

The Isle of Man Alternative Fund Domicile



The Isle of Man's low tax status, political and economic stability and proximity to the key markets of Europe make it a compelling and cost-effective alternative for the domicile of investment funds, particularly alternative investment funds. With a wide range of fund service providers and a sophisticated professional and banking infrastructure, the Island offers a solution for all promoters of institutional-focused hedge funds. The Island prides itself on its "can-do" business environment and the close co-operation between public and private sectors has resulted in a flexible, well-regulated funds sector that meets the expectations of promoters and the concerns of key investors. This briefing note sets out the Island's proposition for hedge fund domicile, with a particular emphasis on the new Specialist Fund category.

Constitutional Position

The Isle of Man is a self-governing dependency of the British Crown. It does not form part of the United Kingdom. By long-established constitutional convention, the Isle of Man has complete autonomy in relation to domestic affairs, including taxation and business law. The Island is not a member state of the European Union. Under Protocol 3 to the Act of Accession, whereby the United Kingdom became a member state, EU rules only apply to the Isle of Man in relation to a limited range of matters. Accordingly, EU directives on tax harmonisation, company law and financial services do not apply in the Isle of Man.

Tynwald, the Island's parliament, has been in

existence for over 1,000 years and is the world's oldest continuously functioning parliament. The Island also has an independent Court system, including a High Court and a locally-based appellate court; the final court of appeal for the Isle of Man is the UK Privy Council. The Island is a common law jurisdiction and its legal traditions draw heavily on those of England; English case law is of high persuasive authority in the Isle of Man. This legal stability gives the jurisdiction the commercial legal certainty long associated with the English legal system, combined with the flexibility of an international finance centre.

Flexibility of Legal Form

As you would expect of a common law jurisdiction, the Isle of Man offers a full range of vehicles for use as fund structures, including open-ended investment companies, protected cell companies, limited partnerships and unit trusts. These are considered in more detail below.

Companies—Traditional and Modern

Corporate vehicles remain the most popular legal form for collective investment. The Island's Companies Act 2006 created a new stand-alone corporate vehicle, which represents the gold-standard for international special purpose vehicles. Minimal administrative requirements, flexible capital structure and limited disclosure requirements are counter-balanced by the Island's well-respected regime for the regulation and supervision of registered agents.

For those whose tastes are more conservative, the Island's long-established conventional companies draw heavily on English legislative traditions, but without the more prescriptive requirements associated with companies incorporated in metropolitan jurisdictions.

All Isle of Man corporate vehicles can be structured as open-ended investment companies i.e. companies that allow investors the flexibility to redeem their shares before the winding up of the company. Open-ended investment companies are regarded as funds for the purposes of Isle of Man law. Closed-ended investment companies, which don't provide this flexibility, are outside the scope of Isle of Man funds regulation.

Protected Cell Companies

Both conventional and new 2006 Act companies can be established in the Isle of Man in the form of protected cell companies or "PCCs". Once a novel idea, these vehicles are now an established feature of the international investment landscape. By segregating the interests of both investors and other stakeholders, such as leverage providers, within each cell, PCCs provide a low-cost and quick-to-launch means of creating legally robust new sub-funds. PCCs are ideal for use both in multi-class/single manager structures and in multi-manager offerings.

Limited Partnerships

Private equity specialists have always appreciated the flexibility offered by limited partnerships, but these vehicles have recently gained favour with managers of other asset classes, particularly property. Being tax transparent under Isle of Man law, these vehicles offer considerable opportunity for efficient cross-border tax planning whilst continuing to allow investors the benefit of limited liability.

Isle of Man limited partnerships also benefit from a flexible legal framework. There is minimal statutory overlay in relation to the operation of an Isle of Man limited partnership. The legislation offers the flexibility to return capital prior to the winding up of the partnership and, in order to provide comfort to investors, sets out a "white-list" of activities that will not result in limited partners being regarded as involved in the management of the partnership and

thereby prejudicing their limited liability status, which includes advising the general partner.

Unit Trusts

Last but not least among the most popular fund structures available in the Isle of Man is the unit trust. The Isle of Man follows England in its trust law. As a result, the concept of the trust arrangement has been an integral part of the Island's legal framework since its jurisprudence began. As a fund vehicle, the unit trust arrangement offers huge flexibility and the security of knowing that the arrangements are not a matter of public record.

After being associated for many years with retail long-only equity investment, unit trust arrangements came to prominence more recently in connection with tax-driven UK property investment structures. Having done so, they are now an increasingly being used in a range of investment scenarios as promoters take advantage of the opportunities they afford for structuring investors' returns.

Regulatory Environment

The Isle of Man has a well-founded reputation as a premier jurisdiction in terms of regulation, achieving a balance between, on the one hand, providing a business friendly environment and, on the other hand, meeting international standards of financial supervision. A number of independent assessments of the Island's regulatory framework have been conducted which verify the Island's status. The most comprehensive of these was the assessment carried out by the IMF which was completed in November 2003, but they have also included the positive assessment by the Financial Stability Forum of May 2000 identifying the Island as a 'category 1' jurisdiction, and confirmation as a co-operative jurisdiction from the FATF in 2000. The IMF is due to publish a further report following an inspection visit to the Island in September 2008. It has been reported that the draft copy of the IMF report praises the Island's financial regulation, financial stability and anti-money laundering legislation.

The Review of the British offshore financial centres commissioned by the Chancellor Alistair Darling and undertaken by Michael Foot is currently taking place. The focus of the review is working with the

financial centres to analyse their assessment of the risks flowing from the current and forecast macro-economic environment. The visits and discussions undertaken so far have been fact finding. The review continues and Mr Foot is expected to deliver his final report in the last quarter of 2009. The Island's Chief Minister, Tony Brown, recently stated that no specific concerns about the Isle of Man have been identified so far. The Island was able to provide the review with information about its internationally recognised standards on regulation and tax as well as an overview as to how its diverse economy is performing during the global downturn. The Island's progress on signing 14 tax information exchange agreements, placing it firmly on the OECD's 'white list' of jurisdictions that have substantially implemented internationally agreed tax standards, was welcomed by the review.

The Isle of Man has worked hard to ensure that it is not regarded as a tax haven with harmful tax practices and its inclusion on the most recent OECD white list in April 2009 is recognition of its efforts. It also demonstrates that the Isle of Man is a co-operative and transparent international financial services centre which takes its international responsibilities very seriously.

By being pro-active and entering into tax information exchange agreement with other jurisdictions, the Island is currently ahead of the game and a number of its competitors.

Regulation of fund managers and administrators, and of collective investment schemes, is undertaken in the Isle of Man by the Financial Supervision Commission or "FSC". As well as a framework for the regulation and supervision of financial services providers, the Island has adopted extensive regulatory measures to prevent money laundering and the financing of terrorism.

Categories of Fund

The Isle of Man has a full suite of fund options ranging from fully regulated, retail-focused "authorised schemes" to private fund arrangements such as "exempt schemes" that fall wholly outside the scope of regulation.

Between these extremes are a range of unapproved

funds that are subject to varying degrees of structural regulation. These categories of fund are not subject to prescriptive regulation, but all involve the appointment of an Isle of Man licence holder and provide certain safeguards for investors. The fund category of choice for institutional alternative investment is the new Specialist Investment Fund, or "SF".

This briefing note concentrates on the Specialist Fund opportunity. The Qualifying Investor Fund, or QIF", is a more regulated vehicle which has no mandatory minimum subscription but is required, amongst other things, to appoint a custodian.

Specialist Investment Fund or 'SF'

The Specialist Fund has been specifically created to meet the demands of the alternative investment community and their institutional investors. The Isle of Man understands that the promoter of, and advisers to, hedge funds need a jurisdiction and a product that provides maximum flexibility and future-proofing in a fast-moving international investment environment.

Asset Management

There are no regulatory restrictions on the types of investments that a SF can make and no restrictions on the trading strategies that can be employed by its manager or adviser. As a result, the Specialist Fund is suitable for any type of alternative investment fund. There are no regulatory limits on the borrowings or leverage that a SF may undertake. If full latitude on investment is not regarded as appropriate, there is the flexibility to embed restrictions in the constitutional documents of the fund.

In order to maintain the quality of the fund business domiciled in the Isle of Man and minimise the jurisdictional risk for investors, it is a requirement that a SF must receive (either directly or indirectly) relevant investment advice or management services, and when assessing the suitability of the entity, the fund's board of directors must take account of the regulated status of that entity. The Isle of Man is unique among international finance centres in continuing to have the capacity to attract and accommodate real business operations. The FSC has announced certain new investment business licence

categories and refinements to its licensing policy designed to attract hedge fund management and related operations to the Island.

Regulated Administrator

A Specialist Fund must appoint a regulated fund administrator to perform its core administration requirements, including transfer agency work, valuations, pricing and fund accounting services. The Isle of Man hosts a range of experienced fund administration outfits, from the global names to boutique providers. The administrator of a SF may be one of these players, but in order to provide maximum flexibility for promoters and managers, this is not a mandatory requirement.

In the alternative, the administrator of a SF may be an appropriately regulated fund administrator based in a jurisdiction that the FSC regards as providing an acceptable level of regulation and mutual assistance arrangements. The FSC has already announced that the United Kingdom, Jersey, Guernsey and Gibraltar are acceptable jurisdictions for these purposes, but the class of acceptable jurisdictions is not closed and the FSC will entertain requests to add further suitable territories to the list. The administrator of a SF has a regulatory responsibility for ensuring that the target investor requirements for a SF (see below) are met, for making certain periodic reports and declarations of compliance to the FSC and for notifying the FSC of certain material events in relation to the SF.

Governance and Board Composition

In order to maintain standards of corporate governance for the benefit of investors, a Specialist Fund must have an independent non-executive director on the board. In addition, where a SF has availed itself of the right to appoint an overseas administrator regulated in another acceptable jurisdiction (see above), there is a requirement that the board of directors must include an Isle of Man resident individual who is either licensed as a fiduciary or working for a licensed fiduciary services provider. The Isle of Man resident director is required to monitor the compliance by the overseas administrator with the SF requirements.

The board of directors of a Specialist Fund has responsibility for ensuring that the SF complies with

its regulatory requirements and, amongst other things, for ensuring that the fund's offering document (see below) is compliant and contains all material information and that the fund is managed and operated in accordance with its constitutional documents and offering document.

No Regulatory Pre-approvals

As there is inevitably an Isle of Man licensed person involved in the launch of a SF, there is no requirement for any pre-approval to be sought from the FSC or any other body, nor are Isle of Man licensed administrators required to obtain any specific approval or consent to act in relation to any particular SF. This means that a SF can be launched quickly and without any risk of regulatory delays.

Fees

No application fee is payable for the establishment of a Specialist Fund. However, an annual fee of £500 is payable to the FSC. In addition, a modest annual corporate charge is payable in relation to the use of an Isle of Man corporate vehicle.

Target Investors

The Specialist Fund is not intended to be a vehicle for retail investment. It is designed to facilitate the establishment and operation of sophisticated alternative investment funds and, accordingly, is aimed squarely at institutional and super-high net worth investors. Prospective investors must certify that they are sufficiently experienced to understand the risks associated with an investment in the SF in question and must fall into one of the categories of permitted investor. Broadly speaking, these cover institutional investors, affiliates of the fund's promoters and managers and individuals with a net worth in excess of US\$1M.

Minimum Subscription

A Specialist Fund must have a minimum initial investment requirement of at least US\$100,000, although it is expected that many of the funds in this category will actually have minimum investment levels that are set much higher. The administrator is required to police compliance with the minimum investment thresholds.

Taxation

The Isle of Man offers a tax neutral environment for hedge fund operations. There are no capital or inheritance taxes in the Isle of Man and stamp duty does not apply. In 2006 the Isle of Man introduced a zero rate of corporate tax for most taxpayers. This means that a corporate fund vehicle will benefit from a zero rate of income tax, as will any fund management or administration business based in the Isle of Man. It follows that the Island no longer has a “tax exemption” regime and therefore fund vehicles need not go through the process for applying for exemption on an annual basis; nor are such vehicles subject to the risks associated with inadvertently ceasing to qualify for exempt status and the adverse taxation consequences that follow. The fees levied by fund administrators and investment managers based in the Isle of Man in respect of services to SFs are exempt from value added tax in the Isle of Man.

Offering Document

Every Specialist Fund is required to have an offering document. The board of directors of the SF must all sign a statement in respect of the offering document in which they acknowledge that they are responsible for the contents of the offering document and for ensuring that it is updated as appropriate.

There are only a limited number of prescribed statements to be included in the offering document of a SF. By and large the content of a SF’s offering document is a matter for its board of directors, subject to an overriding requirement that the offering document should accurately set out all material information to enable a prospective investor to make an informed investment decision. The SF is also required to have an investor application form that contains certain prescribed statements including a certification by the investor that he meets the target investor requirements (see above).

Flexible Custody Arrangements

Given the diversity of assets employed by hedge fund managers it is inevitable that a range of techniques will be used for the safe custody of SF assets and that certain asset classes will not lend themselves to traditional custody concepts. Accordingly, there are no prescriptive requirements for the appointment of

a custodian in relation to a SF. As a result, a SF is free to appoint various custodians or prime brokers as it sees fit and may appoint different parties to act in relation to different types or groups of assets. The arrangements for the custody of the assets of the SF must be described in the offering document.

Accounting and Audit Requirements

A SF is required to prepare annual financial statements in accordance with either international accounting standards, UK GAAP or US GAAP. The annual financial statements must be audited by a qualifying auditor. In order for an auditor to be qualified to report on the financial statements of a SF, the auditor must be a member of a relevant professional body of accounts, such as the Institute of Chartered Accountants in England & Wales, must have a permanent place of business in the Isle of Man and must maintain appropriate professional indemnity insurance to a level of at least £20M. The audited financial statements of a SF must be distributed to its investor within not more than 6 months of the end of its financial year.

Should you have any questions or requests for further information please contact:

Simon Harding
Partner
sharding@applebyglobal.com

Gill Crennell
Senior Associate
gcrennell@applebyglobal.com

Bahrain
Bermuda
British Virgin Islands

Cayman Islands
Hong Kong
Isle of Man

Jersey
London
Mauritius

Seychelles
Zurich