

Fund domiciliation in a fast changing world

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Introduction

2020 has been one of the most unusual years in the world of fund domiciliation for a very long time. The pandemic is of course part of the reason for this but other factors, probably with more long-term significance for future fund domiciliation patterns than Covid-19, have also arrived on the scene at much the same time.

These are: BEPS (base erosion and profit shifting), Brexit, and the impact of the EU substance requirements on both EU and offshore jurisdictions. It is possible that a combination of these factors could alter fund domiciliation patterns for years to come.

Given that fund domiciliation could be at a turning point, IFI Global decided to host an online event in October to discuss the current situation, and then to publish this White Paper, in follow up.



Background

At the October webinar, Debra Franzese, who is a partner at the New York law firm Seward and Kissell, said that fund managers are considering their domiciliation options more closely these days. This is in part because of the growing costs and regulatory requirements of being in jurisdictions like Cayman. On the other hand, she also made the point that managers will only look at new jurisdictions for their funds if they feel that they really have to.

And given what is going on, they may well have to. What Simon Osborn, CEO of IFI Global, called at the online event the three Bs – BEPS, Brexit and Brussels (being shorthand for initiatives coming out of the EU capital) – will be a challenge for many managers. As a result, they may well be required to look again at the domiciliation options open to them.

Of course, we must add on to this Covid-19. At the time of writing, no one knows if the pandemic will be with us for years or just months to come. What is clear is that Covid has brought about a fundamental shift in the way that we work, said Boris Onefater, the CEO and founder of Constellation Advisors, at the October online event. How this will impact the international fund industry is, as yet, unknown. The regulatory authorities haven't caught up with what is going on. But it could well affect the taxation as well as regulation of funds in the future.

The following is an outline of why BEPS, Brexit, the growing regulatory burden allied to the EU's substance requirements, as well as the pandemic, might well cause a fundamental shift in domiciliation patterns over this decade.



BEPS

Every international fund jurisdiction has signed up to BEPS implementation. The impact of BEPS was just beginning to be felt when the pandemic arrived. That might delay implementation for a while, but it won't be going away.

BEPS may well be the most important development for the structure of the alternative fund industry in a generation. Long only funds, known in BEPS parlance as CIVs (collective investment vehicles), are largely exempt.

BEPS (Base Erosion and Profit Shifting) is the OECD's and the G20's attempt to require multinational organisations to pay more tax in the jurisdictions where they operate. IFI Global believes that it 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), which is just swinging into action.

IFI Global thinks it is likely that BEPS will impact EU jurisdictions like Ireland and Luxembourg as much, if not more, than offshore fund domiciles like Cayman, Guernsey and Jersey.

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That is partly because the EU is an early BEPS adopter. EU countries are required to implement the 15 different BEPS plans in full. Also, jurisdictions like Ireland and Luxembourg rely upon a complex set of tax treaty networks, of which their funds take advantage. BEPS aims to reform those tax treaty networks. Offshore jurisdictions, on the other hand, do not need to use these same sort of tax treaties, as they are tax neutral - investors only pay tax once, to their home taxing authority.

The impact of this on fund domiciliation patterns could well be considerable. For example, PwC believes that managers may eventually be talking to investors about their pre and post-tax returns because of BEPS. There could easily be tax leakage as a result of this measure. As a result, there is concern that BEPS could lead to lower returns. This has led



BEPS

some institutional investors to start including questions on BEPS compliance in their due diligence questionnaires.

Tim Hames, former Director General of the BVCA, has said that BEPS will lead to changes in fund structuring. He believes that the private equity industry is entering an era of ‘taxulation’.

Some of the 15 different BEPS Actions Plans are of no relevance to the asset management business. But whilst BEPS is not necessarily aimed at alternative asset management, it will unquestionably be caught up in it. BEPS Actions Plans 5, 7, 8, 9, 10 and 13 are the main areas managers and international fund jurisdictions need to focus on.

These Action Plans include rules on Permanent Establishment and Transfer Pricing. Permanent Establishment touches upon various activities undertaken by the alternative fund business. It has implications for directors of funds, for example. Those in these roles will have to be able to demonstrate that they are carrying out their fiduciary duties correctly. ‘Competent directors anchor the fund in the jurisdiction where it is domiciled,’ says Robert Mellor, PwC Alternatives Leader, Asset Management.

It will be a very long time before all of the various BEPS measures are implemented. Many of the changes brought into tax structures as a result of BEPS will happen so slowly that they might not be noticed at all. And the pandemic looks likely to delay BEPS implementation in some jurisdictions.



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BEPS is a slow-moving evolutionary, not revolutionary, change. But it is still change and it will, over time, likely have a real impact on alternative fund structures.

Brexit

A large part of the reason substance requirements in Ireland and Luxembourg have been beefed up over the last few years is because of Brexit, believes IFI Global. These jurisdictions do not want to become Brexit flags of convenience for UK managers who think that they can carry on running things from London, with a small operation executing orders in Dublin or Luxembourg.

Both the CSSF (Commission de Surveillance du Secteur Financier) in Luxembourg and the CBI (Central Bank of Ireland) have introduced measures to make sure this does not happen. The most recent example of this is the CBI's review of CP86, its consultation on fund management company effectiveness, which was published in October. In this review, it says that Irish fund management companies must have a minimum of three full time employees, each of whom should be suitably qualified and of appropriate seniority to fulfil their roles. 'This number is of course a minimum expectation and only relevant to the smallest and simplest of entities. Other firms will be expected to have

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a level and quality of resourcing determined by the nature, scale and complexity of its operations.'

EY has reported that more than 7,500 jobs in financial services have left the UK since the Brexit referendum vote in 2016. EY says that UK financial services firms have transferred £1.2 trillion in assets. Dublin, Luxembourg, Frankfurt and Paris are the favourite destinations for relocation, EY reports.

If there is No Deal then there could be a period of considerable disruption in financial services, even with temporary permissions to help. The EU and UK will need to get their final recognitions agreed. And fund managers



Brexit

without bases in Ireland and Luxembourg will have to negotiate directly with individual EU states to gain access to their markets.

Speaking at the October webinar Elliot Refson, Director of Funds at Jersey Finance, said that even if there is a deal, there will still be uncertainty. Investors hate uncertainty, he added. Jersey offers investors and managers certainty. He made the point that Jersey has bilateral relationships with nearly every EU state. Managers with funds domiciled in Jersey can use private placement to reach EU investors. Only 3% of managers market into more than three jurisdictions, he said. Jersey has 183 managers marketing into the EU through private placement. This has grown by 76% since December 2015.

As a result of the difficulties in the EU-UK negotiations, it currently appears unlikely that there will even be an agreement on third country equivalence. Equivalence is not perfect but it is better than nothing. Equivalence agreements that the EU has made with third countries are flimsy and can be withdrawn at short notice. Nonetheless, this was the minimum that financial services were working on until the summer. Now it looks like they will not even get this.

Brexit will lead to a substantial divergence in approaches to regulation in the EU and UK over the coming years. The UK Chancellor, Rishi Sunak, has made clear that the UK will not be required to follow the EU's financial services laws from January 2021.

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It is possible that Brexit will lead to the UK becoming a rival international jurisdiction to Ireland and Luxembourg. Work was done on this by the UK Treasury some time ago, when George Osborne was Chancellor. There is a potential blue-print that the UK could put into action. Such a plan might suit the UK government's levelling up agenda in the north, as well as its plan to introduce freeports in certain cities.

Whether that happens or not, it is likely that Brexit will have an impact on fund domiciliation patterns. At the time of writing, the chances of there being a trade agreement hangs in the balance. It is possible that when the transition period comes to an end on December 31 there will no agreement between the EU and UK at all, including in financial services.

EU substance requirements

Offshore jurisdictions have had to jump through hoops to make sure that they complied with the EU Code of Conduct Group's substance requirements. Guernsey, Jersey and the Isle of Man buckled down and did what the EU asked them to do. A lot of effort was put into that last year.

The industry consensus is that Cayman was slow on the uptake. It was blacklisted by the EU in February this year and came off that list in October. Blacklisting Cayman shows that the EU is serious, believes IFI Global.

There could be more of this to come. Added to which, the EU is said to be looking again at whether offshore jurisdictions have advantageous access to its markets through private placement arrangements that are made with individual countries such as the Netherlands and the Nordics.

This is likely to be tackled in the AIFMD II review, which is now expected to come out next summer. Some believe that despite strong support for the National Private Placement

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Regimes, highlighted in KPMG's recent AIFMD II report, these arrangements could be curtailed, but if that happens there will also be an extension of the AIFMD passport.

The extension of the passport has been on the cards for years and appears to have been delayed, largely because of Brexit, as the UK's departure from the EU meant that it put back its review of the AIFM Directive.

The passport looks likely to be given to third countries that can meet the EU's substance requirements. Jurisdictions like Jersey are already compliant. The UK (which will, by then, be a third country) should be able to comply with these requirements, but those in the Caribbean, most notably Cayman, might have more difficulty passing the test, believes IFI Global.



Covid-19

Without a return to normal working conditions by say mid-2021, there might need to be changes made to either to international fund structures or to the governance rules of those structures. It might be that both will be needed.

When the coronavirus crisis arrived this spring, many anticipated that life would be returning to something approaching normal by now. That applied to the emergency measures that were adopted by international fund jurisdictions. Many are due to expire over the autumn.

The second wave of the virus has dashed the expectation that we are on the way back to normal; the pandemic could well be with us for a long time to come. We might still be at the early stages of a multi-year crisis.

If that is the case, there may have to be changes in the rules, rather than just a suspension of them. This would be the cheapest, easiest and simplest option. International fund jurisdictions could allow all board meetings to be virtual.

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The problem with just extending emergency measures and allowing virtual board meetings, for an unknown and indefinite period, is that it will then turn local substance requirements on their head. And building local substance has been the direction of travel over the last few years in cross-border jurisdictions.

If it is not going to be possible to travel safely by air, without going into quarantine, then funds will need to find more local substance including more local directors for their boards. They will need to reduce the number of people on the board who are not resident in the jurisdiction. In future, the majority may need to be local.

That would work in some offshore jurisdictions like the Channel Islands, where there are relatively large numbers of experienced individuals who can act as fund directors. But



Covid-19

in other jurisdictions there are not enough well qualified people, with the right experience, to make this a practical option.

At the webinar, Elliot Refson made the point that Covid-19 is making managers look at their jurisdictions to make sure that their service providers are robust and resilient. He also thinks that the pandemic means that investors will want to allocate to funds based in more substantial jurisdictions.

Now it looks like the pandemic will be here for some time yet, guidance is going to be needed from tax and regulatory authorities. IFI Global considers that Luxembourg appears to need it

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more than most. Many who work there live in Belgium, France or Germany. The population of Luxembourg is said to double in the morning and halve at night. Many people who are making governance decisions on behalf of funds domiciled in this jurisdiction live in another country, not in Luxembourg.

Conclusion

For years, if not decades, fund domiciliation patterns changed very little, if at all. As a result of a strange coincidence of timing, a number of factors have emerged that will challenge domiciliation patterns that were established often way back in the 1990s.

By the mid part of this decade, let alone by the end of it, the jurisdictional choices made by managers for their international funds

might well be somewhat different from those that they make today. And that isn't even taking into account ESG. The rapid advance of ESG is another factor that could impact fund domiciliation too. It will be an interesting decade.



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