

Arguably, far too much has already been written about the European Union's Alternative Investment Fund Managers Directive. Some of it, though, has been of great help to the industry. Awareness of the potential problems posed by some of the earlier drafts has helped to rein in at least a few of the excesses.

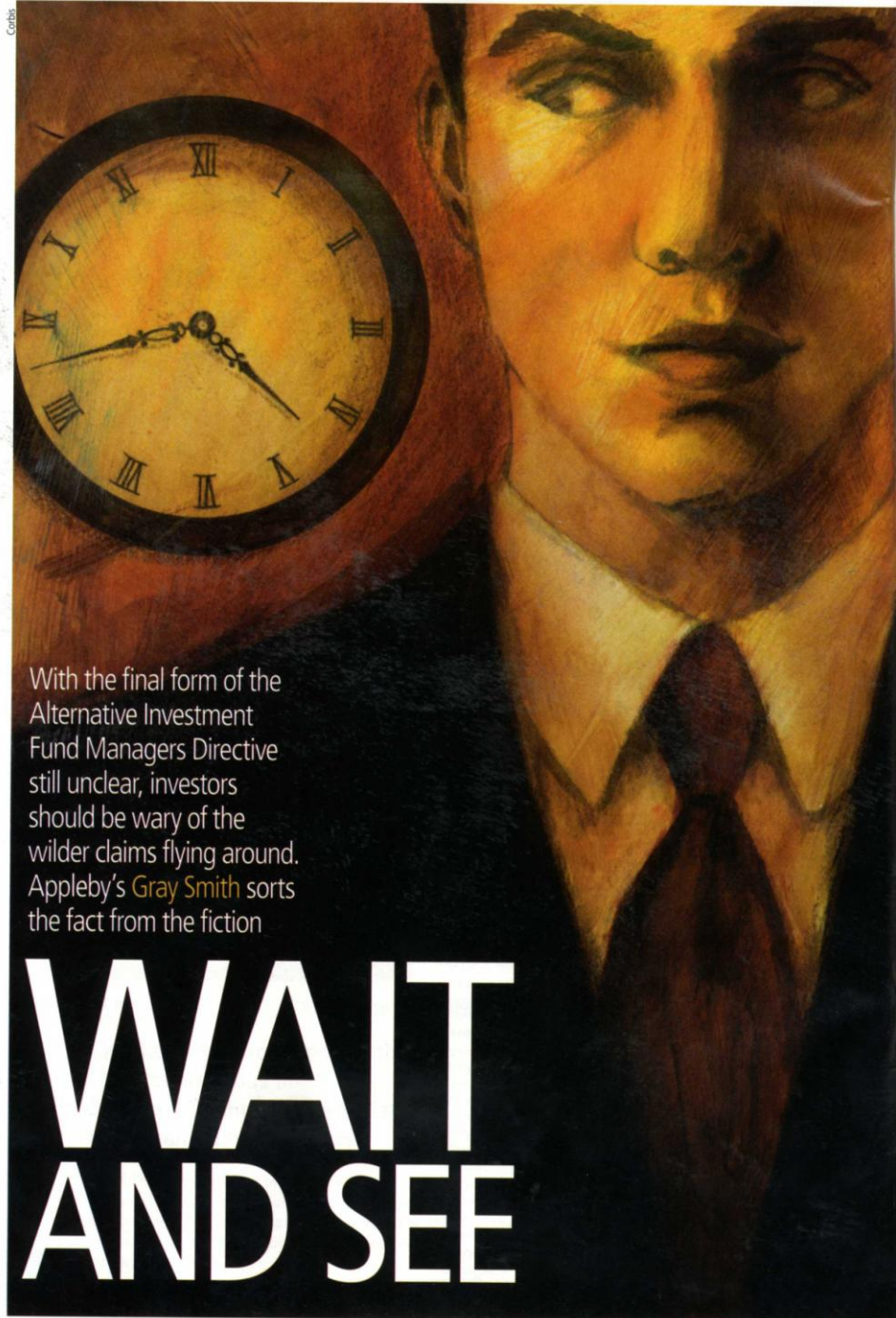
Less helpful has been the plethora of advisers keen to claim that they have the answer to all of your structuring needs, despite the fact that at the time of writing we are still not at a point at which we can say with certainty where the directive will end up. New jurisdictions have even offered to solve problems that have not yet been posed.

It is apparent that the early scare stories painting a picture of fortress Europe and the exclusion of all non-EU domiciled funds have, as suspected, turned out to be false. It now seems likely that the existing private placement regime for offshore funds will remain, albeit with some requirements on equivalent regulation and tax treaties. The major offshore centres such as the Cayman Islands will no doubt meet this obstacle to the extent that they have not already done so – the Financial Action Task Force (FATF) already rates Cayman higher than all but two of the EU countries – and tax treaties are in place or in hand.

The question as to the best jurisdiction in which to domicile a fund has to be reviewed in these new circumstances. Working on the assumption that the private placement regime will remain, does the status quo of Cayman as the domicile of choice remain? Or are there credible alternatives, or perhaps a combination of centres?

What is clear is that, to date, there has not been the predicted mass exodus of funds from Cayman and elsewhere outside Europe to any of the major EU jurisdictions. There have been one or two high-profile cases, such as *Marshall Wace*, and among our extensive client base a few have upped sticks and moved to Luxembourg. However, on the whole clients have heeded the generally-accepted advice and adopted a wait-and-see approach to the Directive. This pragmatism is encouraging.

The other factor clouding the
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With the final form of the Alternative Investment Fund Managers Directive still unclear, investors should be wary of the wilder claims flying around. Appleby's **Gray Smith** sorts the fact from the fiction

WAIT AND SEE



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 issue is regulation. Some investors have been telling managers that, in the brave new world in which we now live, they wish to ensure that a fund is subject to greater external regulation. (Are regulators really better able to ensure that a fund is set up and acting correctly than expert, well-advised investors who can achieve this through their own due diligence?)

It has suited some to argue that Cayman is at the unregulated end of the spectrum, while Ireland and Luxembourg, for example, represent a much more tightly-controlled state of affairs – and therefore investors can derive greater comfort from a fund set up there.

Should either of these factors push a manager in one direction or the other? The best advice with regards to the Directive must remain to wait for the final version. Given that the current private placement regime has worked reasonably well for the industry and looks very likely to remain (subject to a bit of internal input from the jurisdictions themselves to ensure compliance), this must be the best stance.

The idea of a pan-European passport for EU funds is frequently cited as the main reason pushing funds to set up within EU boundaries. However, to believe this is a panacea is to show the sort of naivety that led to the Madoff scandal. To believe that a manager based in any one of the 27 member states will simply have to notify, say, the French regulator and then drive up to Paris to tout

his fund is not plausible. The instinct of a regulator to regulate suggests that much use will be made of the provision to allow individual countries to impose additional requirements before funds can be marketed in their countries. The likelihood of there continuing to be a country-by-country requirement as a matter of practice is very high.

If the benefits under the Directive are not going to turn out to be as great for EU funds as many had hoped, perhaps the level of regulation being imposed by EU countries when compared with their offshore counterparts provides a sound reason to invest within Europe.

It is perhaps worth pointing out that the regulators in Cayman, the fifth largest banking centre in the world, managed to ensure that there were no failures during the recent crisis – a record eyed with envy by a significant number of their counterparts in the EU. It is also worth noting that, on the anti-money laundering front, the International Monetary Fund and the FATF have both reviewed the Cayman position and found it to be superior to all but two EU countries (as well as being superior to the US).

With the quality of the regulator not in doubt, we have to look at the actual regulations to see if this is an area where investors can derive a great deal of additional comfort, justifying the establishment of an EU fund as opposed to a Cayman-based fund. For hedge funds, the obvious comparison for a typical Cayman hedge fund would be

the Qualifying Investor Fund in Ireland. This was introduced at a time when many centres were concerned that the convenience of using Cayman was a major reason why funds went there. As a result, Ireland relaxed its own requirements so that a fund could be authorised the day after the documentation is filed with the financial regulator.

Like its Cayman counterpart, there are no investment restrictions for Irish funds, including with regard to leverage and diversification, and registration is by way of submitting an application form with relevant documents such as the offering document and constitutional documents of the fund. The Irish fund requires the administrator to be based in Ireland and imposes a 90-day limit on payment of redemption proceeds. The investment manager must be approved – although in practice most fund managers will be Financial Services Authority (FSA)-approved, in any event. Furthermore, the directors, management company and custodian must be satisfactory to the regulator.

The Irish requirements go beyond those of Cayman (which requires full disclosure of all matters that would reasonably be expected to influence an investor in order to make an informed decision whether to invest) by demanding specific disclosure on the quantitative limits on leverage, quarterly redemptions if open-ended and other key areas. It is hard to see how such information would not fall under the Cayman catch-all category of providing all necessary information, but under the Irish fund regulations there is a specific requirement to include those matters.

Given the sophisticated nature of hedge fund investors, one has to take a view as to how much comfort an investor obtains from these requirements – what due diligence process would an investor have to go through that does not address the necessary questions relating to all the matters that the regulator deems must be set out, and the omission of which would not fall foul of the requirement to give full and

frank disclosure? In Europe, most funds are run by FSA-regulated managers and invested in by funds-of-funds, institutional investors or high-net worth individuals who are advised by institutions. Issues such as style creep are not addressed and would only be picked up by an investor monitoring the investment closely.

What is the model for the future? With the usual caveat for the Directive, if investors are only being sought in the EU, then the better jurisdictions such as Ireland and Luxembourg are worth considering alongside the traditional Cayman model. If investors are being sought elsewhere, managers will have to consider the universal appeal of the jurisdiction. Will selling an Irish fund in the US be as straightforward as a Cayman fund? Will selling the Cayman fund in the EU be substantially more difficult than an EU fund?

Perhaps nervous investors who seek more regulation will wish to be reminded that Cayman, which has been at the forefront of the global hedge fund world since its inception, has not only the greatest accumulation of expertise, a regulator and regulatory regime that emerged from the credit crunch unblemished with its reputation intact and in control of an internationally-lauded anti-money laundering regime, but also a good level of regulation itself.

This features a registration requirement for all funds, administrators, suppliers of director services, auditors, a local audit requirement, filing requirements for all funds and comprehensive rights on the regulator to intervene on suspicion of a fund being poorly run. As for the investment side of things, they require that all the information is put in front of the investors, who can then make up their own minds.

Maybe in the future we will see more master feeder structures, with an Irish fund for the EU and Cayman for the rest of the world. In any event, I would not redomicile a Cayman fund in the EU or elsewhere just yet – you may well have a need for it shortly.

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