. In 2009, a solid economy supported a reasonable recovery from the 2008 sub-prime crisis. For the remainder of 2010 and the next few years, forecasts are promising, as the country builds a pre-salt oil-regulatory framework and hosts the next World Cup and Olympic Games.

Despite these difficult times for export economies, Brazilian consumer spending has proved to be an important engine of growth and cushion for the economy. The country is obviously not isolated from worldwide volatility, which has haunted the domestic stock market, but in the long run interest rates are expected to drop and inflation to remain under control. In 2010, a presidential-election year in Brazil, analysts expect GDP to grow 6%, a reasonable rate compared to previous years and especially in times of global economic turbulence.

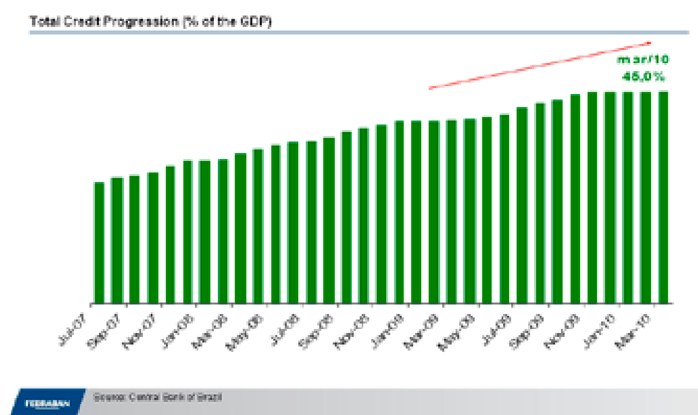
Investors – shifting their investments and savings away from those economies most vulnerable to the crisis – have turned their eyes to Brazil. Indirect foreign investment (in stocks and fixed-income financial assets) reached an historical record of US$46.2 billion in 2009, while direct foreign investment is expected to peak in 2010, at US$45 billion.

Brazil still depends heavily on long-term investments, mainly in infrastructure, which analysts say is the bottleneck (energy, telecommunications, ports and airports, railways and sanitation). Long-term financing in Brazil has traditionally only been provided to Brazilian companies by the Brazilian Development Bank (*Banco Nacional de Desenvolvimento Econômico e Social – BNDES*), while domestic banks have limited their activities to short-term and medium-term loans. Needless to say, however, that meeting this financial demand is essential for the country's 193 million people to effectively enjoy the benefits of long-lasting economic prosperity. Industrial segments, such as oil and gas, sugar and ethanol, mineral, metallurgical, petrochemical, pharmaceuticals, pulp and paper, electronics and the automotive industry, among others, may also have interesting investment opportunities.

Driven by strong market players, and aimed at improving investor confidence, Brazil has approved important changes to its legal and regulatory framework in recent years. In addition to the safe, expeditious, existing mechanisms for foreign investment and open exchange rules, the financial system - whose role in intermediating supply and demand of financial funding is essential for envisaged economic growth - and creditors in general, have benefited from important legal improvements, such as ranking privileges provided by the 2005 Recovery and Bankruptcy Law, more effective use of fiduciary types of liens, and the creation of important new credit instruments for both funding and lending transactions such as the Bank Credit Certificate (CCB), the Real Estate Credit Certificate (CCI), the Real Estate Credit Bill (LCI), the Agribusiness Credit Rights Certificate (CDCA), the Certificate of Agricultural Deposits (CDA), the Agricultural Warranty (WA), the Agricultural Credit Bill (LCA), and the Certificate of Agricultural Receivables (CRA). These credit instruments represented an important step with regard to legal safety and liquidity for trading financing on the secondary market backed by industrial, consumer, real-estate and agricultural credit rights.

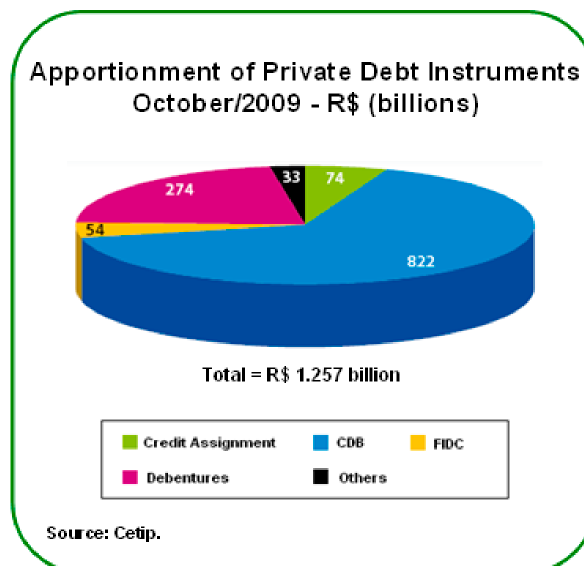
However, a long-standing demand of Brazilian financial institutions, especially middle-market banks that are clearly more affected when liquidity in financial markets is low, is the creation of long-term funding instruments that allow them to match the maturities of their assets with their liabilities. With the growth of credit in recent years from 25% to about 45% of GDP (see figure 1), the average maturity of financial assets became longer than the average maturity of financial liabilities. It is important to note that banks are prohibited by the National Monetary Council (*Conselho Monetário Nacional - CMN*) from issuing debentures (long-term bonds).

Figure 1. Credit progression (% of GDP)



The primary funding instrument of banks in Brazil is currently the Bank Deposit Certificate (CDB), which has proven to be an important, liquid, transferable, time-deposit instrument (see figure 2). The average maturity of a CDB, however, is less than one year, and the deposit can be redeemed by investors prior to maturity. This leads to the aforementioned asset-liability mismatch.

Figure 2



The so-called Credit Rights Receivable Investment Fund (*Fundo de Investimento em Direitos Creditórios – FIDC*), currently the primary securitization tool on the Brazilian capital market, has played part of that asset-liability matching role. Since 2001, these funds have provided alternatives for banks or companies assigning their credit rights, on one side, and investors, on the other side, the latter often happy to run a limited risk, as the fund liabilities and the underlying securitized pool are ring-fenced and therefore bankruptcy remote. Payroll deductible loans (*empréstimos consignados*), trade bills, corporate credits and even credits under recovery have been securitized through FIDC structures. However, an investment-fund structure is obviously not always suitable.

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Figure 3. Middle market banks issuances in the foreign markets in 2009 and 2010.

Issuer	Type of Transaction	Liquidation Date	Maturity in months	Amount US$ million	Cost %	Yield %
Banco Cruzeiro do Sul	Eurobond	06/17/2009	24	60	9	-
Banco Mercantil do Brasil	Eurobond	08/03/2009	27	26,726	-	9.2*
Banco Cruzeiro do Sul	Eurobond	09/17/2009	36	175	8	8.5
Banrisul	Bank loans	10/21/2009	6	15	-	-
Banco PanAmericano	Eurobond	10/26/2009	36	200	7	7.25
Banco BMG	Subordinated bond	11/05/2009	120	300	9.95	10.25
Banco Fibra	Subordinated bond	11/06/2009	84	110	8.5	8.5
Paraná Banco	Eurobond	12/23/2009	36	100	7.375	7.75
Banco Votorantin	Subordinated bond	01/20/2010	120	750	7.375	7.375
BicBanco	Eurobond	01/20/2010	36	275	6.25	6.25
Banco Pine	Subordinated bond	02/08/2010	83	125	8.75	9
Banco Votorantin	Eurobond	02/11/2010	36	500	4.25	4.375
Banco Cruzeiro do Sul	Eurobond	02/22/2010	60	250	8.5	8.75
Banco Daycoval	Eurobond	03/16/2010	60	300	6.5	6.75
Banco ABC Brasil	Subordinated bond	04/08/2010	120	300	7.875	8.125
Banco PanAmericano	Subordinated bond	04/23/2010	120	500	8.5	8.625
BicBanco	Subordinated bond	04/27/2010	120	300	8.5	8.625
Banco Fibra	Eurobond	04/29/2010	36	200	5.125	5.25
Banco Safra	Eurobond	04/29/2010	42	200	3.5	3.5
Total in 2009				**987**		
Total in 2010**				**3,700**		
Total in 2009 & 2010**				**4,687**		

Source: Financial institutions and international agencies. Elaboration: Valor Data.
** Average profit until maturity (9% until November 08 2010 and 9.5% until November 08 2011).*
*"Put on November 08 2010. ** Table updated on May 20, 2010.*

At times of reasonable liquidity, the issuance of notes on foreign markets may be attractive for Brazilian banks, offering them an alternative for raising funds with longer maturities. Between 2009 and 2010, middle-market Brazilian banks raised US$4.7 billion through foreign-note issues (see figure 3). Scarce liquidity in recent weeks, however, has forced many planned foreign issues to be suspended, at least temporarily.

The sale of asset pools to larger financial institutions may, in certain cases, be the last resort for middle-market banks that need to raise immediate funds. These deals, which had also been suspended during the peak of the financial crisis, have now resumed. A number of larger banks intending to recover market share lost during the financial crisis have purchased asset pools from illiquid middle-market banks.

In 2009 and 2010, a scenario of reasonable domestic economic stability, increasing demand for infrastructure and other long-term financings, the bank asset-liability mismatch and low liquidity on foreign markets, all motivated the creation of two important instruments for long-term funding of financial institutions in Brazil: the FGC Special Collateral Time Deposit (*Depósito a Prazo com Garantia Especial do FGC - DPGE*) and the Financial Bill (*Letra Financeira – LF*).

The DPGE, regulated by the CMN in March of 2009, is a type of time deposit collateralized by the so-called Credit Guarantee Fund (*Fundo Garantidor de Crédito – FGC)*, a private non-for-profit organization created in 1995 to collateralize bank liabilities[2].

The DPGE, which, in principle, is transferrable[3], offers 1 to 5 year maturities. Commercial, multiple, investment, development and saving banks, as well as loan, finance and investment companies (*financeiras*) are entitled to collect funds through the DPGE.

Redemption of the DPGE – in full or in part – is not permitted prior to its stated maturity.

The DPGE must be registered with a clearing and settlement system duly authorized by the Central Bank of Brazil.

A DPGE interest rate, once settled, may not be renegotiated.

The DPGE limit stated by regulations is the greater amount between (i) twice the respective Tier 1 reference capital, calculated on December 31, 2008, and (ii) the aggregate between the balances of time deposits and bills of exchange (*letra de câmbio*) held by the relevant financial institution on June 30, 2008. This amount in no event may be more than R$5 billion.

Financial institutions are subject to a required reserve (*depósito compulsório*) of 15% of the DPGE at the Central Bank of Brazil. In addition, they are subject to a special contribution to the FGC at a rate of 0.0833% per month, calculated on the aggregate amount of DPGE agreements in place, which many claim makes the DPGE an expensive tool. Notwithstanding, at times of scarce liquidity for foreign-bond issues, the DPGE is seen by the Brazilian market as a valuable option for long-term funding.

The LF, in turn - created in December 2009 and regulated in February 2010 - is a transferable and freely negotiable credit instrument issued by multiple, commercial, investment and saving banks, as well as loan, finance and investment companies (*financeiras*), mortgage and real-estate credit companies.

An LF must be issued for a minimum term of 2 years.

Redemption of an LF – in full or in part – is not permitted prior to its stated maturity.

An LF must also be registered with a clearing and settlement system duly authorized by the Central Bank of Brazil.

As for an LF's par value by unit, the regulations state that it may not be lower than R$300,000 (around US$160,000).

If not publicly offered, an LF may be subordinated, meaning that, in this case, it will not be paid before the issuer's unsecured and other creditors in the event of liquidation or bankruptcy. When subordinated, an LF shall be classified as Tier II reference capital of the issuing bank for the purposes of the Basel provisions.

LF interest periods cannot be less than 6 months, with interest accruing at either fixed or floating rates.

An LF may be repurchased by the issuing bank for future sale, provided that the buyback takes place on exchanges or through over-the-counter markets. Buyback transactions, however, are limited to 5% of the total amount of unsubordinated LFs issued by the relevant bank.

An LF may be publicly offered, provided however that, in this case, it cannot be subordinated. Public distribution of LFs must comply with all the requirements still to be set forth by the Brazilian Securities and

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An LF may be also used by financial institutions as a funding instrument for linked credit transactions (*operações ativas vinculadas*) funded with financing delivered or placed at their disposal by third parties, as permitted by current regulations. Through these linked credit transactions, a financial institution may transfer the credit risk of a certain client to an LF investor who invests in the LF with specific instructions for a further loan to the client. In this case, the financial institution will only repay the investor if the client also repays his debt.

Finally, as for taxation levied on income earned by investors from a DPGE and LF, as a general rule income arising from fixed-income investments in Brazil are taxed at regressive rates varying from 22.5% to 15%, depending on the investment term (this taxation is definitive for non-resident investors or for individuals, and just an advance of part of the Corporate Taxes due at roughly 34%, if the investor is a legal entity domiciled in Brazil). Taxation of income from the sale of a DPGE or LF on the secondary market is still under discussion, but in principle the same rules apply. If (i) the investor is domiciled outside of Brazil, not in a jurisdiction classified as a tax haven by the Brazilian Federal Revenue Service; and (ii) the investment follows the provisions of the applicable CMN rules (Resolution N. 2,689), then the applicable rate is 15% regardless of the investment's maturity.

It is also worth mentioning that, following steps taken by foreign markets over the last 20 years, new legal provisions in Brazil have also authorized financial institutions to issue another instrument called the Structured Transactions Certificate (*Certificado de Operações Estruturadas - COE*), to represent derivative transactions in accordance with the terms and conditions still to be set forth by the CMN. The COE may also be an alternative for financial institutions in Brazil to raise funds backed by underlying derivative transactions in a pool. This new type of instrument, which has yet to be fully regulated, is promising and expected to be of great benefit for players on domestic financial markets.

From a legal and regulatory standpoint, these improvements are expected to enhance credit, reduce spreads and support the required long-term investments in Brazil. The DPGE offers an alternative to the traditional CDB, while the LF meets a long-standing demand of financial institutions that have not been allowed to use debentures. The numbers provide evidence of interest in these new instruments: in 3 months, the total amount raised by financial institutions through LFs was R$3.4 billion, while DPGEs currently total R$16 billion, according to the CETIP, an organized market in charge of registration, clearing and settlement of LFs and DPGEs.

A number of issues, however, are still pending clarification and regulation by financial authorities. Taxation is also still unclear. The perspective of market players, in general, is that the country needs more effective actions to enhance the development of a secondary market for long-term instruments. These actions would involve the reduction of costs and tax exemptions, for instance, as Brazil still suffers from an intricate taxation system, with a considerable number of accessory tax obligations to which taxpayers are subject. ■

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2. As per the FGC rules, the total amount of DPGE credits held by each person against the same financial institution member of the FGC, or against all member financial institutions that are part of the same financial conglomerate, must be collateralized up to a limit of R$20,000,000 (equivalent to about US$11,000,000).

3.Due to taxation issues, transferability of the DPGE is still under discussion.

Turkey: Eurasia's Energy Nexus

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In the decade leading up to the global recession, Turkey metamorphosed from a regional oil and gas transit hub into an important international energy corridor. Bordering the Middle East, Russia, and states of the Caspian region, Turkey neighbours areas that hold 70% of the world's remaining oil reserves, making Turkey a vital bridge between the major oil producing countries of the Persian Gulf, Caspian Sea and Africa, on the one hand, and the high-demand European markets on the other.

The optimism generated by this era of dynamic transformation was tempered somewhat by the end of 2008, when the country faced a looming energy crisis. Its economic and industrial infrastructure had been developing so rapidly that the demand for energy would soon have outstripped supply. By sometime in 2009, Turkey would have experienced severe energy shortages. The economic contraction caused by the global crisis helped Turkey avoid these insufficiencies in the short term, but a crisis is expected sooner or later. For now, we can expect the recent shift in investor focus towards alternative energy sources – including wind, hydro and nuclear – to continue.

We can likewise expect Turkey, a fast-growing emerging economy, to push ahead with developing its infrastructure at a steady pace, promoting investment in bridges, tunnels, ports, and so forth. Nevertheless, lingering uncertainty over the fate of the energy sector casts doubt over the pace of regional development for the immediate future, a situation compounded by perceived instability in the policies of Russia and Iran, both major natural gas exporters which could eventually halt deliveries to Turkey in response to the crisis. A slowdown would leave underutilized a substantial energy regulatory framework designed to facilitate rapid investment and development.

As a full member of the Energy Charter Treaty, Turkey has naturally attracted financing for projects to transport oil to Europe from the Middle East, Russia and the Caspian Basin. The pioneering example of such projects in the last decade has been the Baku-Tbilisi-Ceyhan (BTC) Petroleum Pipeline Project, the first direct and sole major export route for Caspian oil to the Mediterranean. Since then, construction of other oil pipelines has been planned, most notably the Samsun-Ceyhan bypass, conceived to deliver crude oil from Turkey's Black Sea port of Samsun to Ceyhan on the Mediterranean, and the Trans-Anatolian Petroleum (TAP) Pipeline, a strategically vital project designed to transport Russian and Caspian crude to international markets.

In the area of natural gas, the pioneering transnational gas transit project is the Baku-Tbilisi-Erzurum (BTE) Pipeline, involving

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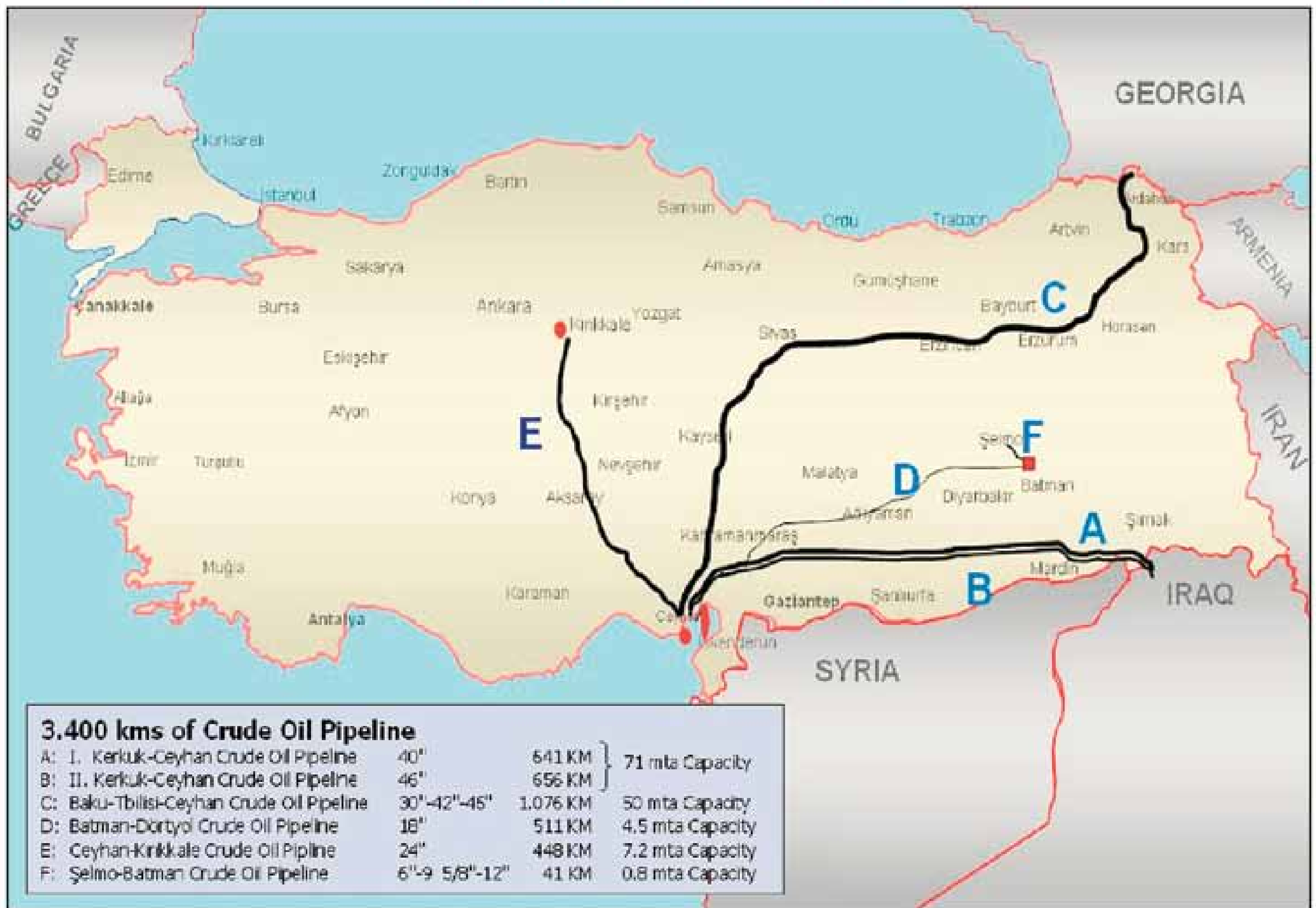

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Azerbaijan, Georgia and Turkey. However, a host of projects are now in the planning phase, including the Nabucco Project (through Austria, Hungary, Bulgaria, Romania and Turkey), the Trans-Caspian Pipeline (Moldova, Romania, Bulgaria and Turkey), the Blue Stream Pipeline (Russia and Turkey), the Interconnector Pipeline (Turkey, Greece and Italy), and the Shah Deniz Pipeline (Azerbaijan, Georgia and Turkey). Only the BTC and BTE projects are fully operational at present, but regardless of how quickly other oil and gas pipelines come on line, the expansion of project planning has accelerated the development of the transnational energy transit sector's laws into a sophisticated, investor-friendly legal and regulatory regime.

Until 2001, the only pieces of legislation governing oil and gas activities in Turkey were the Petroleum Law of 1954 and the Petroleum Regulation of 1989.

Then came the enactment of the Petroleum Market Law in 2003 and the Liquefied Petroleum Gas Market Law in 2005. The Petroleum Law of 1954 is arguably still one of the world's most liberal and progressive laws governing oil exploration and exploitation. But the Petroleum Market Law of 2003 brought a range of activities under its jurisdiction, including refining, storage, transmission, transportation and sale, and this made it necessary to amend the Petroleum Law to prevent regulation of the same activities by two different pieces of legislation. Amendment was also necessitated by the goals of harmonizing Turkish legislation with the European Union's *acquis communautaire* and offering further incentives to those investing in petroleum exploration and production activities in Turkey.

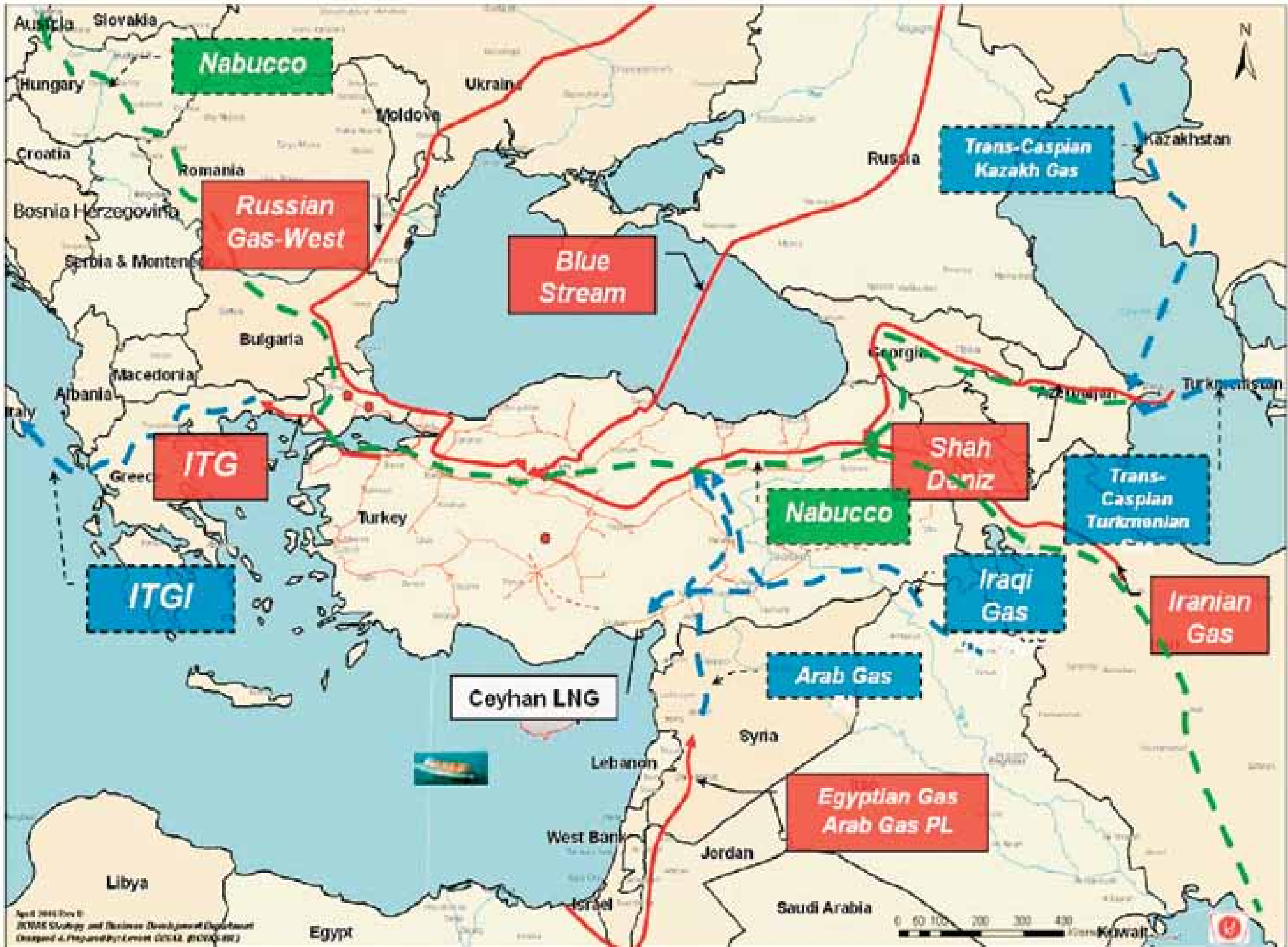
Now the Petroleum Law regulates only exploration, exploitation and transit passage of crude oil, leaving other oil sector activities to the Petroleum Market Law and the Liquefied Petroleum Gas Market Law. Nevertheless, the Petroleum Law is still important in that it authorizes the Council of Ministers (the Turkish government) to determine the legal regime for operations that transport oil or refined products from abroad across Turkey to other countries, without performing any refining or other processing activities within Turkey itself. In other words, the Petroleum Law grants the government – not parliament – the authority to determine the legal regime for transit pipeline systems, and this feature of the law still serves the interests of efficiency and expedience in the realization of projects in the sector.

The multi-billion dollar pipeline projects transporting oil through Turkey demand a stable and consistent legal regime in addition to an attractive investment climate with clearly defined financial conditions and other assurances for investors and financiers. As explained, such a framework has been developing steadily over the past decade. Currently, two different legal regimes apply to oil pipelines: one for projects governed by international agreements, the other for the rest. If a project is based on an international agreement executed by and between the participating countries including Turkey, the relevant international agreement determines the applicable legal regime together with the Petroleum Transit Law of 2000. If there is no international agreement underlying a project, Turkish law governs, and the Petroleum Law still gives the Council of Ministers the power to determine the rules that apply.

The Transit Law regulates the principles and procedures for transit passage of petroleum through pipelines, as well as the implementation of international agreements related to projects. An example of a project governed by the Transit Law is the BTC Project, the enterprise that gave birth to the world's second longest oil pipeline, carrying crude oil extracted in the Caspian Sea to Ceyhan, one of Turkey's Mediterranean ports. The BTC Project involves the national governments of three countries – Turkey, Azerbaijan and Georgia – and an incorporated joint venture consisting of eleven sponsor companies, collectively known as the "MEP Participants".

The legal documentation for the BTC Project includes the Intergovernmental Agreement (IGA), signed by the governments of

INTERNATIONAL GAS PIPELINE PROJECTS



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the three countries across whose territories petroleum is transported through the BTC Main Export Pipeline. The enactment of the Transit Law simultaneously with the ratification of the IGA in 1999 created an enabling legal environment that recognized and supported the enforcement of rights, exemptions, privileges and other benefits granted to the MEP Participants, because under Turkish law international treaties and agreements supersede domestic laws. The BTC Project's legal structure, together with the Transit Law and enabling legislation at the national level, has achieved the clarity international investors previously sought. It is a unique arrangement that has created – for the benefit of the MEP Participants – fully enforceable legal rights which cannot be challenged under Turkish law.

If a petroleum pipeline does not fall within the scope of the Transit Law – ie. it neither is subject to an international agreement nor entails the "transit" passage of petroleum through Turkey – the Petroleum Law applies, and construction of the pipeline is subject to the government's approval. A recent example of pipeline construction planned within the scope of the Petroleum Law is the TAP Project, a 553-km oil pipeline expected to ensure the country's continuing role as the gateway for crude oil transiting from Turkey's Black Sea territorial waters to international markets. It is also meant to promote and improve the safety of the Bosporus Straits and surrounding area.

This year, the Turkish Parliament is expected to pass the Draft New Petroleum Law. Although a whole chapter of the Draft New Petroleum Law is devoted to the transfer of petroleum through pipelines governed by the Petroleum Law, specifying that the Council of Ministers may authorize construction of an oil or gas transit pipeline provided that the law's authorization periods are respected, nonetheless, and contrary to expectations, the said article only refers to the provisions that apply to "other petroleum activities," as opposed to establishing specific rules for pipelines.

In line with the current Petroleum Law, the Draft New Petroleum Law provides that if no applicable international agreement applies, the Council of Ministers may authorize construction of pipelines for the transit passage of crude petroleum through or to Turkey. The Draft New Petroleum Law also gives the Ministry of Energy and Natural Resources (MENR) the authority to regulate the implementation of pipeline projects. This means that, while the "authorizing authority for transit pipelines" remains the same as before (ie. Council of Ministers), the "implementing authority for transit pipelines" is now to change. Since MENR decisions will determine the rights and obligations regarding transit activities once the Draft New Petroleum Law is enacted for the time being, it is not possible to set forth a complete legal regime. But as the global economic crisis lifts, the pace and scale of regulatory development aimed at streamlining procedures for investment and operation in the energy sector will continue.

Turkey increasingly serves as the meeting point of European commerce and industry with many unstable yet economically critical regions, including Russia, the Caucasus and the Middle East. Thanks to its close proximity to the largest oil and gas deposits in the world, by constantly restructuring and liberalizing its energy legislation Turkey has managed to take full advantage of its position as a natural energy bridge between resource rich regions and consumer markets. Often referred to as the "Silk Road of the 21st Century" based on energy-related successes in the face of economic downturn – such as the operation of the BTC Project, the Turkish Straits bypasses, the BTE Pipeline, the Blue Stream Pipeline and the planned Nabucco Project – Turkey is emerging as a vital international energy distribution centre. Positioning itself as the world's energy bridge through secure, economically profitable and environmentally friendly pipelines will bring stability and wealth to the area and improve relations among regional neighbours. ■

The State Of Bavaria

- A High Performer Heading For the Big Payoff

Investing in innovation and infrastructure has given Bavaria an unexcelled track record of economic success, ecological progress and security and reliability of operation.

And the real payoff's yet to come.

Bavaria: the briefing

Bavaria has:

- Germany's strongest growing economy over the last decade – and over the last thirty years.
- Germany's greatest purchasing power, largest number of start-ups, and greatest volume of venture capital.
- Germany's lowest rates of unemployment and public sector and private indebtedness – and highest rate of personal security.

Bavaria is:

- home to the world's top-ranked city – Munich.

  The state capital has Europe's highest-rated real estate market, airport and public transport system. Munich's quality of life has been repeatedly ranked the best in the world.

Many regions claim to be number one in Europe, and can cite one or two (often commissioned by them) studies to back it up. As the above shows, Bavaria has an impressive breadth and depth of solid, objective proof of its pre-eminence to offer.

To find out how this has been achieved – and where the state's going, it's necessary to take a look at another set of figures, starting with 1100.

That's the number of regions in the EU. Of these, five of the top ten and twelve of the top twenty-five are located in Bavaria, making the state the number one base in the union, reports an authoritative study commissioned by manager magazine and released in December 2009.

Highly pertinent is how these rankings were put together. Instead of being derived from the views of executives or other necessarily subjective sources, the rankings employed standardized data issued by Eurostat and other official sources to compile 25 indicators.

These, in turn, include relative numbers of scientists and technologists, of holders of advanced degrees, and of high placements in cutting-edge sectors.

What this all means: Bavaria is set to be even more successful in the years to come.

Exciting though these figures are, they do not adequately express the dimensions of Bavaria's achievements.

To do such, it's necessary to take a look at the field of regenerative energy. The ability to use 'home-grown' sources to produce your energy is becoming a matter of survival for economies facing a forthcoming scarcity of fossil fuels – and, of course, for the world's climate as well.

A further figure shows what Bavaria has accomplished in this area.

35,000. That is the number of photovoltaic (PV) facilities installed in Bavaria in 2009, reports grid operator E.ON Bayern.

This world-best mark may well be topped in 2010. During the first three months of 2010, applications for 17,000 PV facilities were registered with E.ON Bayern.

Germany ranks 61st in size among the world's countries. Despite this lack of size, and despite its notoriously rainy weather, Germany is the world's largest generator of solar energy, accounting for 52% of the capacity installed worldwide in 2009.

That's primarily due to Bavaria, its largest state. Accounting for 14% of the country's surface area, Bavaria is home to some 40% of the country's PV facilities, thus making it number one in this field in the country and the world.

Of key importance: many of the innovations and very much of the ensuing equipment and services making roof-top photovoltaic facilities a staple of every residential neighbourhood and industrial park in Bavaria were developed and produced by the state's research and business communities.

This DPA (development, production and application) chain has also given Bavaria its position of leadership in geothermal, biomass, hydraulic and other sources of renewable and non-greenhouse gas producing energy.

What this all means: Bavaria has a huge head start towards achieving the energy self-sufficiency considered to be a prime driver of sustainable development, in which economic progress and environmental protection sustain each other in the decades.

Another key driver: cleantech – the capacity to manufacture with a maximum of output and a minimum of resource consumption and environmental impact.

And, here too, Bavaria is at the head of the pack, as revealed by a searching look at the sectors in which the DPA chain has made Bavaria a world leader – automotive, materials and aerospace engineering; ICT; the life sciences; optronics; nanotechnologies; and industrial and automation technologies.

Also accounting for Bavaria's sterling exports figures, this chain was produced by a series of decisions made in the mid-70s - 80s by the state's economic planners.

The State of Bavaria

Area: 70,551.57 km²
Population: 12,501,200
Rate of unemployment: 4.8 % (April, 2010)
Capital: Munich (1.36 million)
Other major cities:
Nuremberg: 504,000
Augsburg: 263,000
Regensburg: 134,000
Würzburg: 133,000

www.bayern.de

Decision number one: targeting innovation

"An economic backwater". That's the standard description of Bavaria some three to four decades ago. It's based on Bavaria's macroeconomic indicators and they are somewhat misleading.

True, Bavaria's GDP and export figures were well below those of several of Germany's other states in those days.

But, as a close look would have revealed, many of the seeds for today's achievements had already been sown.

Ottobrunn and Oberpfaffenhofen were already major nodes of aerospace development, production and services.

Siemens had well over a century of being a world leader in every emerging field of electrical and electronics engineering and of medical and communication devices and systems.

BMW and Audi had become the synonyms for automotive excellence and elegance.

Microsoft, Intel, Hewlett Packard and Toshiba had already set up operations in the state, becoming in the process the vanguard of what is now continental Europe's largest community of internationally-owned technology companies.

And, equally important, a large number of the state's 650,000 SMEs (small and medium-sized enterprises) had embarked upon the paths that would make them "world champions" in their niches.

The decision reached by Bavaria's planners was to allocate funds, largely stemming from the proceeds of its privatization of state holdings, to these and other sunrise industries.

This support took the form of founding (of institutions of higher education, incubation centres, research institutes and the agencies capable transferring the findings emanating from all these to local companies) and of financing (of the research, development and application undertaken at these new and at existing institutions).

This founding is still being set forth today. In 2006 the state launched its Clusters Campaign. Its ambitious brief is to network the academic, research and business communities into clusters in 19 key cutting-edge sectors.

Decision two: make growth state-wide

As any businessperson or researcher can tell you, 'Munich' is synonymous with excellence in virtually all fields of high-tech. But that fact should not be construed to mean that technological development is restricted to the city and its suburbs.

Quite the opposite. Comprising also Fürth and Erlangen, greater Nuremberg (Nuremberg is Bavaria's second largest city) is a major centre of medical, wireless and optronic technologies.

Number three Augsburg is a leader in environmental technologies, aerospace production and services, and materials engineering, with numbers four and five Regensburg and Würzburg being centres of biotechnologies and high-tech services.

Innovative, market-leading companies are to be found, however, in virtually every town and even village in Bavaria.

And that they are is largely due to the state's policy of building institutions of higher education all throughout the state.

Bavaria has 11 universities. They include such longstanding heavyweights as Munich's Ludwig Maximilians University and TUM Technical University, each repeatedly ranked by the German government and by trackers of academic performance as being among the very best in the country.

Bavaria is also home to such 'youngsters' as the University of Passau. Founded in 1978, it has one of the country's best law schools and a path-breaking cultural management degree program.

Also in Bavaria: 26 universities of applied sciences. Along with the universities, they are among the prime sources of the highly-qualified personnel and technological breakthroughs (along with the 12 Max Planck and 8 Fraunhofer institutes) serving as the staff and livelihoods of the companies based in their home towns of Coburg, Kempten and Amberg.

Decision three: invest in infrastructure

The first impressions of visitors to Bavaria are highly positive. The gleaming efficiency of Munich Airport. The speed of the ICE express trains hurtling down the line between Nuremberg and Munich. The broad and impeccably maintained autobahns making the state one of Europe's great crossroads. The barges making their ways down the Rhine-Main-Danube waterway, which links the North and Black Seas. The lack of blackouts, brownouts and other power outages so common to so many other areas of the world.

This ease of transport and communication and corresponding lack

of delay and interruption are the products of the state's policies of systematically planning for growth – and of then allocating the requisite funds for realizing these plans.

Decision four: supporting the small and medium-sized

As seen above, Bavaria is home to a large number of world players. Their ranks also include EADS (the world's largest aerospace company), truck and bus manufacturer MAN and Linde, a world leader in the industrial gases field.

Via Bayern ("Bayern" is German for Bavaria) International, Bayern Innovativ and other state agencies, the government of Bavaria facilitates the technology development operations and market entries and expansions of these and other local business giants.

The special target of these agencies' efforts is, however, the state's SMEs. And for good reason. Going by the collective name of the "Mittelstand", these play a hugely important role in the state's economy, one even greater than the facts that they are responsible for two fifths of the state's economic output and three fifths of its jobs would indicate.

For one thing, they are prolific sources of technologies.

As you would expect, many of these stem from the state's start-ups. To enable these – many of them spin-offs from local universities – to hit the ground running, the state and its communities maintain 42 incubation centres. These offer everything from low rents to access to specialized equipment and business development services.

An equally prolific source of such path-blazing innovations is Bavaria's traditional companies. Case in point: Schott Solar in the Upper Palatinate town of Mitterteich. It has turned glass, once mainly produced for windows, into the key components of revolutionary solar thermal, pharmaceutical and chemical production and illumination devices and systems.

The Mittelstand does a lot, but it doesn't do it by itself. Via the above-mentioned Clusters Campaign and agencies, and via such dedicated networks as BAIKA (the network of Bavarian automotive suppliers), the state government has created an environment nurturing innovation and excellence and thus growth.

Decision number five: maintaining the traditional

It may be the state government's great accomplishment. While becoming one of the world's major centres of manufacturing and technological development, Bavaria has retained the look and feel of the rural backwater it once was, and, by doing so, remained one of the world's major tourist destinations.

In addition to such world-class 'hits' as the Oktoberfest, King Ludwig II's palaces (Neuschwanstein), Nuremberg's Christmas market, the Alps, the Danube, the Lake of Constance, the English Garden in Munich and other perennial favorites, it is the state's traditional ambience and healthfulness that draw millions every year to it.

This ambience is comprised of such surpassingly beautiful and time-crafted communities as Bamberg, Rothenburg ob der Tauber, Wasserburg am Inn, Bad Tölz, Landshut, Miltenberg am Main, Grafenau and many others – and of the traditions forming such an important part of daily life there.

This healthfulness expresses itself in the pure air and water and lovingly preserved countryside to be found everywhere in the state.

These traits are the results of other state policies – of enacting and enforcing zoning and environmental protection laws enabling the harmonious and mutually-compatible pursuit of business, cultural activities, shopping and sports.

The result is an exceedingly high quality of life. Joined with the state's excellent health care (itself a major attraction for those needing care) and world-class personal safety and security statistics, it is this quality which makes Bavaria such a favourite with immigrants from elsewhere in Germany and with expatriates from around the world. ■

To find out more about doing business in Bavaria please visit: http://www.invest-in-bavaria.com

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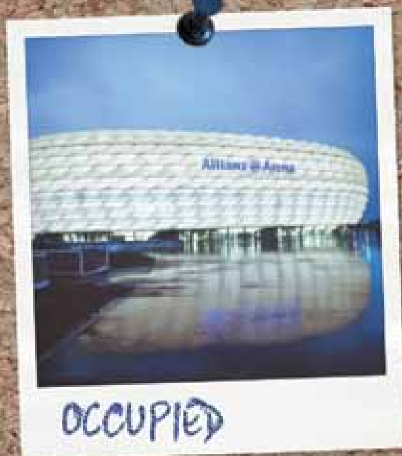

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