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Financial Services

# DOMICILES OF ALTERNATIVE INVESTMENT FUNDS

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# 1. EXECUTIVE SUMMARY

This study examines where alternative investment funds are domiciled, the reasons behind the choice of domicile and expected future trends. The study shows that the Caymans Islands are the most important jurisdiction for alternative funds overall, driven by their popularity among hedge funds. Delaware by contrast is the most popular jurisdiction for private equity and real estate funds. These preferences have stayed fairly constant over the last two years.

Until recently the choice of domicile was significantly influenced by tax and regulatory considerations. However, there has been, and continues to be, pressure from home market regulators on offshore funds. Over time this pressure will induce some alternative funds to domicile onshore. However, contrary to what is frequently claimed, we believe offshore centres will continue to attract a large share of alternative funds for the foreseeable future due to good infrastructure and familiarity, with only a gradual shift onshore.

# 2. INTRODUCTION

Increasingly the choice of domicile matters for alternative investment funds (AIFs). Traditionally AIFs choose to be domiciled offshore. This reflects a broad range of reasons including favourable tax regimes, confidentiality, lower levels of "red tape", and the quality of fund infrastructure available in these locations. However, the status quo is now under pressure as, rightly or wrongly, offshore centres have attracted some negative attention and onshore centres are levelling the playing field. The choice of fund domicile is also becoming more relevant to end investors and hence more critical to the fund management business as a whole.

In this study we identify which major fund centres are currently used by AIFs as domiciles, looking separately at hedge funds (HFs), private equity (PE) funds and real estate (RE) funds. In addition, we look at the key drivers behind the choice of domicile and at potential futures trends. However, only limited public data exits on where AIFs are domiciled, which makes these tasks quite challenging.

Certain locations can be clearly considered offshore (e.g. Cayman Islands or Jersey), while others are clearly onshore (e.g. Germany, France). However, certain locations have elements of both (e.g. Ireland, Luxembourg, Delaware), what characterises these jurisdictions is that funds do not chose to be domiciled there because there is a large domestic market, but because of other reasons, such as the regulatory framework, infrastructure or distribution channels. We call these locations "international onshore". In this study we focus on the offshore and international onshore categories, as these locations typically compete for similar types of funds. However, to keep the data manageable we have restricted our analysis to centres in the Americas and Europe.

### EXHIBIT 1: OUTLINE OF SCOPE OF STUDY

| | Offshore | International onshore | Onshore |
|---|---|---|---|
| Europe | Jersey<br>Guernsey | Luxembourg<br>Ireland<br>Malta | UK<br>Germany<br>France etc. |
| USA | Caymans<br>Bermuda<br>British Virgin Islands | Delaware | Other US states (e.g. Maryland) |
| | *Focus of study* | | |

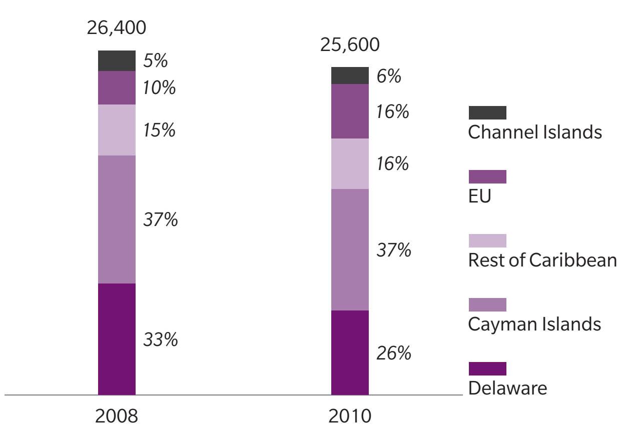
# 3. CURRENT FUND DOMICILE BY ASSET CLASS

The Cayman Islands and Delaware are clear frontrunners when it comes to AIFs domiciles, with more than 60% of all AIFs, relevant to the study, domiciled there. The Cayman Islands' market share stayed essentially the same between 2008 and 2010. Delaware, on the other hand, lost significant market share over the same time period, and the international onshore jurisdiction in the EU gained considerable market share. It is difficult to ascertain precisely why Delaware's market share has dropped. One possible explanation may be that that US AIFs were hit hard by the recent turbulent financial conditions and a number of funds had to close. As most funds in Delaware are American, Delaware's market share fell. EU centres, like Luxembourg, Ireland or Malta, on the other hand gained market share by investing considerable effort to attract AIFs.

However, an equally significant aspect of the funds landscape is that there has been little change in proportions. This is remarkable because many commentators have predicted that recent turbulent financial conditions and governance lapses would lead to a fall in the number of offshore funds. However, the funds landscape in the last two years has remained relatively stable. So far the new wave of regulation (e.g. AIFMD, Dodd-Frank, etc.) did not have a major impact on offshore funds. Similarly, institutional investors, so far, have not re-allocated significant sums away from offshore AIFs to other funds, as some commentators have predicted.

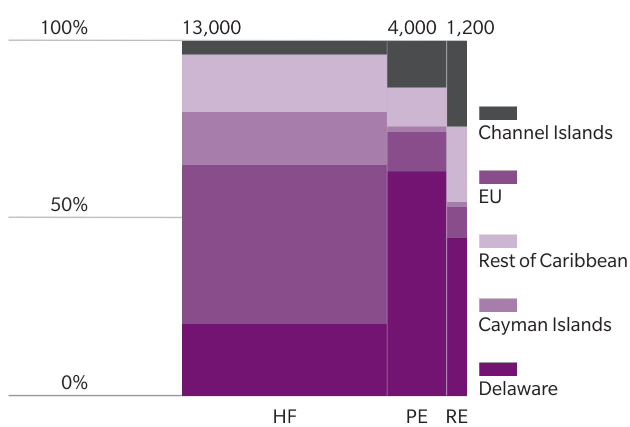
There are considerable differences among jurisdictions across the three major asset classes under consideration. The main reason for this is that over the years the regulatory framework and the supporting infrastructure have typically been designed to support the idiosyncrasies of a particular asset class (e.g. US REITs[1] are domiciled more in Maryland than Delaware due to franchise taxes in Delaware, and a RE lawyer found in Maryland would not be useful to help set up a HF).

EXHIBIT 2: NUMBER AND PROPORTION OF AIFS IN MAJOR FUND JURISDICTIONS




**Source:** Oliver Wyman analysis
**Notes:** Rest of Caribbean is Bermuda and British Virgin Islands; EU consist of Ireland, Luxembourg and Malta

EXHIBIT 3: ESTIMATED DISTRIBUTION OF NUMBER OF AIF IN MAJOR FUND CENTRES




**Source:** Oliver Wyman analysis
**Notes:** Figures do not include fund of funds; Rest of Caribbean is Bermuda and British Virgin Islands; EU consist of Ireland, Luxembourg and Malta

1 Real Estate Investment Trusts

## HEDGE FUNDS

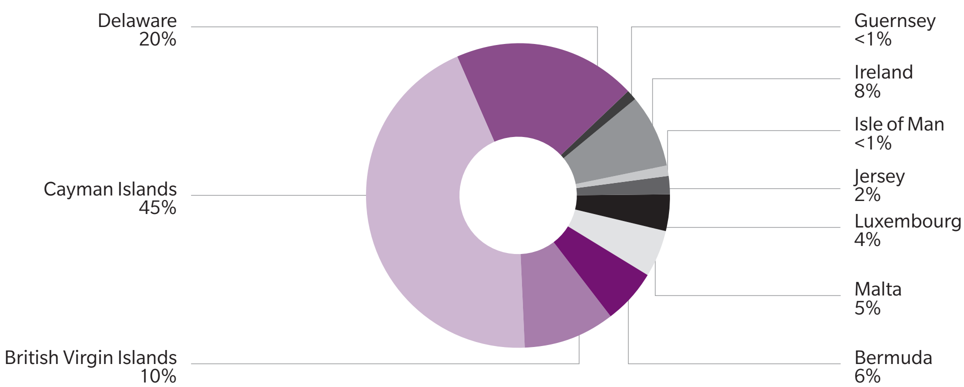
The **Cayman Islands** are the largest HF jurisdiction, popular with both US and UK based managers[2]. It enjoys a good reputation among institutional investors which helps HFs with their fund raising effort, and has strong supporting infrastructure. It has become almost routine for a major hedge fund to be domiciled in the Cayman Islands.

Similarly, **Delaware** has strong HF infrastructure, particularly suited to US based HFs. In addition, it is known for its business-friendly legal system and being based within the USA provides institutional investors with certain degree of confidence. The **British Virgin Islands** and **Bermuda** attract both UK and US funds, particularly as both countries benefit from historic ties to the UK and geographical proximity to the US.

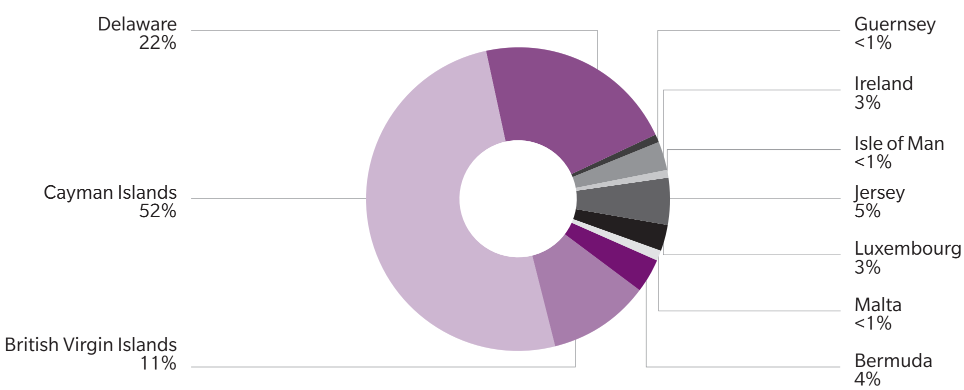
**European centres** are mainly popular among European HF managers. **Ireland** is well known as a country for HF administration, with around 40% of all HFs worldwide serviced in Ireland[3]. **Luxembourg** is the world's leading jurisdiction for UCITS, and is keen of to increase its market share among AIFs.

### EXHIBIT 4: DISTRIBUTION OF HEDGE FUNDS FUNDS AND AUM

BY NUMBER OF FUNDS




BY AUM




**Source:** Oliver Wyman analysis
**Note:** AUM for Malta is Net Asset Value

2 Eurekahedge/Oliver Wyman analysis
3 Irish Funds Industry Association, "Excellence in Alternative Investments", 2010

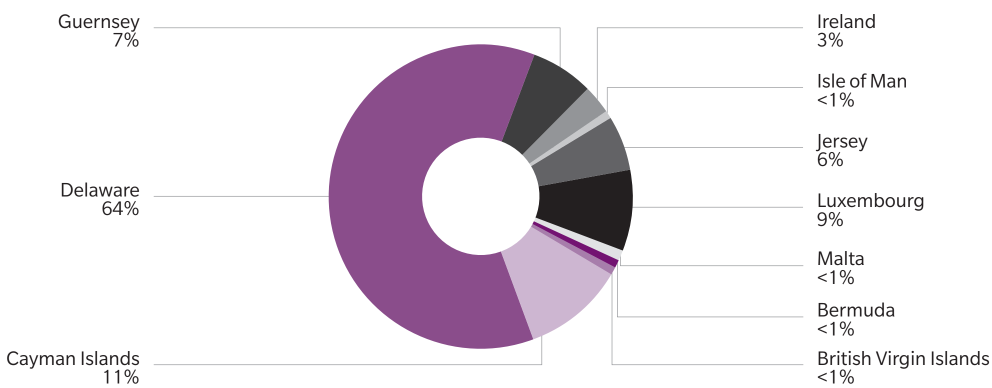
# PRIVATE EQUITY

**Delaware** is by far the most important domicile for PE funds out of the locations in consideration – this is due to the large US PE industry typically choosing this location. In addition, outside the US ~90% of PE funds are domiciled onshore[4], driven by a requirement to tap investors more frequently for funds.

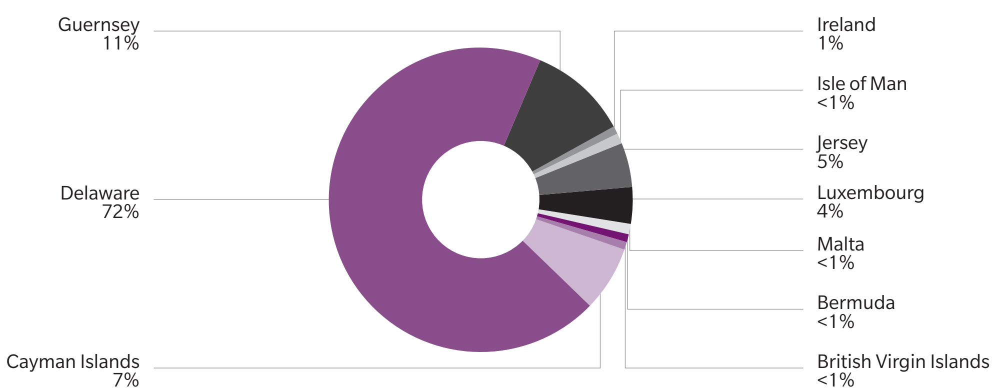
The **Channel Islands**, i.e. Jersey and Guernsey, attract a substantial number of PE funds, especially from UK and European based managers. They have a sophisticated infrastructure and benefit from close geographical proximities to other financial centres, e.g. London. The Isle of Man, on the other hand, attracts substantially less funds.

## EXHIBIT 5: DISTRIBUTION OF PRIVATE EQUITY FUNDS AND AUM

BY NUMBER OF FUNDS




BY AUM




**Source:** Oliver Wyman analysis
**Note:** AUM for Malta is Net Asset Value

4 Eurekahedge, Oliver Wyman analysis

## REAL ESTATE

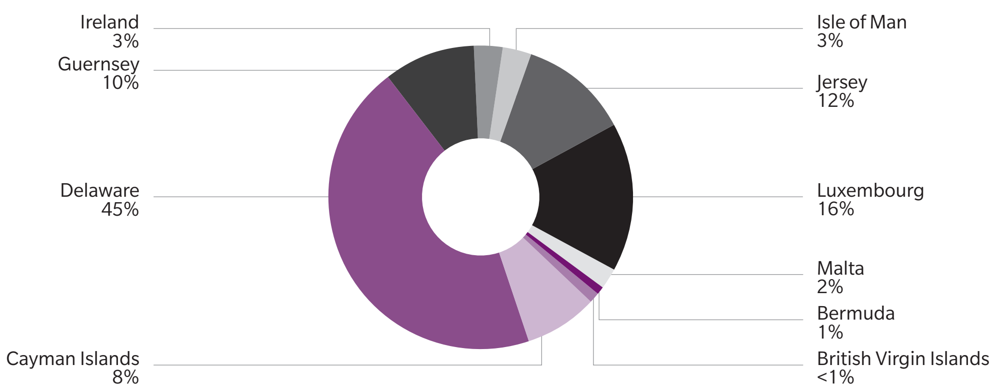
RE funds have a similar fund structure and life cycle to PE funds (although the duration of the funds usually differs), and thus RE fund distribution is similar to PE fund distribution. However, the choice of domicile for RE funds can be more complex due to unique tax considerations relevant to real estate in some jurisdictions (e.g. UK REITS must be tax resident in the UK).

The **Channel Islands** used to attract UK RE funds because of tax benefits. These benefits are now largely gone and, although we have not seen a wholesale shift away from the region so far, we believe that their share will begin to erode.

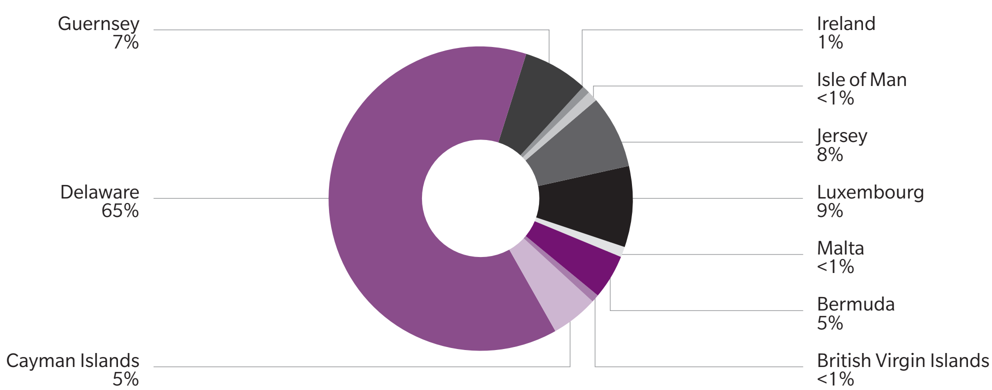
**Luxembourg** is the domicile of choice for a significant number of EU RE funds. It offers a wide range of vehicles that are suitable for RE investments (e.g. SICAF[5], SICAV[6] and FCP[7]).

EXHIBIT 6: DISTRIBUTION OF REAL ESTATE FUNDS AND AUM

BY NUMBER OF FUNDS




BY AUM




**Source:** Oliver Wyman analysis
**Note:** AUM for Malta is Net Asset Value

5 Société d'Investissement à Capital Fixe
6 Société d'Investissement à Capital Variable
7 Fonds Commun de Placement

# 4. MARKET TRENDS

## REGULATION

We identified a number of regulatory developments that have the potential to change the relative attractiveness of domiciles for AIFs.

### THE ALTERNATIVE INVESTMENT FUNDS MANAGERS DIRECTIVE (AIFMD)

The AIFMD was published in the EU Official Journal in July 2011, and member states have two years to implement it. The AIFMD states that all managers of AIFs marketed or managed within the EU (including those domiciled offshore) need to be registered and must comply with the relevant provisions. This leads to some of the benefits of operating offshore (e.g. smaller compliance costs) being significantly reduced. In addition, funds domiciled in the EU will gain special benefits, such as immediate passporting provisions. Offshore funds will only be able to benefit from the passport after a transition period, subject to further positive assessment by EU authorities. The earliest the passport will be available to offshore funds will be by 2015.

Another downside to offshore funds will be that they may lose control over who regulates them. Under the AIFMD onshore funds will be regulated by the financial regulator in their home jurisdiction, while offshore funds will be regulated by a "member state of reference", in addition to their home regulators. Funds may face some uncertainty over which member state will be their "member state of reference". This can result in a fund ending up with a regulator that is less favourably disposed than if it had, for instance, been registered in Luxembourg or Ireland.

### UCITS

New UCITS provisions enable some AIFs strategies to be marketed to retail investors. However, in order to take advantage of these provisions funds need to be domiciled within the EU. Thus, participants who want to tap this investor base have an incentive to relocate onshore or create an onshore variant of their funds.

### DODD-FRANK

Dodd-Frank provides that funds with more than $150 MM AUM need to register with the SEC. Once the relevant provisions are in force (probably Q1 2012) some of the benefits of being offshore will diminish. Thus, the attractive of these jurisdictions may decrease.

### GLOBAL PRESSURE ON TAX HAVENS

There have been a variety of initiatives across countries and supranational bodies with the stated aim to bring an end to tax havens. In the US there have been discussions to introduce the so-called "Stop Tax Haven Abuse Act". The G20 made various statements condemning tax havens. Other initiatives which aim to put pressure on tax havens are the Financial Action Task Force black list and OECD black/grey list.

Whilst each of the above regulatory factors will certainly have an impact on where AIF chose to domicile, we believe that it is unlikely that they will fundamentally alter the domicile landscape.

The benefits under the **AIFMD** of being domiciled in the EU are unclear:

- The passporting benefit is only a temporary (i.e. after the transition period passporting will be available to off-and onshore funds)
- Costs (e.g. tax, registration fees etc.) will remain lower for offshore funds although compliance costs will increase for on-and offshore funds
- Funds may choose to establish clone funds in the EU in order to get the regulator they want

The new **UCITS** provision is unlikely to trigger a mass movement of funds to the EU. Only certain fund strategies are suited to be marketed as a UCITS, and even for strategies that are suitable it is more likely that managers will create clone/feeder funds, rather than domiciling the whole fund in the EU.

The impact of **Dodd-Frank** may also not be particularly dramatic because a lot of the benefits of being in locations such as Delaware (e.g. taxes, large infrastructure, a business friendly legal system) will remain in place.

For **tax haven regulation** it is important to note that no offshore centre is either grey or blacklisted. However, it is the case that tax codes in many jurisdictions increasingly aim to limit the use of tax havens, this has lead to more and more complex schemes being created in order for AIFs to benefit from offshore tax advantages.

One common theme is that there will be an increase in co-domiciliation of AIFs, by which we mean that AIFs will continue to operate from offshore but set up clone or feeder funds onshore. Although the details of the rules still need to be worked out, co-domiciliation, as previously mentioned, could potentially ensure a business-friendly regulator for the purpose of AIFMD and the possibility to structure HF as UCITS. In addition, many of the complex tax structures, mentioned in the paragraph above use a clone or feeder fund structure.

## INFLUENCE OF INSTITUTIONAL INVESTORS

Institutional investors are an increasingly important client segment for AIFs, and it has been argued that this increased importance will induce AIFs to move onshore. We, however, believe that this effect will be smaller than many expect because most institutional investors are generally tolerant of offshore locations. This trend is especially prevalent among experienced investors, who are most likely to increase their allocation to AIFs.

Demand by institutional investor is commonly cited as one of the main reasons HF managers move their funds to the EU. However, in surveys 80% of institutional investors state that they do not care if funds are domiciled offshore or onshore. In addition, lack of investor demand is the main reason for HFs not considering a move back to EU.

Also, it was thought that the Madoff scandal would lessen the appetite of institutional investors to invest in offshore funds; this, however, does not seem to have materialised. Institutional investors appear to be demanding greater quality of due diligence, rather than an onshore domicile.

There are other reasons why certain institutional investors demand onshore funds, e.g. insurers face a higher capital charge if they invest in offshore funds, or some institutional investors are prohibited from investing in offshore funds by their bylaws/constitution. However, the numbers above show that this does not seem a strong enough reason to move a substantial number of funds onshore, especially because a clone or feeder fund structure could potentially solve the problem.

However, one interesting point relates to institutional investors in Asia and the Middle East. There appears to be a clear desire from these investors to have a fund centre in this region. Investor demand is matched by interest from fund managers, who would like to see a fund centre in the region too. Therefore, it only seems to be a matter of time before a fund centre will emerge somewhere in Asia and/or the Middle East.

# 5. CONCLUSION

In conclusion, we believe that, whilst there will not be wholesale changes in the fund domicile landscape, the following trends are likely to emerge:

- Some AIF managers, who would otherwise have decided to domicile offshore, will move onshore due to regulatory reasons and/or perceived investor demand, with European onshore funds likely to go to Ireland or Luxembourg
- Greater co-domiciliation and clone/master-feeder fund structures between offshore and onshore jurisdictions will increase the overall proportion of onshore domiciles
- Offshore centres are likely to emerge in Asia and/or Middle East, as a response to the clear demand from both investors and fund managers
- Improvements in infrastructure and supportive regulations, as well as reductions in bureaucracy across all major domicile locations are likely, as they look to try to win more business to maintain domiciliation share in a increasingly level global marketplace.

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