# The future of international fund domiciliation

IFI Global Research 2020


Jersey Finance

Delivering Insight ▪ Driving Innovation

IFI Global

Publishers of:

The**NED**

**The Tracker**

The Briefing Report

# Introduction

Current patterns of fund domiciliation were established some time ago. There have been a number of challenges to the existing order but arguably no great changes to it since Cayman emerged as the dominant offshore fund jurisdiction in the western hemisphere back in the 1990s whilst Ireland and Luxembourg became the main fund jurisdictions in the EU around the same time.

This looks like it is about to change. At the beginning of this new decade various themes have emerged on the scene that could influence fund domiciliation decision-making for years to come. These include Brexit and BEPS (Base Erosion and Profit Shifting). They also include the EU's drive for more substance and transparency in offshore jurisdictions as well as similar efforts, in terms of developing more local substance, in Ireland and Luxembourg.

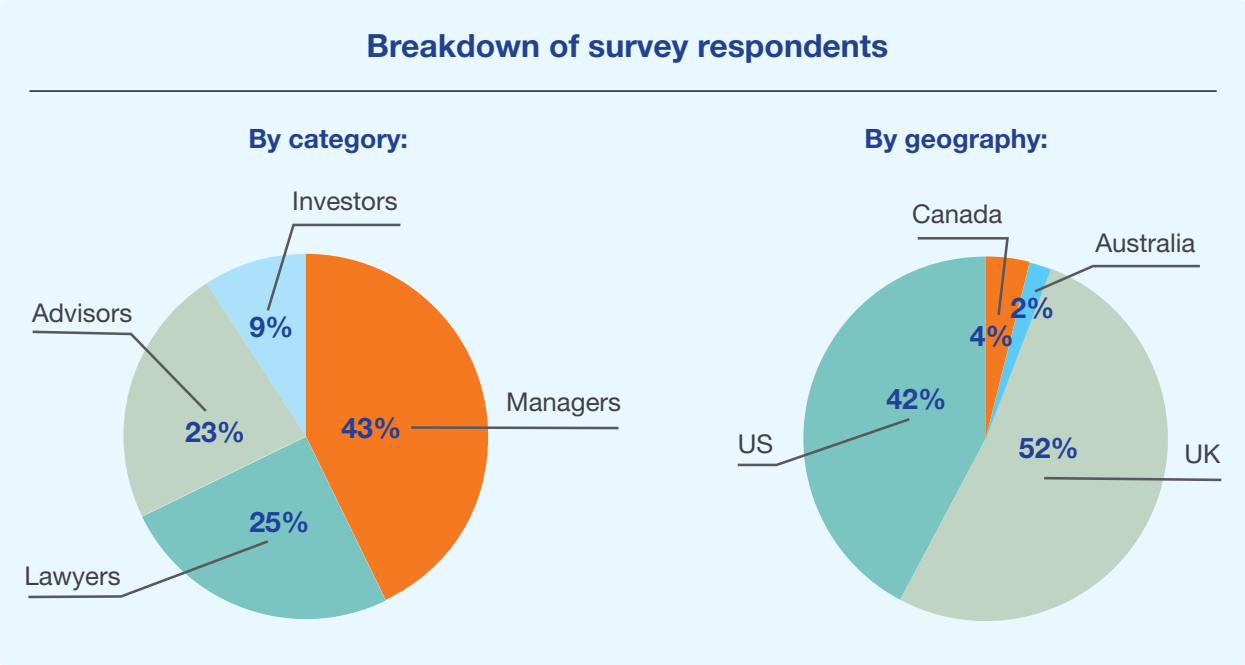
Whether they do make an impact or not one thing is for sure: the fund jurisdictional decision-making process is becoming more complicated than it once was. More factors have to be taken into account than was the case in the past.

IFI Global's research department, in collaboration with Jersey Finance, therefore thought this would be a good time to undertake a major global research study on fund domiciliation given the changes that are occurring at present. Such a study is long overdue: it has been many years since any kind of survey was undertaken on this topic.

Please note that this is an entirely independent report undertaken by IFI Global's research department.

Between October 2019 and February 2020 50 investors, alternative managers, law firms and advisors were interviewed for this study.

# Introduction




Fund managers with a combined AUM of approximately $2 trillion were surveyed over this five-month period. Some of the world's largest investors in alternatives – from Australia, Canada, the UK and US - were also interviewed. And the views of many of the leading advisory firms and fund lawyers, in London and New York, were also included.

IFI Global would like to thank all those that gave up their time to contribute to this study.

# Summary of the main conclusions

**Investors**

- The most important determinant in domicile selection is whether a jurisdiction is well known, and respected, or at least accepted, by investors that are being targeted by a fund manager. Investors do not want any surprises when it comes to domiciliation.
- Investors want to allocate to funds that are domiciled in jurisdictions with good infrastructure, considerable local expertise and knowledge of the asset class in question along with well-established regulations. They are happiest when they are following a well-trodden path that has been taken by many other investors in the same category as them.

There was some investor dissatisfaction at recent increase in costs in international fund jurisdictions as a whole but especially those in the EU

- This survey picked up on some investor dissatisfaction at recent increase in costs in international fund jurisdictions as a whole but especially those in the EU. A common complaint is that the drive to develop local substance has increased costs for no particular benefit to investors. Investors recognise that this has been done in the EU primarily for regulatory reasons. Some investors said that the recent growth in regulations has contributed to the increase in costs which they ultimately have to pay for.

**BEPS**

- A significant number of the managers surveyed are not yet that familiar with BEPS. Many of those that are aware of it – along with the advisors interviewed – believe it could well have an effect on domiciliation decision making in future. The EU's substance requirements, which are connected to BEPS, will most likely also have an impact.

BEPS will impact all domiciles with alternatives

- BEPS will impact all domiciles with alternatives, especially jurisdictions in the EU whose funds rely upon treaties for their tax exemptions. Luxembourg is popular with UK private equity managers because of its large number of tax treaties. Some of these may well be threatened by changes that will be required by BEPS, said a UK based advisor. Luxembourg is changing its laws to meet the BEPS principal purpose test. PE managers were first drawn to Luxembourg because of its regulations on SPVs and the tax treatment of them. Funds followed. This is likely to be reviewed in 2020 because of BEPS mandated tax changes.

# Summary of the main conclusions

**The Americas**

- US managers, in particular, use reverse solicitation extensively. New York lawyers said this will continue until a case is won against a manager using reverse solicitation. Lawyers interviewed are not aware of one case that has been brought against a manager, let alone one that has been successful. They said that this is unlikely to happen because the legal agreements made between investors and managers should always be watertight (assuming the manager has a competent law firm).
- Cayman is still the default domicile for US alternative managers going overseas. Alternatives to Cayman are only looked at in certain, specific circumstances – for example, if there was investor resistance to it. Europe is likely to be a region where there might be investor resistance to using Cayman (primarily with public pension funds).
- Cayman came in for some criticism by some US interviewees because there is a concern that it is becoming more bureaucratic and expensive than it once was. This is because of the tsunami of regulatory and reporting requirements being imposed on Cayman by outside bodies, which is forcing the government to bring in more regulations such as its Private Funds Bill. Cayman is popular because it is seen as being relatively low cost, easy and flexible. Anything that undermines this model is seen as a negative in the US and so brings other domiciles into play. 'Cayman is becoming less automatic,' said one US advisor.

Cayman is popular because it is seen as being relatively low cost, easy and flexible. Anything that undermines this model is seen as a negative

- Canada is beginning to be used as an alternative to Cayman in certain situations by US managers. A partner at a leading US law firm for alternative funds said Canadian partnerships for US venture capital and PE funds is a growing trend at present. They are mainly being set up in Alberta and Ontario.

**Europe**

- The recent increase in costs in EU cross-border jurisdictions, like Dublin and Luxembourg, is believed to have been exacerbated by Brexit but dates back to the introduction of AIFMD (Alternative Investment Fund Managers Directive). The alternative fund industry in Jersey, Ireland and Luxembourg has grown strongly over the last few years. In the EU this is a >>

result of AIFMD partly because of the additional functionality that is required to be conducted in the jurisdiction where funds are domiciled. The cost of the risk monitoring function alone is considerable. These rules were not strictly enforced when AIFMD first came in but that has now changed, said several interviewees.

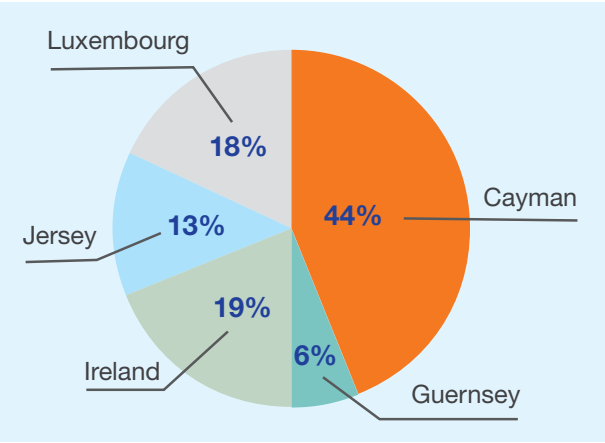
- The substance rules that offshore jurisdictions are required to introduce are seen as being part of a continuum that is forcing these domiciles to become less flexible and 'nimble' as one UK based advisor put it. Demands for more local substance mean more rules and costs. Some UK lawyers said that there is pressure on offshore centres to be 'super-compliant' with regard to money laundering, substance, disclosure of beneficial owners and so forth.
- Most interviews for this study were conducted before the UK general election on December 12. Brexit was discussed extensively but it was not seen as likely to change the ability of UK managers with offshore funds to access EU markets. If the AIFMD passport is extended to include UK and other third country AIFMs, and their AIFs, then any possible negative impact of Brexit on distribution would be neutralised. Brexit will also mean more UK managers will use Luxembourg or Irish AIFM platforms to passport their funds into the EU.
- But longer term many interviewees expressed a concern that the UK's absence from decision-making in Brussels might make the EU more protectionist. If that occurs the fear is that it will become more difficult for managers from third countries to access EU markets. In 2018 the EU Commission proposed a much more comprehensive degree of financial regulation and market integration in Europe post Brexit. There was also concern that delegation rules could be changed.
- All interviewees, who gave an opinion on it, expect that alternative investing will grow strongly in the next few years and that the jurisdictions that have the skills and experience in domiciling and servicing alternative funds will do very well. It is anticipated that in the next stage of their development alternative fund jurisdictions will acquire more specialist skills to meet growing market demand. This will make those jurisdictions more attractive to investors and managers alike. It is thought that they are far more likely to use jurisdictions which have these skills and expertise, over those that are not able to offer this.
- The alternative fund managers that were surveyed, who are part of larger mutual fund complexes, generally domicile their funds in Luxembourg or Ireland. Some also have fund ranges offshore. But most stand-alone, dedicated alternative managers surveyed do not domicile funds in the EU. A few UK based real estate managers interviewed do, and a number of private equity managers do as well, but this tends to be to meet particular investor requirements only.

# Survey results

Following are the questions put to survey interviewees with a summary of their responses.

**In which jurisdictions are your funds domiciled? Please include EU jurisdictions like Ireland, Luxembourg and Malta and offshore ones like Cayman, Guernsey and Jersey.**

Many managers interviewed have funds domiciled in multiple jurisdictions. Domiciling in both the EU and in one of the offshore jurisdictions is common.




**Do you expect to use either EU or offshore fund jurisdictions more, less or about the same in future than you do today? If more or less please say why.**

No one interviewed said that they have plans to redomicile funds or to use either EU or offshore jurisdictions more or less in future than they do at present.

Managers surveyed said that domicile selection is determined by the wishes of their investors. 'We are governed by our investors on this', said one London hedge fund manager. Advisors, lawyers and managers surveyed all made much the same point: when choosing a fund domicile investor acceptability is all.

A global manager, with a large presence in Europe, said that his firm has a range of alternative UCITS funds domiciled in Ireland, as well as having funds offshore for other investor categories. This was done for their European institutional investors.

A London based lawyer said that it is too early to tell if the EU's recently imposed substance requirements, on offshore jurisdictions, will have an impact on domiciliation patterns, but it is possible that they will.

A UK based advisor who has followed Brexit closely believes that the UK's EU departure might lead to further regulatory changes in EU cross-border jurisdictions like Dublin and Luxembourg, which will make these locations less attractive for Anglo-Saxon managers in future than they are today – if they are using these domiciles for global distribution, rather than just access to the EU.

Many US based survey respondents said that Cayman remains their default international jurisdiction. Structures based in Cayman are popular with US tax exempt investors. But a number of New York lawyers and advisors surveyed said that they are concerned that the recent 'ramping up' (as one put it) of regulatory requirements that have been imposed on Cayman 'threaten its competitive edge'. >>

## Survey results

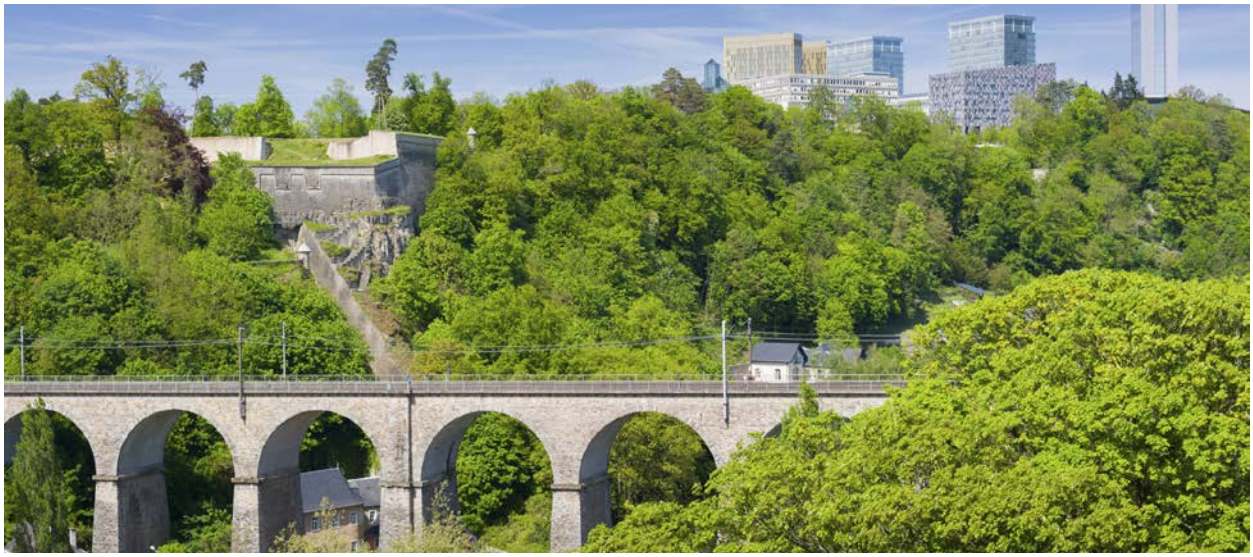
One New York lawyer interviewed is domiciling some funds in Canada for US managers which he said he would have previously put into Cayman.

> What investors want is to invest in funds that are domiciled in well-known jurisdictions, with good infrastructure, considerable local expertise of the asset class in question and well-established regulations

Investors surveyed did not pick a preference for one jurisdiction over another. Nor do they have a preference for the EU over offshore (or vice versa). What investors stated that they want is to invest in funds that are domiciled in well-known jurisdictions, with good infrastructure, considerable local expertise of the asset class in question and well-established regulations. Investors do not want to allocate to a fund in an unusual jurisdiction for this reason.

The investors that were interviewed for this survey are all long-standing and experienced allocators to alternative asset classes and are therefore comfortable investing in funds that are domiciled offshore. They would only stop doing this if regulations were ever to require them to do so.

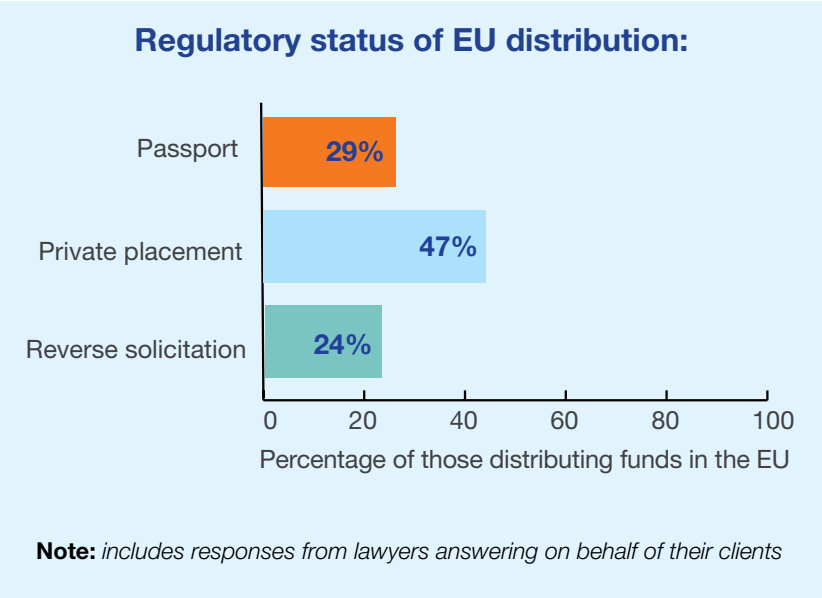
One investor interviewee said that she notices that the costs of allocating to funds in EU jurisdictions has recently been rising more quickly than in offshore ones. However, she added that costs are going up everywhere which she is concerned about as the performance of some of the funds that she is invested with does not justify this. She wishes investors could have some input on the regulatory changes in fund jurisdictions which add to costs often without much benefit to investors.



# Survey results

**If you are distributing funds in Europe do you use private placement (NPPR), reverse solicitation or the AIFMD passport?**

US alternative managers and their advisors interviewed mainly use private placement or reverse solicitation to reach European investors. Those using the passport are EU-based managers.




They will go through the process of becoming AIFMD compliant only if absolutely necessary or if they are part of a larger group with a base in Ireland or Luxembourg. But they would do it if this is required by their targeted investors. US manager survey respondents say their legal counsel provide them with a range of options, for different circumstances. Only alternative managers who are part of larger mutual fund complexes will automatically go straight to full AIFMD compliance.

Reverse solicitation remains popular with US managers and lawyers surveyed as a means of getting a foothold in Europe. Responses to this research study suggest it will continue to be used by many US managers until, or if, this option is phased out by EU regulations. Law firms interviewed say that they are experienced in drawing up documentation that is required to ensure that their clients will not find themselves in any legal difficulty should something go wrong.

> 'We have been able to rely upon private placement to get to the investors we want'
> *– US Hedge Fund Manager*

Private placement arrangements are used by managers surveyed for particular markets such as those in northern Europe. 'We have been able to rely upon private placement to get to the investors we want,' said one US based fixed income hedge fund manager.

But a number of lawyers and advisors interviewed said that private placement arrangements cannot always be relied upon across the EU as a whole, including in Germany. However, private placement is still common in the largest and most sophisticated EU markets for alternatives such as in the Netherlands and the Nordic region, said interviewees.

More UK based interviewees use the AIFMD passport or UCITS to distribute funds in Europe than US ones. But many UK managers surveyed with AUMs of below $500 million are not targeting European investors. A number said that they see more opportunities in the Asia-Pacific region, Gulf or US than the EU.

**Have you noticed any trends or changes in the EU and offshore fund industries over the last 5 years? If yes please say what they are.**

Top 3 trends/changes in EU & offshore fund industries by number of mentions over the last 5 years were identified as follows:

- Introduction of AIFMD (in 2013)
- Development of local substance requirements
- Increase in regulations

> 'It is probably under-appreciated just how much AIFMD has changed the (alternative) investing culture in Europe' *– UK Lawyer*

Overwhelmingly, interviewees referred to the impact of AIFMD on the European fund industry – offshore as well as in the EU. One London based lawyer said: 'It is probably under-appreciated just how much AIFMD has changed the (alternative) investing culture in Europe.'

Survey respondents said that the Directive requires more executive functionality to be carried out in the jurisdictions where funds are domiciled. For example, it requires risk management to be conducted in the jurisdiction where the fund is domiciled if the portfolio management function is delegated. This has had an effect upon fund domiciliation behaviour, in that it requires managers to locate funds >>

where there is sufficient local substance and a professional support network, with recognised service providers.

The growth of local decision making by funds in the jurisdiction where they are domiciled in Europe (both offshore and in the EU) is believed also to be a very significant trend in fund domiciliation over the last 5 years by most survey respondents. A number of interviewees in the UK also said that the drive to more local substance has also meant that there has been more focus on fund boards along with a growing professionalism by non-executive directors.

**Do you expect to see any trends or changes in the EU or offshore fund industry over the next 5 years? If yes please say what they are.**

Top 4 trends/changes in EU & offshore fund industries by number of mentions expected over the next 5 years were identified as follows:

1. BEPS & drive for more substance
2. More regulatory & reporting requirements
3. ESG
4. Consolidation

Significant change is anticipated in the next 5 years in all international fund jurisdictions – both those in the EU and offshore. That is because of BEPS, as well as the recently imposed transparency and substance requirements from the EU, along with anti-money laundering and related reporting measures from other international bodies.

The imposition of these measures is making Cayman 'not so automatic' as it once was said one New York based advisor. A number of US based interviewees fear that the additional bureaucracy and costs, create risks that >>

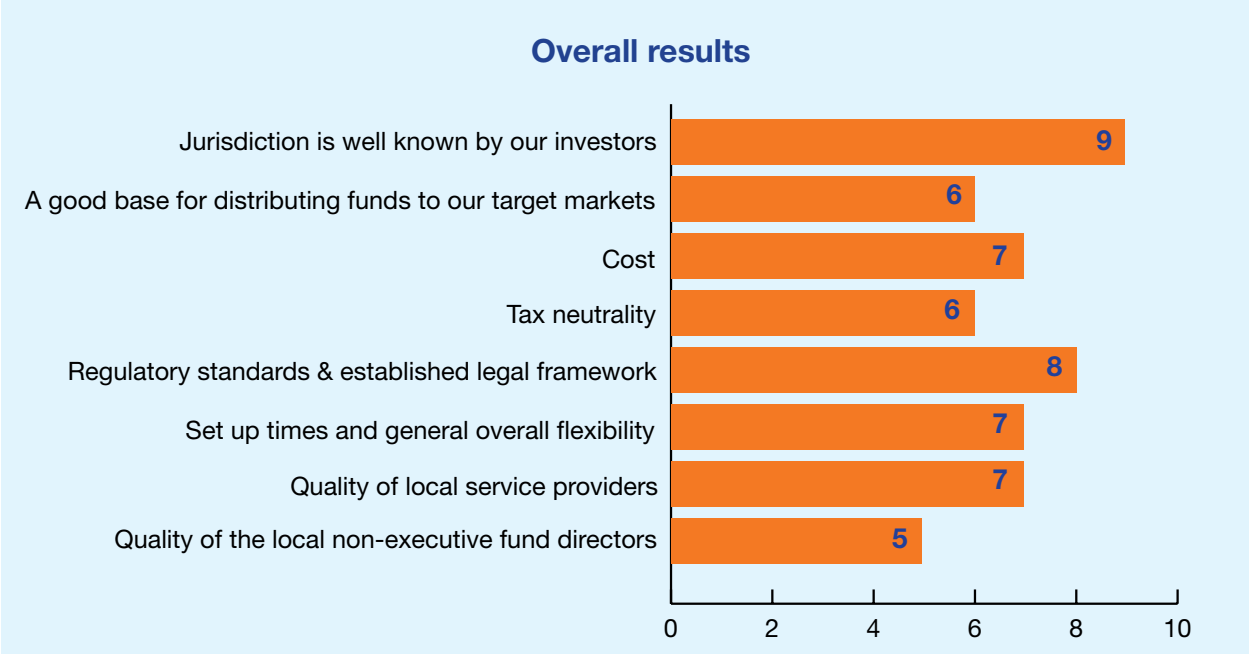
These measures are making Cayman 'not so automatic' as it once was

undermine Cayman's competitive advantage of being a low cost, flexible and easy to use jurisdiction.

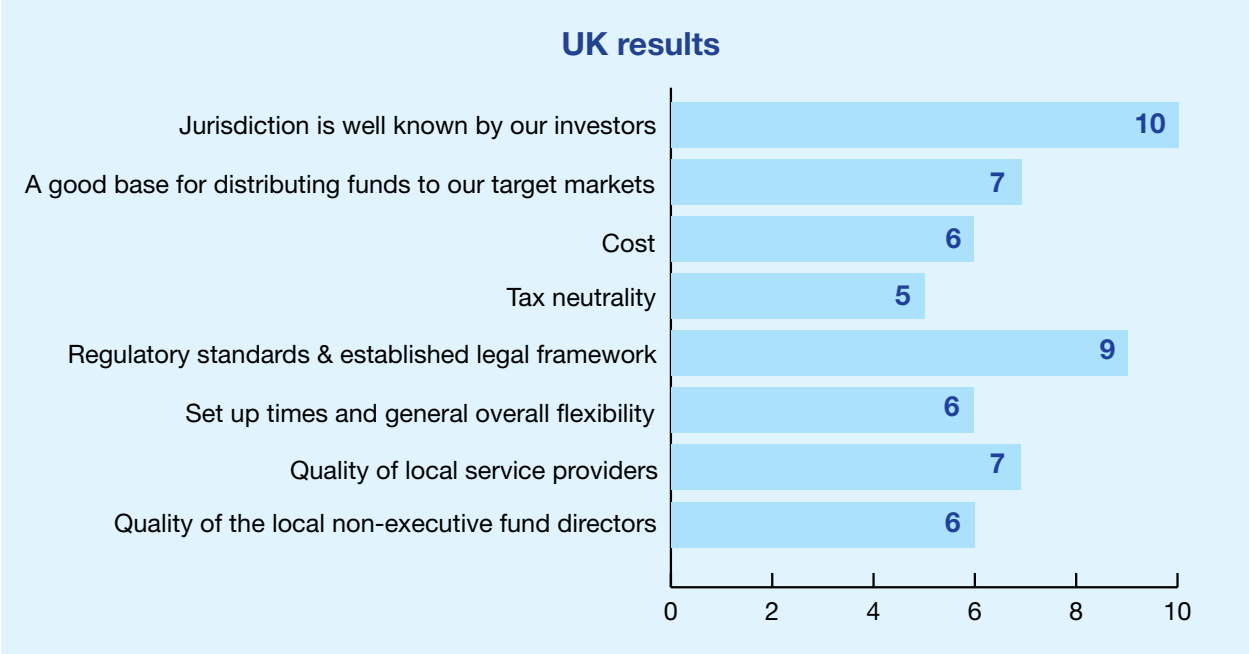
Measures taken to counter BEPS may well have a real impact on jurisdictions like Luxembourg and other domiciles that have a wide-ranging tax treaty network which is used by alternative funds that are domiciled there. One interviewee said private equity has grown strongly in Luxembourg because of the tax advantages enjoyed by private equity managers there. BEPS measures could threaten this. BEPS could be more of a challenge for onshore jurisdictions, with their network of tax treaties, than offshore jurisdictions which do not rely upon such arrangements.

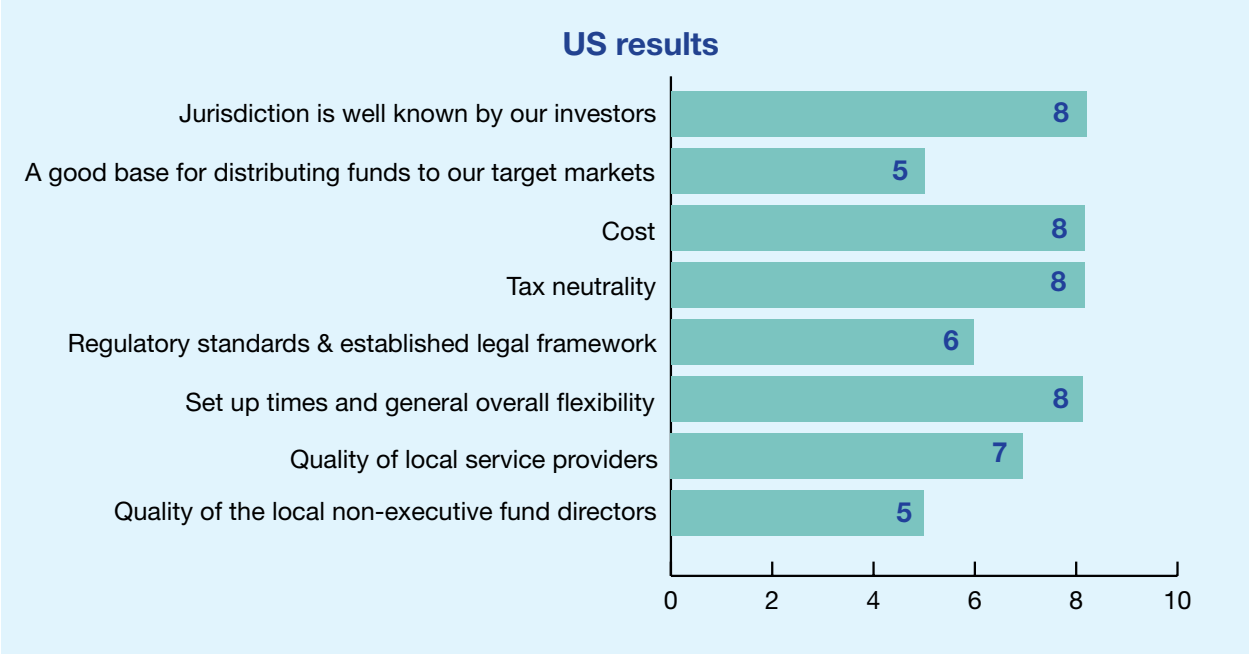
A number of interviewees said that they are looking to consolidate their fund ranges into one overall jurisdiction. In the past this was difficult to do but the larger service centres have people with the requisite skills to enable this to happen across a range of asset classes. Consolidation is seen as being cost effective.

**Please rate out of 10 (with 10 as the highest value) the reasons why you chose to domicile your funds in the jurisdiction(s) that they are in:**



# Survey results



# Survey results

Summary of quotes and unprompted comments on domicile selection criteria and jurisidictions

**Selected quotes**

> ‘Domicile selection is not as straightforward as it was’

‘The jurisdiction has to have investor buy-in’

‘Cost is becoming more critical’

‘Interaction with the regulator is important’

‘More decisions are being made by directors but sponsors would prefer them to be strawmen’

‘We see a big increase in manager relocations but no changes in fund domiciliation at present’

‘We tell our clients that they need to focus on substance issues now’

‘Domicile selection is not as straightforward as it was’

**Views on individual jurisdictions:**

**Cayman**

‘Cayman is becoming less automatic’

**Ireland**

‘The CBI has become much more focused on the fund industry since Brexit’

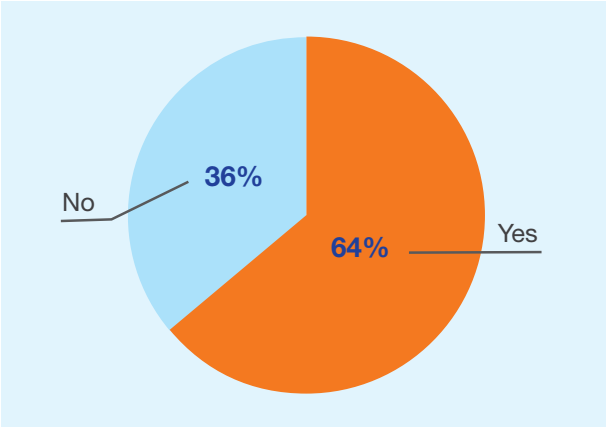
**Jersey**

‘Jersey has an excellent reputation’

## Are you aware of changing substance requirements in fund jurisdictions?

The majority of interviewees are aware of the substance requirements that the EU’s Code of Conduct Group has imposed on offshore jurisdictions. Knowledge of them is greater in the UK than US but the US lawyers interviewed are aware of them.

A number of UK based interviewees said that Brexit has also changed substance requirements in Dublin and Luxembourg. The Central Bank of Ireland and the CSSF want to make sure that UK managers do not set up small branch offices in their jurisdictions and then continue to make the major decisions in London. One of these interviewees said that the substance changes in EU jurisdictions imposed by Brexit will be more significant than the Code of Conduct Group’s substance demands on offshore jurisdictions.



# Survey results

**Will these changing substance requirements prompt you to review your own arrangements in your fund jurisdictions?**

No one surveyed said that anticipated making any changes to their domiciliation arrangements as a result of the new substance rules. But several interviewees said that they are monitoring the situation. Results from this study would suggest that US based advisors and lawyers are more concerned about the impact of the substance changes on Cayman than UK based advisors and lawyers are concerned about their impact on the Channel Islands.

**If yes might you add more local substance to your fund arrangements as a result of these new rules? In what ways might you add substance:**

- **A higher proportion of local non-executive directors on your boards**
- **More local employees**
- **Other (please state)**

Nor has anyone surveyed made plans to change their offshore operations as a result of the new substance requirements. But one UK interviewee said the new rules will have a negative effect on the development of Cayman's local fund industry. The new rules will mean that Cayman will become more reliant upon its pass-through fund business because funds are not in scope but local fund management activity is. Local fund managers that delegate their CIGA (Core Income Generating Activity) back to their head office might be closed down as a result of this measure.

# Survey results

## Do you think that Brexit will impact fund domiciliation patterns?

Brexit has boosted Ireland and Luxembourg as UK managers have built up their presence in these jurisdictions as a result of the UK's decision to leave the EU. Additionally, most interviewees said that Brexit has the potential to further impact fund domiciliation patterns (beyond Ireland and Luxembourg) but the general view is that it is too early to tell what that is.

One UK based manager said his firm has launched a UK based OEIC as a 'Brexit hedge'.

US interviewees made the point that London has always been the choice for an office location for their managers, when coming to Europe. It is too early to say if that will continue to be the case in future.

If the UK becomes an international fund domicile post Brexit then that will obviously have a significant impact on domiciliation patterns. But, again, it is too early to say if this will occur.

# Views on fund jurisdictions

For the overwhelming majority of survey respondents Cayman, Dublin and Luxembourg are effectively 'default' domiciles (as one interviewee called Cayman).

Cayman is popular with hedge fund managers globally and also with all alternative fund categories in the US. Dublin and Luxembourg are automatic choices for managers who want to domicile in the EU. They are also used as bases for global distribution by a number of survey respondents.

Jersey is seen as offering a more substantive offshore option, for all classes of alternative funds, than Cayman – and a less bureaucratic alternative to Dublin and Luxembourg for managers that want access to EU markets. Those that know it well enough to make a comparison with other fund jurisdictions praised its level of professionalism and expertise.

A number of interviewees from the US said that they are concerned that Cayman's competitive advantage over other jurisdictions is being eroded by the recent series of regulatory and reporting requirements being imposed on it by outside bodies. As a result, this research study picked up on advisors who are beginning to explore other options for the first time.

Many survey respondents are in Ireland and Luxembourg because they believe that they have to have funds domiciled in the EU.

There is a feeling that the success that these jurisdictions have had has driven up fees. As well as for supply and demand reasons fees are also going up because of regulations that have been imposed recently to ensure that local managers have the requisite level of local substance (in part because of Brexit).

For these reasons, and others, there may well be considerable change in fund domiciliation patterns in the years ahead.


IFI Global

IFI Global Ltd is a fund management research and media business, focusing primarily on the alternative side of the asset management industry.

For more information please go to:
http://www.ifiglobal.com