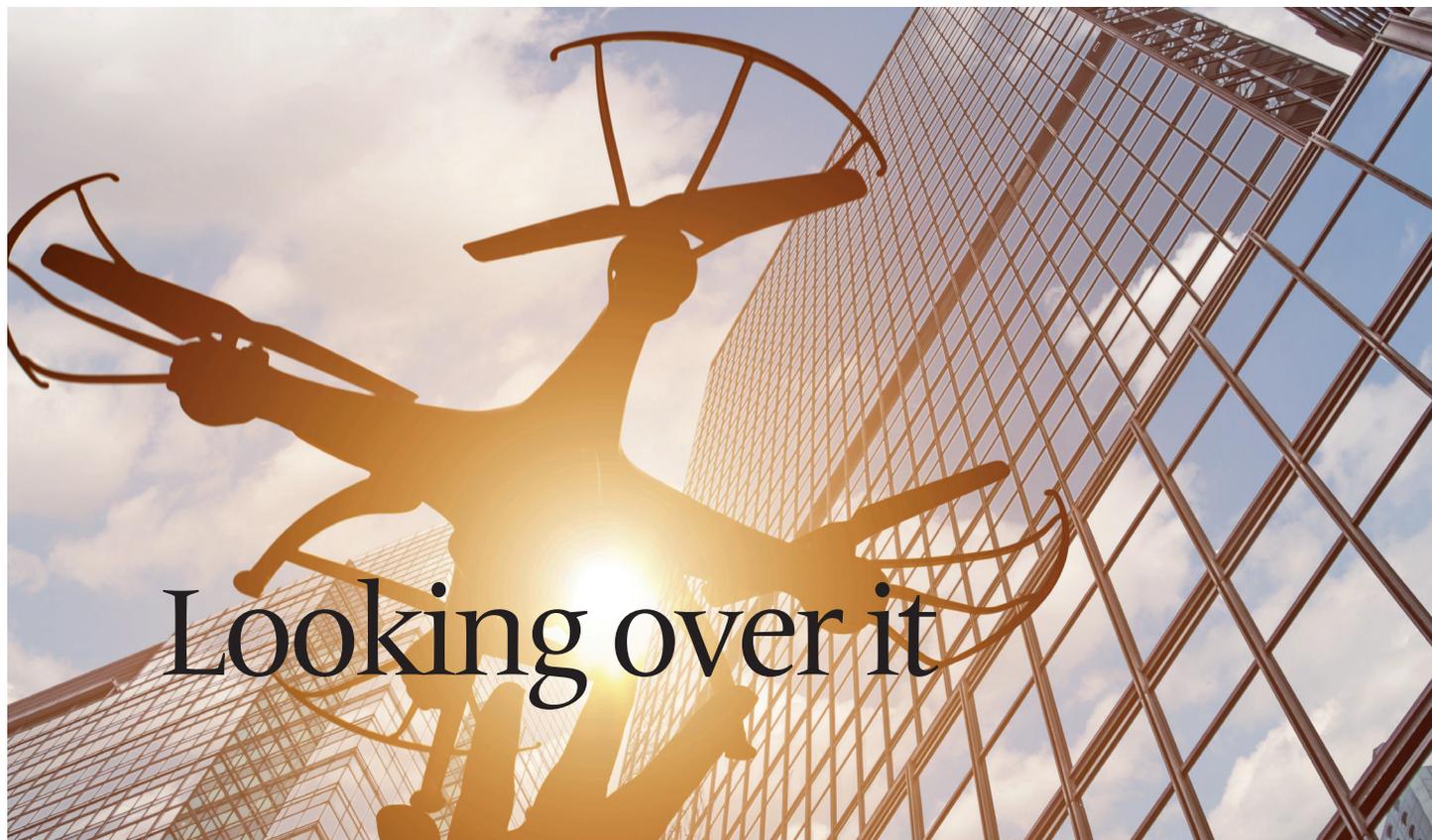


“Changes in the regulatory landscape of a particular jurisdiction or a failure to adopt and implement international regulatory changes can create concerns that prompt managers to redomicile”



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Looking over it

Jonathan Law provides an overview of the unexpected advantages of redomiciling a hedge fund, and assesses some of the drawbacks also

Conventional wisdom in the private funds industry has tended toward fund domiciliation in a few key jurisdictions, but the evolving legal and regulatory environment in other jurisdictions like the EU, Dubai and Ireland, for instance, may counsel in favour of a rebalancing of the factors that originally weighed in favour of a hedge fund manager's decision to domicile a fund in a certain jurisdiction.

This article looks at how the factors traditionally regarded as drawbacks of a new jurisdiction, such as increased regulation, could actually be potential advantages.

WHY CONSIDER RE-DOMICILIATION?

Hedge fund managers typically consider re-domiciliation for four main reasons: regulation, operations, costs



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and marketing restrictions. From a regulatory perspective, a change in jurisdiction can result in either a lighter or a more substantive governing regime, both of which can be advantageous depending on the circumstances.

In addition, from time to time, changes in the regulatory landscape of a particular jurisdiction or a failure to adopt and implement international regulatory changes can create concerns that prompt managers to redomicile.

Operational considerations often aren't the sole driver of a decision to redomicile, but they can be influential when re-domiciliation would result in significant savings. Conversely, cost may be the deciding factor against re-domiciliation if an increase in costs cannot be passed on to the fund.

The fund's key service providers could also request or require a change in domicile for regulatory alignment or other reasons.

FROM LESS TO MORE...

When managers move from a less-regulated jurisdiction to a more highly regulated one, it's typically for marketing reasons. The decision is typically animated by concerns about investor capital—either the manager has experienced outflows or one or more investors conveys that the fund must move to a more heavily regulated jurisdiction to garner additional allocations. Highly regulated jurisdictions can also be optimal locations for managers reigniting their marketing activities to new investors.

The same rationale applies for funds moving from an offshore environment to a more highly regulated

1949 Year in which the term “hedge fund” was first coined by Australian investor and sociologist Alfred Jones

jurisdiction, particularly because increased regulation means greater transparency for investors or the additional benefits that inure from domiciliation in an established market.

The principal deterrents to moving funds to a more highly regulated domicile are cost-related. Increased regulation often results in increased costs to the fund, the manager or both, and a change in domicile often requires a manager to invest resources in performing again the same research and inquiry for the new jurisdiction that it initially performed during the decision and diligence process for the original domicile in order to develop familiarity with its regulatory and operational environment. Managers may also have to convince existing investors that the potential for access to additional capital by being in a new jurisdiction will benefit the investors as a matter of the economy of scale and broader investment opportunities.

Although these drawbacks are unavoidable, set against the balance of advantages, re-domiciliation can still decidedly benefit investors. Of course, if the manager is not successful in delivering on the anticipated economies of scale and/or accessing new sources of capital and target investments, its relationship with investors will suffer. Investor sentiment can also shift should other unexpected legal or operational consequences transpire.

... OR FROM ONE TO ANOTHER

In some cases, there are benefits for offshore funds in one jurisdiction to move to another jurisdiction with a similar level of regulation and operational requirements, but with which investors have a higher degree of familiarity and comfort. An example of such a jurisdiction is the Cayman Islands.

By adopting FATCA, CRS, beneficial ownership reporting, an LLC vehicle model broadly similar to Delaware's and maintaining ongoing discussions about securing compliance with

other international transparency initiatives, Cayman has shown that it prizes its leading offshore jurisdiction title.

That positioning can directly and/or indirectly assist managers redomiciling from another offshore jurisdiction since Cayman is perceived to have a higher level of regulation and transparency than other offshore jurisdictions.

FIRST STEPS

A hedge fund manager's decision to redomicile should always be made and assessed within the context of its relationship with investors. From the outset, the manager or the fund's governing body should contact investors and set out the business case that undergirds the proposal to redomicile. Because managers are trusted advisers with the expertise to assess the needs of the fund, managers should highlight the specific reasons redomiciling is in investors' best interests while also explaining the decision's potential adverse consequences.

Next, a manager should task a team to review the new jurisdiction's operational requirements and assess, among other things, whether redomiciling will increase staffing requirements for the manager's middle or back office; and the costs associated with redomiciliation, including which will be borne by the manager and which will be borne by the fund. Together, these considerations should form the basis for the redomiciliation budget.

The re-domiciliation process itself involves two main considerations: rules intrinsic to and extrinsic to the fund. Managers should consider, on one hand, the internal mechanisms, permissions and timelines that arise out of the fund's governing agreements and impact on the re-domiciliation variables. At the same time, the manager must consider regulatory requirements in both the existing and the new jurisdiction.

Typically, in-house and outside counsel drive the re-domiciliation project once the initial analyses have been conducted.

The project plan should address the sequence and timetable for fulfilling requirements in both jurisdictions and involve frequent liaising between counsel in each jurisdiction to ensure that the process is completed properly, on time and without any risk that the fund is technically either domiciled in two places at any one time or left without legal domicile.

The logistics of filing the documents with two sets of entity registries and two sets of regulators need to be carefully managed as well.

RE-DOMICILIATION IN IRELAND AND THE EU

Ireland. It is more common for funds to move to Ireland than the reverse. A migration into Ireland requires the incoming fund manager to certify that it is solvent at the time of migration, and that certification has to be supported by an opinion from the fund's auditors.

The remainder of the re-domiciliation process, however, should be handled by the counsel in the original domicile and local counsel in Ireland simultaneously.

Hedge fund managers redomiciling from Cayman, Bermuda and BVI often can maintain the same administrator since Irish administration firms maintain a significant presence in those jurisdictions.

Other EU member states. When the fund is redomiciling into an EU member state, immediately the AIFMD or UCITS regimes are relevant. One of the infrastructure conditions on an EU-domiciled regulated fund is that it must appoint a

depository or custodian.

From an operational level, appointing a depository or custodian is the primary change that creates the most work for managers. There could also be a requirement that the custody of assets come under a depository in

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FEATURE: HEDGE FUNDS

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an EU member state but that doesn't necessarily mean a manager must begin transferring the custody of assets from an existing provider to a new provider. It does, however, likely mean that an existing provider has to sign an agreement with an EU depository.

In terms of fund administration, audit or other service providers, a redomicile may not require that fresh relationships are established, because it may be possible to retain the same firms, although the manager may have to engage with a different office of that same firm if they have a global business.

THE COSTS OF REDOMICILIATION

From an operational perspective, custodians, depositories, auditors, directors and other necessary third parties typically do not charge onboarding fees and instead tend to assume the costs of redomiciliation specific to their function.

Costs for attorneys fees, however, are a different matter, and may account for the bulk of the cost associated with redomiciling a fund, because the process requires two sets of lawyers whose fees depend on the law firms involved, the complexity of the redomiciliation and concerns specific to the facts of each fund and jurisdiction.

Whether the manager or the fund bears these costs depends on agreements with and/or disclosures to investors. The manager may well decide that some or all of the costs can legitimately be charged to investors because they will benefit from the move. Some managers, on the other hand, bear most of the costs.

OTHER CONSIDERATIONS

It should be noted that there is no mandatory requirement for investors to be given a vote on re-domiciliation. Considering the substantial nature of a change of jurisdiction, though, managers do typically at least discuss the project with shareholders. In circumstances where no formal vote is taken, the manager

commonly offers investors the opportunity to redeem out under a special redemption procedure.

The fund's liquidity also factors into managers' strategic road map for re-domiciliation, particularly if the fund is illiquid. Investors may dissent to the decision to change jurisdictions but may not be able to redeem, and such circumstances can increase managers' legal risk vis-à-vis investors.

Other similarly knotty scenarios include cases in which a vote is required but there is some element in the fund's governing documents that makes the vote more difficult to carry – such as failure to procure a majority or high quorum requirements – or cases in which potential regulatory issues create practical problems with individual investors.

The latter would occur if, for example, a manager intends to redomicile as a registered fund in Cayman, which requires that all existing and new investors meet a minimum investment threshold. The Cayman requirement could be problematic for certain individual investors if the original jurisdiction has no investment minimum or has an investment minimum that is lower than the Cayman threshold.

For those investors who don't meet the new domicile's requirements, either a redemption must occur or they have to add to their investments. Either of these scenarios can create difficulties for managers navigating investor relationships.

Service provider relationships also could be affected by re-domiciliation. A manager may need to employ the services of a locally-regulated administrator or an administrator located in one of a number of approved overseas

jurisdiction for AML purposes, for instance.

In addition, the directors of the fund likely need to be registered with the new local regulator and all annual audits should be signed off on by a locally-approved auditor.

Most larger funds have the resources to address these issues by engaging additional services or replacing existing service providers as may be necessary.

IN TERMS OF FUND ADMINISTRATION, AUDIT OR OTHER SERVICE PROVIDERS, A REDOMICILE MAY NOT REQUIRE THAT FRESH RELATIONSHIPS ARE ESTABLISHED

ALTERNATIVES, AND RISKS

Managers must, of course, engage outside legal counsel to advise on the regulatory requirements of a new jurisdiction, what they must do to comply and potential risks. Counsel should also advise on and explain issues that might not immediately be obvious, such as data protection and banking secrecy laws, and AML issues. Any regulatory variations could require a manager to implement operational changes, or prompt amendments to existing investor disclosures.

A manager should also consider other impacts and risks aside from those that are purely related to the fund's new legal and regulatory environment before making the decision to redomicile a fund. Separately, any pre-existing claims or rights of action arising out of a fund's original jurisdiction generally are preserved since the fund remains the same legal entity.

In some cases, setting up a parallel fund domiciled in an onshore jurisdiction, such as the EU, is less risky than re-domiciliation for managers with offshore funds. These parallel funds pursue the same or a similar strategy as the offshore fund.

Managers may choose this alternative over redomiciling in recognition of the two distinct investor universes that would be targeted by the respective funds. ■

THE PRINCIPAL DETERRENDS TO MOVING FUNDS TO A MORE HIGHLY REGULATED DOMICILE ARE COST-RELATED