The Evolution of the International Fund Jurisdictions

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Introduction

How or why a group of islands became the established bases for the asset management industry's international funds is rarely, if ever, discussed or commented upon. They were subsequently joined by two small European countries. Neither of these had had any previous connection with the fund industry.

To understand how the asset management business might develop in future, it is a good idea to know something about how the international fund jurisdictions, on which this industry depends, are evolving.

Jersey, BVI, Bermuda, Cayman, Guernsey, Ireland and Luxembourg are currently the world's main international fund domiciles. Each reached this position at slightly different times and often for different reasons. They are continuously evolving, which they need to do in order to stay competitive.

Fund domiciliation patterns have always been subject to change. There is no reason to believe this will not continue to be the case in future. New investment products will be invented and they will need tax neutrality for international investors. Funds are domiciled in jurisdictions that have adapted their regimes to achieve tax neutrality for their international investors, and are compliant with international standards. These international standards have changed quite drastically over the years and, if anything, the pace of change is likely to speed up.

This White Paper explores what may well happen to international fund jurisdictions over the next few years. Prior to that, it touches upon how a few unlikely locations, dotted around the world, got into this business, as well as focusing on what is happening in international fund domiciliation today.

The origins

It isn't possible to put a precise date on when international fund domiciliation got started. Nor is it possible to identify a particular reason for why this happened in the first place. Arguably, it was mainly happenstance; and it is worth pausing to reflect on just how different the international fund industry would have been if a series of unconnected events hadn't occurred.

Jersey and Bermuda look to have been the first offshore locations to have developed a connection with international finance. Jersey began to do so as far back as 1961. Banks in Jersey set up accounts for UK nationals working overseas for the first time (M. Samuel later Hill Samuel, was the first to arrive). Bermuda didn't follow until 1981, with its first Companies Act, covering investment products.

Nonetheless, the international fund industry didn't really get going until closer to the end the 1980s. The first investment products offered were mainly for UK nationals working overseas and for other expatriates. They were very different from the products available in Jersey and the other jurisdictions today.

Money market funds and investment products with a life assurance wrapper were popular. Equity and bond mutual funds were also being offered to retail investors using international fund domiciles for the first time back then. Jersey was joined by Guernsey and the Isle of Man in this endeavour.

Meanwhile, hedge funds were beginning to be set up in the Caribbean by the late 1980s too. BVI, Cayman and Curacao were the preferred destinations for those early hedge fund managers, many of whom later went on to become the most famous names in the industry. Bermuda was also a popular hedge fund domicile back in this industry's very earliest days. However, despite being much closer to New York, where almost all hedge fund managers were based back then, it lost out as these funds started to set up, en masse, in the Caribbean.

The origins

Jersey's prominent funds industry was set up in the 1970s when leading fund management groups established Jersey offices to develop and promote products to international investors.

In the late 1980s and early 1990s, hedge funds were investment instruments just for the high net worth market. No one, back then, in any European fund jurisdiction – offshore or onshore – would have ever anticipated that hedge funds would have grown to the extent that they did and that they would expand out of the Caribbean. They were de facto investment clubs in which their largest investor was frequently the manager himself. Other investors were often family members and friends. Institutional investors didn't start to allocate to them for another decade or more.

A large part of the reason why hedge fund domiciliation began in the Caribbean was because of the confidentiality it offered to high net worth investors. Lack of any real local regulation was another draw. These investors would not have gone anywhere near Cayman, BVI or Curacao if they had thought that there was a chance that their confidentiality was not going to be respected by those who worked there. Confidentiality trumped competency. Back then, the name of the firm doing the administration was often a secret, as were the directors of the funds. If information on a fund was ever given out it was strictly on a need-to-know basis only.

Private equity funds, and other investment vehicles that are now considered to be in the alternative category, followed on afterwards.

There was relatively little international fund domiciliation from the private equity or real estate industry until the late 1990s, at the earliest. The private equity and real estate investing industries went through a long period in their development, when almost all of their investment products were based onshore, mainly in the UK or US.

At the end of the 1980s, Luxembourg began to develop as a retail fund centre for Europe. Several fund managers from the UK and the US were quick to set up their own offices there - such as Fidelity, Flemings and Schroders – in order to have a foothold on the Continent. Other managers began domiciling funds in the Grand Duchy and used the local Luxembourg banks as their fund administrators.

Neither Luxembourg nor Ireland had had any previous connections with the fund industry

The origins

Looking at the success that Luxembourg, a small country on the mainland of Europe, had had in muscling its way into the fund industry gave Ireland the idea that it should give it a go too. It is worth emphasising that neither Luxembourg nor Ireland had had any previous connections with the fund industry at all. Until the late 1980s, Luxembourg's only link with finance was as an offshore centre for Belgium. And there was no fund management done in Dublin back then either (Irish banks managed that in London).

Until the 1990s, the asset management industry was almost entirely Anglo Saxon. There were no fund management companies in continental Europe, outside the Netherlands. For Luxembourg and Ireland to bet that Europeans would take to funds run by Anglo Saxon managers, especially equity funds (they were mainly bond investors at the time), was quite a gamble.

Early Key Dates in the Evolution of the International Fund Jurisdictions

1961	Banks establish offshore operations in Jersey for expatriate customers
1981	Bermuda's first Companies Act
1984	Jersey's first Trust Law
1985	EEC's first UCITS Directive
1988	Luxembourg fund industry formation
1990	Cayman's first Mutual Funds Law
2008	Market crash (and the collapse of various well-known funds)
2008	Madoff fraud revelation
2012	Luxembourg's CSSF introduces Circular 12/546
2013	EU's Alternative Investment Fund Management Directive (AIFMD)
2016	OECD's Base Erosion and Profit Shifting (BEPS) announced
2016	Brexit vote & the announced withdrawal of the UK from EU regulation
2018	Ireland's CBI introduces CP86
2018	Luxembourg's CSSF introduces Circular 18/698
2018	EU announces the formation of a Code of Conduct Group to review offshore jurisdictions for fair tax competition

The dawn of alternatives

The 1990s saw the arrival of regulations specifically for fund industry entities based in international domiciles. UCITS had come into effect in the1980s, but that was a pan-European measure from Brussels. It was also exceptionally early in the evolution of the international fund industry. In the 1990s, services such as fund administration, and infrastructure, were set up for fund managers in offshore jurisdictions like Jersey, as well as in Ireland and Luxembourg.

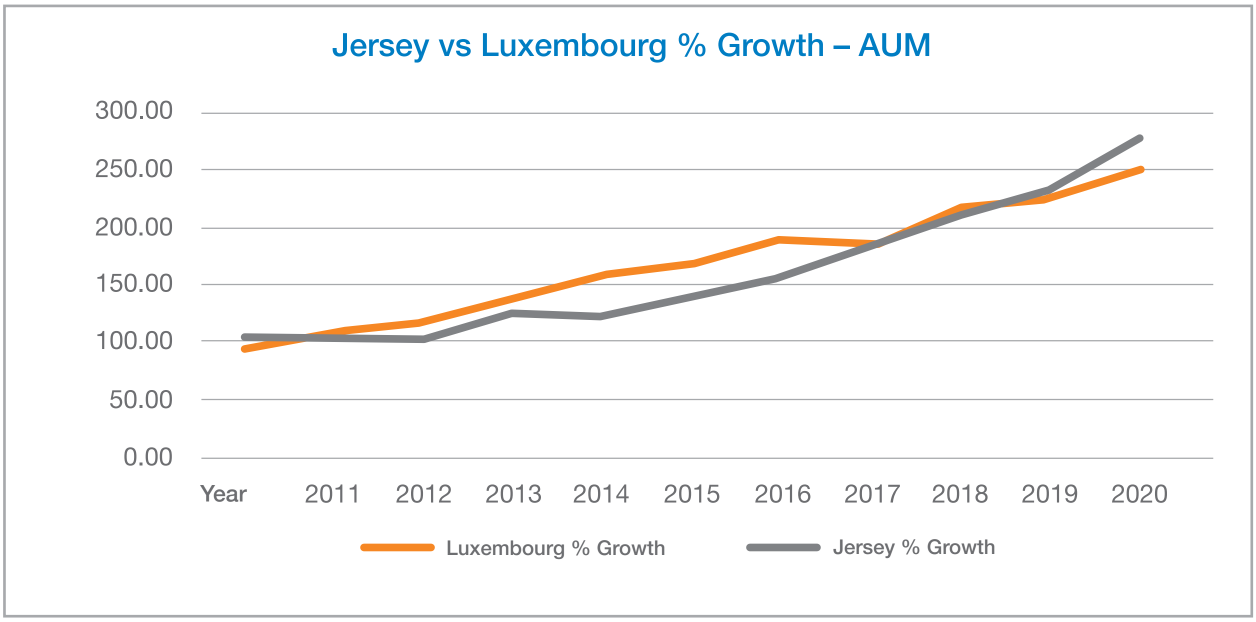
In retrospect, these jurisdictions were effectively laying the groundwork for the strong growth that they were to experience from the end of that decade, and on into the new century. That growth was driven by the extraordinary expansion of hedge funds, private equity funds, real estate funds and other alternative investment products – especially in offshore domiciles.

By the time the new millennium came around, institutional investors were beginning to allocate to alternatives. This was transformative. Alternative managers needed a home for the funds that they were offering to institutional and other professional investors around the world. The offshore fund jurisdictions were the obvious places to go.

> The offshore fund jurisdictions were the obvious places to go

Institutional investors, fund of fund managers and other professional allocators moving into alternatives, demanded higher standards of operational capability than had existed in the industry up until this point. This meant that service providers in the international fund jurisdictions had to be at the top of their game.

However, the trend towards professionalism in fund servicing, across these various and very different jurisdictions, didn't happen overnight. Up until the crash of 2008, there were still a fair number of examples of practices that would not be considered acceptable today.



Source: Figures obtained from the Jersey Financial Services Commission and the Association of the Luxembourg Fund Industry

The dawn of alternatives

That particularly applied to the Caribbean. Until the 2008 crash, for example, it was possible to find individuals who served on boards of 300 to 400 funds in Cayman.

In the fallout from the 2008 market crisis, and before that, it wasn't particularly uncommon to come across scandals that no longer occur today. This was the era of the Weavering blow-up in Cayman, for example, as well as the Carlyle Capital Corp collapse in Guernsey, along with various other funds whose sudden and unexpected demise failed to make the headlines. It was also the era of Madoff. There were very many Madoff feeder funds domiciled in the international fund jurisdictions – including in Luxembourg.

One of the effects of the various blow-ups that occurred, such as those previously mentioned, was to raise the level of professionalism that was required to be an independent director of an international fund. It was now understood across all jurisdictions, including those in the Caribbean, that being a fund director included taking on serious responsibilities with liabilities. Jurisdictions like Jersey, that have a deep pool of experienced independent directors, have benefited as a result.

Until the 2008 crash, fund domiciliation patterns had changed relatively slowly. Some jurisdictions in the western hemisphere had faded because of the growing dominance of Cayman in that part of the world. Post the market crisis, the pace of change in fund domiciliation patterns begun to speed up.

Reforms post 2008 - and substance

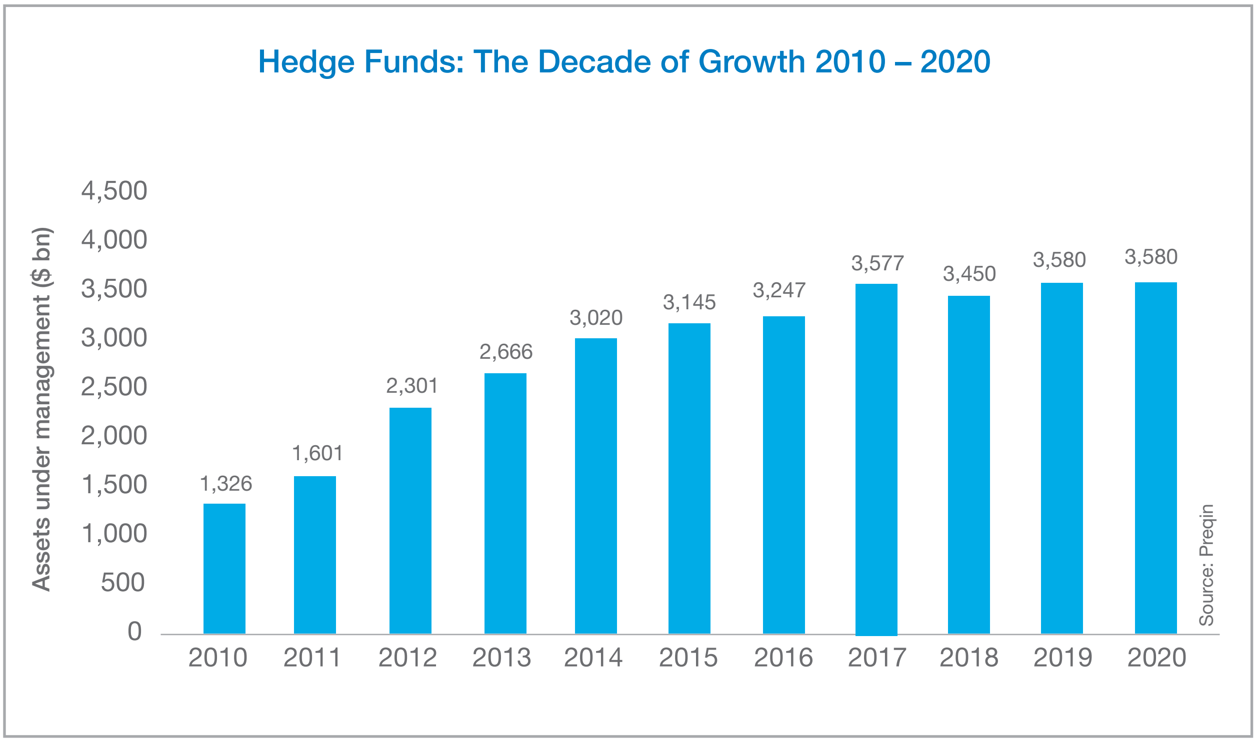
One of the most substantial changes in the way that the international fund jurisdictions operate today has been brought about by the EU's Alternative Investment Fund Management Directive (AIFMD). Fund domiciles outside the EU have been affected by it as well.

AIFMD was brought in as a result of the market crash of 2008. It was introduced for investor protection purposes, to play a similar role for alternative funds as UCITS had for retail funds. The EU Commission and ESMA determined that they wanted to build up substance in EU jurisdictions where funds are domiciled, particularly in Ireland and Luxembourg. They also began to demand that offshore jurisdictions that wished to have their funds distributed in the EU should have a certain level of substance too.

Jersey, for example, was the first jurisdiction to lodge new legislation in 2018 to meet the EU Code of Conduct requirements on Business Taxation for businesses to demonstrate economic substance.

In particular, the Commission and ESMA did not want funds domiciled in the EU to be dependent upon portfolio management teams from third countries, which now includes the UK, as well as the US.

Luxembourg jumped on to the local substance trend earlier than Ireland. It began with the CSSF Circular 12546 in 2012. In August 2018, CSSF circular 18698 then went further. It is exceptionally detailed and focuses on just about all practices that a management company in Luxembourg could cover. It runs



Reforms post 2008 - and substance

to just over 140 pages. The Central Bank of Ireland brought in something similar, CP86, 2018.

The CSSF Circulars and CP86 are all about ensuring that the regulators have strong supervisory powers over the Irish and Luxembourg fund industries. This means that – via AIFMD - the investment manager is viewed as another delegate to the fund, with a level of responsibility to it that is not that different to its service providers, such as the custodian or the fund administrator. In the US, by contrast, the investment manager is key to everything. Under Sarbanes Oxley, for example, the investment manager in the US has the ultimate sign off.

That is no longer the case in the EU. The AIFM in the European jurisdiction where the fund is domiciled has executive functionality. This is a large part of the reason why the governance of funds in the EU has become so complex. Adding ever more regulatory substance on to structures where the fund is domiciled, as opposed to where the investment manager is, can make oversight complicated, especially when the portfolio manager is back in London or New York. The roles that regulators require the Designated Person in Ireland and the Conducting Officer in Luxembourg to play is attempting to re-create, or in some ways duplicate, the job of the investment manager. The cost of running funds in Ireland and Luxembourg has increased considerably in recent years as a result.

The drive to ever more substance in EU jurisdictions is also about making sure that

The Big Five

	Funds	Assets
Jersey	1,244	$737 billion
Guernsey	856	$407 billion
Ireland	8,372	$4.4 trillion
Luxembourg	14,427	$6.2 trillion
Cayman	27,398	$5 trillion*

End 2021 £1 = $1.34 €1 = $1.13 * Estimate

funds cannot be considered 'letter-box' entities. Letter-box entities was a term that used to be reserved for offshore structures. It was rare for this term to be applied to any kind of fund entity in Ireland or Luxembourg.

Brexit changed that. EU-based regulators have said, on many occasions, that they are on their guard against UK managers setting up letter-boxes in their jurisdictions while making all the important decisions back in London.

Brexit has had a large impact on the way that EU jurisdictions operate today, especially upon Ireland. The Central Bank of Ireland has made it clear that UK managers setting up there must have local substance, including senior management based in the jurisdiction. This has led to capacity concerns and a wage spiral.

> Brexit has had a large impact on the way that EU jurisdictions operate

Offshore substance

Demands for more substance have also driven developments in offshore jurisdictions.

Some jurisdictions have been more relaxed about this than others. Jersey and Guernsey didn't have any difficulty in complying with the EU Code of Conduct Group's substance requirements. BVI and Cayman, on the other hand, have found it more difficult to keep up with requirements that have been put upon them. Cayman introduced a Tax Co-operation (Economic Substance) Law in 2018, chiefly to comply with BEPS, but did not implement all of the requirements on time, and, as a result, ended up temporarily on the EU's non cooperative tax jurisdictions blacklist in February 2020, and were taken off this list in October 2020.

Jersey believes that having local substance fits in well with its strategy to develop skills to support its expanding alternative fund industry. It believes that the EU Code of Conduct Group's substance requirements are effectively a codification of what it already does. It means that managers can base their funds there and access EU markets via private placement for example.

Cayman was also placed on the Financial Action Task Force's (FATF) grey list in 2021, due to deficiencies in the effectiveness of Cayman's AML regime. Cayman is undergoing a 15-month period during which it must implement an action plan agreed with the FATF to come off its grey list. This addition to the FATF greylist in 2021 also meant that Cayman was highly likely to appear on the EU AML blacklist in due course. Indeed, they were added to the EU AML blacklist on 21 February 2022, which came into force on 13 March 2022. This could prevent Cayman funds from marketing into the EU in future, because changes to the AIFMD proposed by the Commission would, if accepted, mean that Articles 36 and 42 would no longer refer to the FATF non-cooperative countries and territories list but, instead, to the EU AML blacklist. If Cayman was still on the AML blacklist when these changes came into effect, it would most likely restrict the ability to market Cayman AIFs into the EU under the NPPRs.

This is a large part of the reason why costs have been going up in Cayman. Some US managers are now looking around at other domiciliation options as a result.

> It is now very difficult to find a reputable offshore fund jurisdiction that is cheaper and lighter on regulation than the others

Regulatory requirements that have arisen in the industry over the last decade mean that it is now very difficult to find a reputable offshore fund jurisdiction (with access to the EU and in good standing with the FATF and other para-statal bodies) that is cheaper and lighter on regulation than the others.

BEPS

Much of the drive for more substance in international fund jurisdictions is because of BEPS (Base Erosion and Profit Shifting), which is an OECD initiative. Every international fund jurisdiction has signed on for BEPS implementation.

BEPS may well be the most important development for the structure of the alternative fund industry in the last decade, but few people know much about it (long only funds, known in BEPS parlance as CIVs are largely exempt). Funds that are domiciled in international jurisdictions are tax neutral.

BEPS is used as the underlying economic rationale by the EU to impose substance requirements on offshore jurisdictions. Similarly, BEPS underlies the OECD's Forum on Harmful Tax Practices (FHTP).

The impact of BEPS on fund domiciliation patterns has been, and could still be, considerable. PwC believes that managers may eventually be talking to their investors about their pre and post tax returns because of BEPS. Tim Hames, the previous Director General of the BVCA, said that BEPS will lead to changes in fund structuring in private equity. He believes that the private equity industry is about to enter a 'taxulation era' in part because of BEPS.

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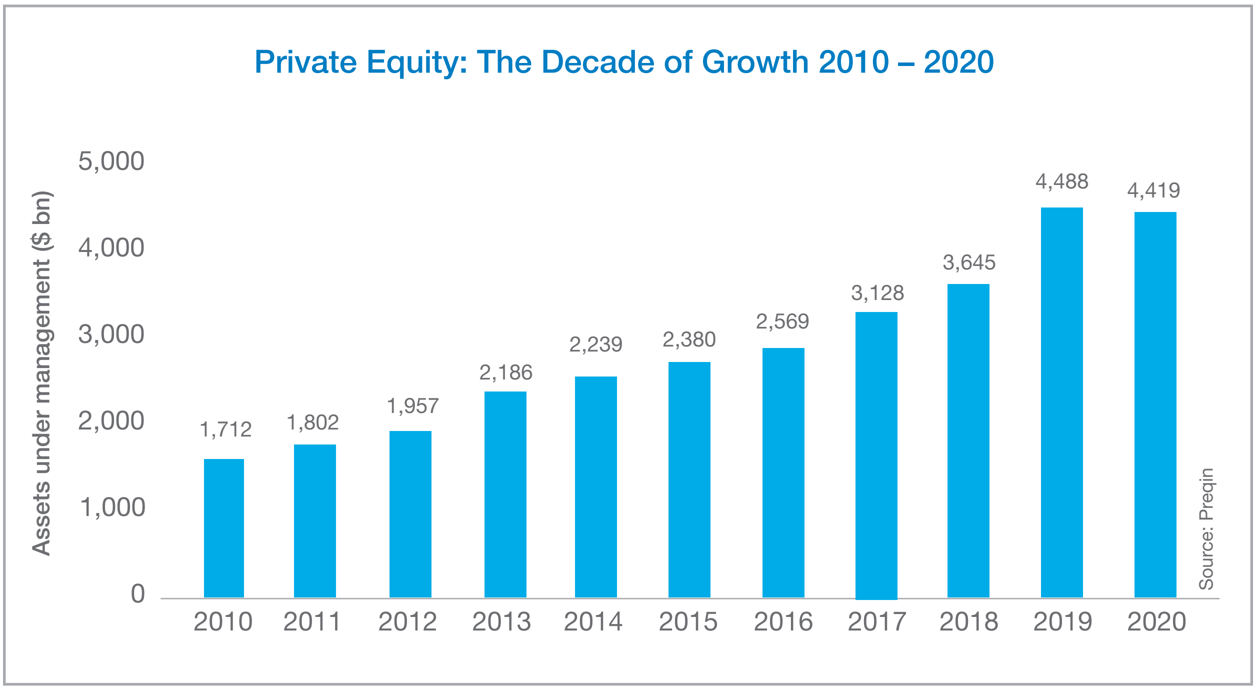

The future

Sustainable finance is almost certain to become hugely influential in the development of the international fund jurisdictions in the future. Investment houses with over $100 trillion in AUM support the UN's PRI. Bloomberg Intelligence forecasts that global ESG assets will reach $53 trillion by 2025.

Just as some fund domiciles are known today for their connections with private equity funds, hedge funds, ETFs and so forth, it is likely that, in future, they will become known for their expertise in certain ESG investment categories too.

Crypto funds are another fast-growing area of the investment industry. According to a report by PwC in 2021, the number of crypto funds is increasing rapidly, but the structuring of these entities is sometimes not yet of the standard that investors would expect to see if they were to allocate to them. The developing crypto fund industry is embryonic at present. It is likely that one or more of the international fund jurisdictions will become the recognised domicile for crypto funds in the not-too-distant future.

Doubtless other new investment categories – beyond ESG and crypto – are just over the horizon. The jurisdictions that are quickest to develop expertise in whichever investment categories that are emerging on the scene are the ones that usually benefit the most from what is going on.

There is very often a first-mover advantage in fund domiciliation trends. Once a pattern is established it is very difficult, if not impossible, to change it. Investors don't like surprises when it comes to managers' jurisdictional choices.

> There is very often a first-mover advantage in fund domiciliation trends

The future

Investors like allocating to investment products that are based in locations where there are many other funds in the same category.

Given the trends over the last decade or more, it appears likely that the fund jurisdictions that will be most successful in future will be those with strong local expertise and infrastructure: it is impossible to envisage that current substance requirements will be eased. If anything, they are likely to grow stronger.

There is, however, a danger that this might make some jurisdictions bureaucratic, expensive and inflexible. That is becoming a matter of some concern in the EU fund domiciles at present. Expertise and infrastructure, along with flexibility, particularly from the regulator, would appear to be the best formula for success.

It is remarkable how much some of the international fund jurisdictions have changed over the last 30 years as a result of their association with investment funds. It is worth noting that St Helier in Jersey, the Docklands in Dublin, as well as large parts of Luxembourg, look very different today because of this. By comparison the cities where many of the managers who use these fund domiciles are based, such as London and New York, look much the same as they did back in the 1990s.

Over the next decade and beyond, there will be many more changes – both foreseen and unforeseen. The international domiciliation of investment products, which began almost by accident, is now an integral part of the global fund business. It isn't possible to envisage how asset managers could operate if these jurisdictions, dotted as they are around the world, didn't exist today.

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

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