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Financial Services

DOMICILES OF ALTERNATIVE INVESTMENT FUNDS

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1. EXECUTIVE SUMMARY

The following study identifies reasons behind choice of domicile for alternative investment funds (AIFs) and discusses future trends. The study was commissioned by the Association of the Luxembourg Fund Industry (ALFI) for their annual conference on Alternative Investments in Luxembourg.

We estimate that since 2010 the number of AIFs have increased by 10% and assets under management (AuM) by 13%. The distribution of domiciles remained relatively stable during this time, but there are a number of clear trends emerging.

The study identifies four main trends in choice of domicile for AIFs

1. Strong growth in European domiciles, fuelled by the introduction of the Alternative Investment Funds Manager Directive (AIFMD)
2. Demand for AIFs under mutual fund structures/UCITS
3. Demand for 'one-stop-shop' domiciles and the decreasing appeal of smaller offshore domiciles
4. Successful domiciles maintaining or strengthening their dominant role (Cayman Islands for hedge funds, Delaware for private equity and real estate funds)

Going forward, we expect the demand for regulated AIFs to continue to drive growth in European onshore domiciles. The traditional demarcation between regulated mutual funds and non- or less-regulated AIFs are diminishing yet further. AIMFD-compliant vehicles are expected to become the preferred investment structure for investors looking for a combination of both a regulated vehicle and full blown alternative investment strategies.

2. INTRODUCTION

This study builds upon the initial Oliver Wyman report from 2011 on *Domiciles of Alternative Investment Funds* and continues the discussion around domicile choices. Since the last report, offshore domiciles have attracted increasing attention from regulatory bodies and investors, resulting in greater transparency about their role as global fund domiciles. Nonetheless, the availability of public data remains very limited, increasing reliance on a variety of (sometimes contradicting) fund databases and interviews with industry experts to derive robust estimates.

In the following study, we defined AIFs as investment schemes that apply investment strategies typically not available to traditional mutual fund/UCITS structures. AIFs can be grouped into three main asset classes: hedge funds, private equity funds, and real estate funds. In addition, to acknowledge recent market developments in the mutual fund industry, we look at alternative investment strategies replicated under mutual fund/UCITS structures in a separate analysis.

To keep the data manageable we have restricted our analysis to jurisdictions in the Americas and Europe. The study examines those domiciles attracting the largest number of AIFs by number fund registrations and AuM, as well as key domiciles in the European Union (EU). These are

- Cayman Islands
- State of Delaware in the United States of America
- Key domiciles in the EU: Luxembourg, Ireland and Malta
- The Channel Islands comprising Jersey, Isle of Man and Guernsey
- Rest of Caribbean Islands: Bermuda and British Virgin Islands (BVI)

3. OVERVIEW OF DOMICILES AND TRENDS

Since 2010 the number of AIFs has increased by 10% and there are now more than 25,300 funds in scope of the study. At the same time AuM grew by more than 13%, totalling US$3.7 TN in 2013. The distribution of fund domiciles remained relatively stable during this time. Cayman Islands, the largest domicile by number of funds, increased its market share from 39% to 43% by the end of 2013. This corresponds to a nominal increase of around 2000 funds, of which more than half related to hedge fund registrations. The large increase in 2012 is explained by the revision of the fund regulation, resulting in increased master fund registration (Exhibit 1). The following year the number of registrations declined, however the Cayman Islands was still able to strengthen its position relative to other domiciles.

Delaware, the second largest domicile, showed a net increase of around 500 funds. Their relative position remained nearly unchanged with one percent point drop in market share.

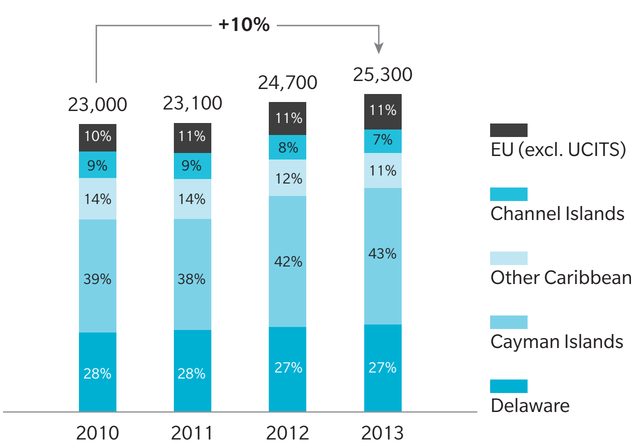
Smaller domiciles like the Channel Islands and Rest of Caribbean show a decrease in relative positioning of two and three percent points respectively.

For the analysed domiciles of the EU, that is Luxembourg, Ireland and Malta, we look at both traditional and UCITS compliant AIFs. Traditional EU domiciled AIFs have increased their market share from 10% in 2010 to 11% in 2013, corresponding to the largest growth rate of 27% (see Exhibit 2). At the same time UCITS-compliant alternative structures reported strong growth of 17% (Exhibit 2).

These observations allow us to derive four main trends in AIF domicile choices that we will discuss further in the next sections:

1. Strong growth in European domiciles, fuelled by the introduction of the AIFMD
2. Demand for AIFs under mutual fund structures

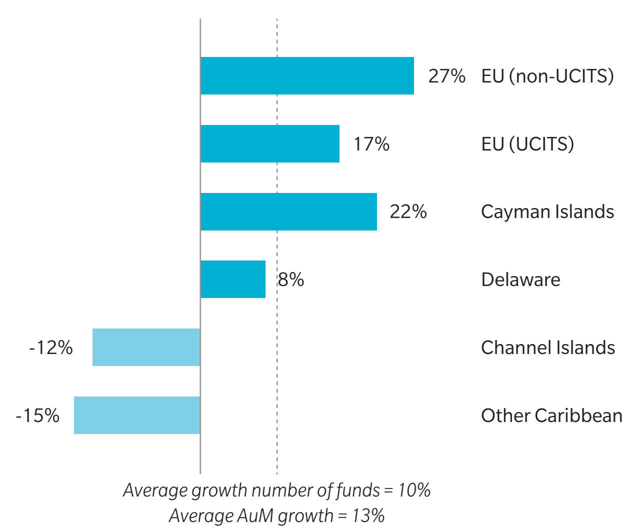
Exhibit 1: Total number of traditional AIFs 2010-2013



Note The EU numbers are for Luxembourg, Ireland and Malta; Other Caribbean is British Virgin Islands and Bermuda; Channel Islands comprise Jersey, Guernsey and Isle of Man. Other domiciles are smaller and not included in the analysis; numbers include sub-funds and funds of hedge funds

Source Oliver Wyman analysis of each jurisdiction data and estimates where data is not publicly available

Exhibit 2: Change in number of AIFs 2010-2013



Source: Oliver Wyman estimates

3. Demand for 'one-stop-shop' domiciles and decreasing appeal of smaller offshore domiciles
4. Successful domiciles maintaining or strengthening their dominant role (Cayman Islands for hedge hunds, Delaware for private equity and real estate funds)

3.1. STRONG GROWTH IN EUROPEAN DOMICILES

The introduction of AIMFD increased the attractiveness of European onshore domiciles. Effective since July 2013, AIFMD defines a regulatory framework for management and marketing of AIFs in the EU. It introduces new requirements, among others, authorisation and ongoing oversight of alternative investment fund manager (AIFM), the obligatory appointment of an independent depositary, independent valuation of assets, effective liquidity and risk management, and increased investor disclosure requirements. Moreover, the regulation introduced the EU-wide passporting concept to AIFs that has previously only been available for UCITS funds. It allows EU domiciled managers to market authorised funds across the EU and is expected to replace National Private Placement in 2018.

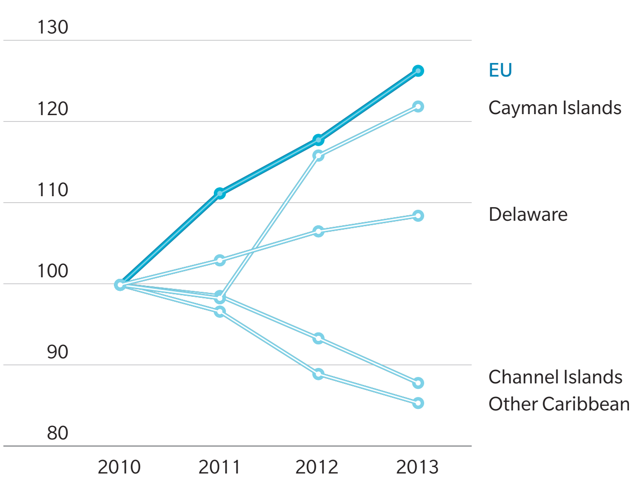
Despite the initial fear of high compliance costs and additional complexity, the industry adapted quite well to the changes. Survey results show that the majority of market participants see opportunities arising from the new regulation and would look to set up some form of EU operations to take advantage of the AIFMD[1] – a trend that is confirmed by the growth in total number of AIFs and corresponding AuM as can be seen in Exhibits 3 and 4.

European domiciles report strongest growth among all regions, both in terms of number of funds and the underlying assets. However each with different 'sweet spots':

Luxembourg, largest EU domicile corresponding to ~60% of all analysed EU alternative funds, grew by 11% during 2010-2013 (+169 funds). The strongest growth contribution came from private equity and real estate funds, with approximately 30%-35% growth in funds and AuM, while number of hedge funds shows a decreasing trend since 2010. Growth in private equity and real estate was further boosted in 2014 by the introduction of a new legal form known as the SCSp (special limited partnership, Société en Commandite Spéciale) which is broadly similar to the Anglo-Saxon limited partnership structure.

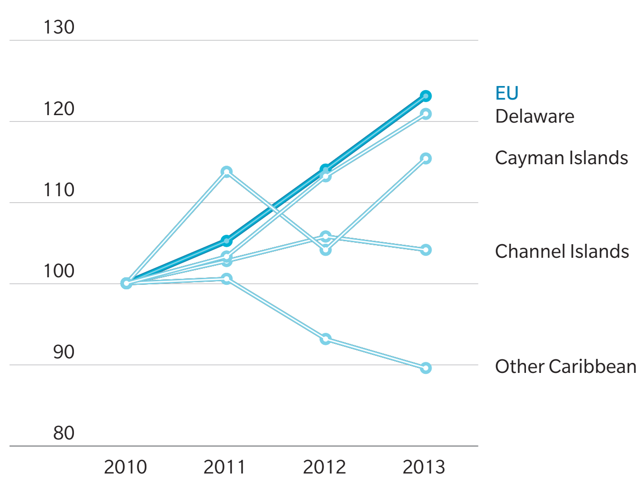
Ireland, the second largest EU domicile with around 21% of analysed EU funds, grew by 58%, mostly

Exhibit 3: Total number of funds, 2010 indexed



Source Oliver Wyman estimates

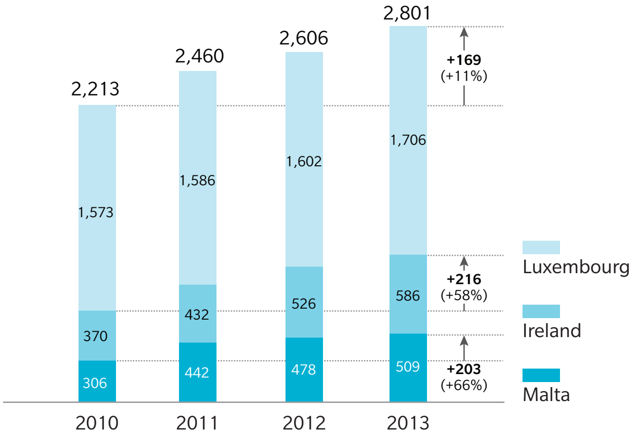
Exhibit 4: AuM, 2010 indexed



Source Oliver Wyman estimates

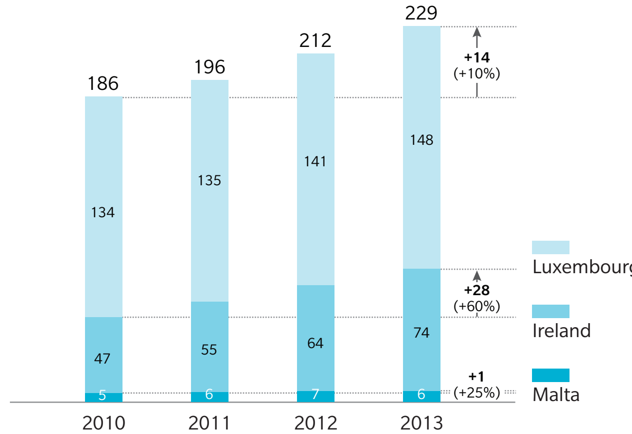
1 Multifonds 2012 survey.

Exhibit 5: Total number of EU domiciled funds



Source ALFI, MFSA, Monterey Insight, Oliver Wyman estimates

Exhibit 6: AuM of EU domiciled funds



Note Numbers for Ireland estimated based on average fund size of Irish QIFs

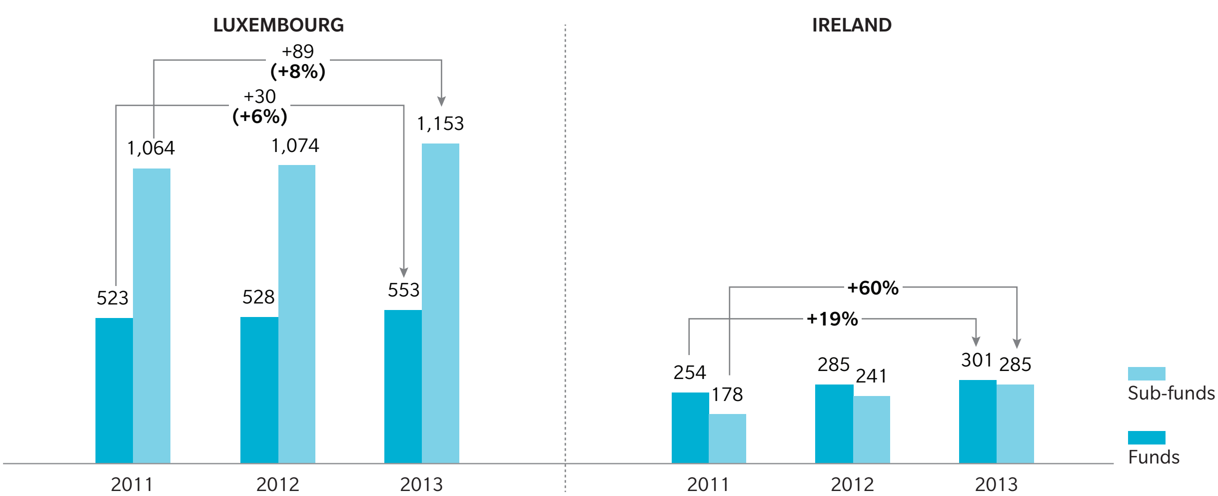
Source ALFI, MFSA, Monterey Insight, Oliver Wyman estimates

explained by the increase in number of hedge funds that account for the vast majority of Ireland's AIFs. Ireland is typically seen as a large global centre for hedge fund administration, with well-establish infrastructure in place. Currently around 40% of global hedge funds are estimated to be administered in Ireland[2].

Malta shows the strongest growth among the analysed EU domiciles – not surprising giving the relatively small size of the domicile and its 'newcomer' status. The domicile is perceived to be attracting niche markets within the hedge funds industry, with average fund size below €20 MM (compared to €80-120 MM for Luxembourg or Ireland). Malta continues investing in its fund infrastructure, with the number of custodians increasing from two in 2010 to six currently.

Overall, the domicile still requires increased critical mass to mature further.

Exhibit 7: Number of funds and sub-funds



Note: Data on sub-funds for Malta not published; funds/sub-funds split for Luxembourg estimated based on ratios for total PIF universe

Source: Monterey Insight, Oliver Wyman estimates

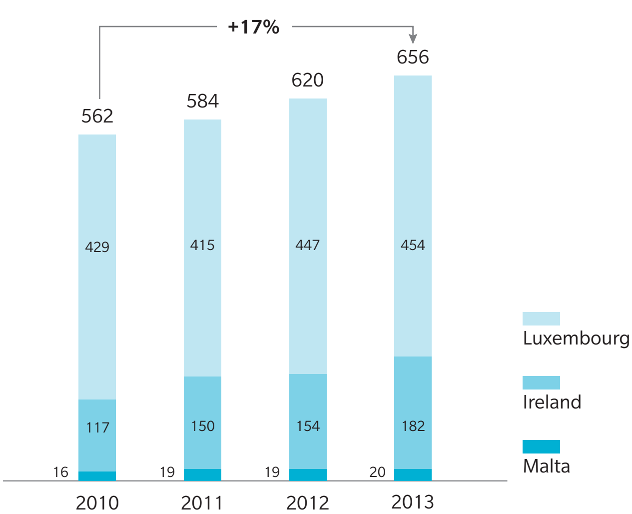
2 HFMWeek 20th Survey & IFIA, April 2013.

Data from Luxembourg and Ireland shows that a large part of the growth in EU funds has been contributed by the increasing number of sub-funds, many of them setup up by offshore fund managers with the aim to co-domicile in the EU (see Exhibit 7). With the introduction of the AIFMD, non-EU AIFMs cannot take advantage of the EU-passport until 2015 unless they manage their funds from the EU. Moving to the EU is not an attractive solution for most non-EU AIFMs, especially to the ones without a sizeable European investor base. Given that marketing under the National Private Placement rules can prove costly when targeting multiple European markets and client solicitation remains under scrutiny from regulators, many non-EU AIFMs decide to co-domicile their fund in the EU. Co-domiciliation allows fund managers the option to keep the original fund domiciled in the offshore jurisdiction and operate a regulated parallel fund in the EU at the same time. We see an increasing number of AIFMD compliant co-domiciliation arrangements being constructed through third-party AIFM platforms, where the platform provider is authorised by an EU Member State regulatory body and appoints offshore portfolio managers to manage the sub-fund, or through advisory agreements, where the EU AIFM takes advice from offshore advisors on investment decisions.

3.2. DEMAND FOR AIFS UNDER MUTUAL FUNDS STRUCTURES/ UCITS

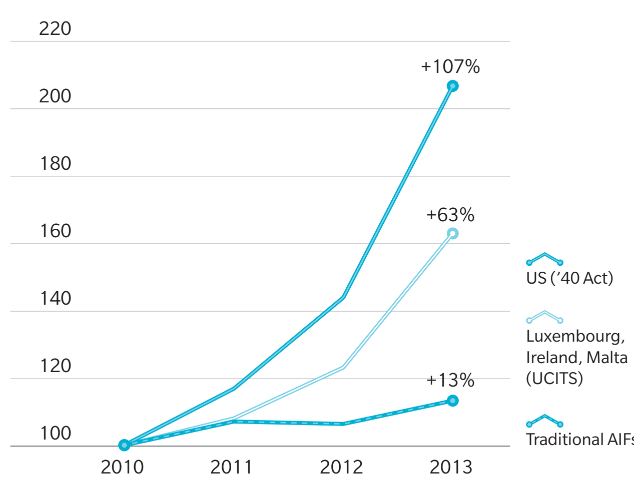
Since its introduction in 2002, UCITS III has become a cornerstone of European mutual funds regulation, defining standards in areas of investor protection, investment regulation and investor disclosure. The usage of UCITS compliant structures for alternative investment strategies is estimated to have more than doubled since 2009 on a global basis. Demand for transparency and regulation post-crisis increased the attractiveness of UCITS structures, in particular in relation of UCITS attractive liquidity terms, public disclosure requirements and permanent oversight from regulatory bodies. For the analysed EU domiciles, we estimate the number of funds to have increased by 17% since 2010 (see Exhibit 8). A similar picture can be seen on the other side of the Atlantic. In the US, AIFs constructed under the Investment Company Act of 1940 are gaining momentum ('40 Act funds). A comparison

Exhibit 8: Number of UCITS compliant AIFs 2010-2013



Source Monterey Insights, MFSA, Eurekahedge, Oliver Wyman estimates

Exhibit 9: Growth in AuM 2010-2013



Source Morningstar, Oliver Wyman analysis and estimates of the AuM growth rates reveals the true magnitude of that trend (see Exhibit 9). Today, most of the large names in the hedge fund industry employ a UCITS compliant structure of their investment strategies in parallel to the traditional AIFs.

Although most investors welcome the regulation of UCITS fund structures, it imposes significant investment restrictions at the same time, for example with regard to the utilisation of derivatives, leverage or investment concentration. A significant number of the alternative UCITS funds try to mimic the performance of the underlying traditional AIFs by employing solutions based on usage derivatives (e.g. total return swaps). Regulators on both sides of the Atlantic realised the possible risks associated with the replication strategies and put them under investigation (see for example ESMA Guideline 2012/832)

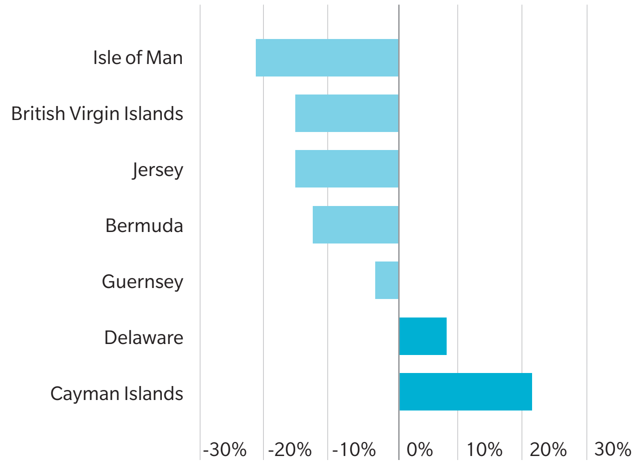
Overall, UCITS compliant AIFs resulted from investor demand for regulated funds, but UCITS imposes significant limitations that make them not always favoured, especially by large investors. Typically UCITS structures that have a smaller asset base, suffer from the strict investment constraints and risk underperforming the unconstrained parent fund.

3.3. DEMAND FOR 'ONE-STOP-SHOP' DOMICILES

We see domiciles offering 'one-stop-shop' solutions to continue to attract funds at expense of domiciles with less well developed fund infrastructure. One of the main criteria of fund managers when choosing the fund domicile is quality of prevailing fund infrastructure in the jurisdiction. With the introduction of AIFMD, fund administration has turned out to be a crucial element of the regulator's agenda. Under AIFMD, it is required to appoint an independent depositary for a fund's assets, whose function includes safekeeping of the fund's assets (with strict liability for custody of financial instruments, and best efforts verification of ownership of other assets), cash monitoring as well as overseeing NAV,

3 Multifonds survey 2013

Exhibit 10: Funds growth rate 2010-2013 of non-EU domiciles



Source Oliver Wyman estimates

distribution and settlement processes, and compliance with applicable rules.

The increased regulator pressure is expected to foster the consolidation among fund depositaries. Based on a 2013 survey[3] among fund administrators and fund managers, 41% of respondents expect reduced depositary support for certain geographies. Factual examples can be seen from Bermuda, Guernsey or the Isle of Man, where HSBC withdrew local operations. The example of the Isle of Man shows how vital a comprehensive fund infrastructure for a domicile can be – number of funds and AuM tumbled since the departure of HSBC. Overall, we expect large domiciles to win the race over smaller domiciles with less developed fund infrastructures.

3.4. SUCCESSFUL DOMICILES MAINTAINING A DOMINANT ROLE

Between 2010 and 2013 traditional offshore domiciles confirmed their dominant role within respective AIF asset classes.

Cayman Islands has traditionally been seen as the global home of hedge funds and has strengthened that role over the last four years, allowing it to increase its AuM share from 55% to 60%. Delaware instead plays a dominant position among both, private equity and real estate funds with nearly 70% of all analysed private equity and real estate assets domiciled in the US state. Delaware is an important jurisdiction for US investors in particular, with some AIF managers having onshore feeder funds in Delaware for taxable US investors and an offshore master fund (e.g. on the Cayman Islands) for non-US taxed investors at the same time. Overall, there is no clear winner across all asset classes. Instead, there are asset class dependent elements that decide on the attractiveness of a domicile – these are discussed in the following sections.

HEDGE FUNDS

We estimate around 17,700 funds with €2.1 TN AuM classified as hedge funds. Of this €1.3 TN is currently domiciled in the Cayman Islands in the form of hedge funds and funds of hedge funds, confirming the Cayman Islands dominant role as a global hedge funds domicile. There are a couple of factors that make the Cayman Islands so successful. First, they offer a large hedge fund infrastructure that can supply qualified service providers (legal counsel, administrators, auditors and directors of hedge funds) and has a long tradition as hedge funds jurisdiction with a good reputation among investors.

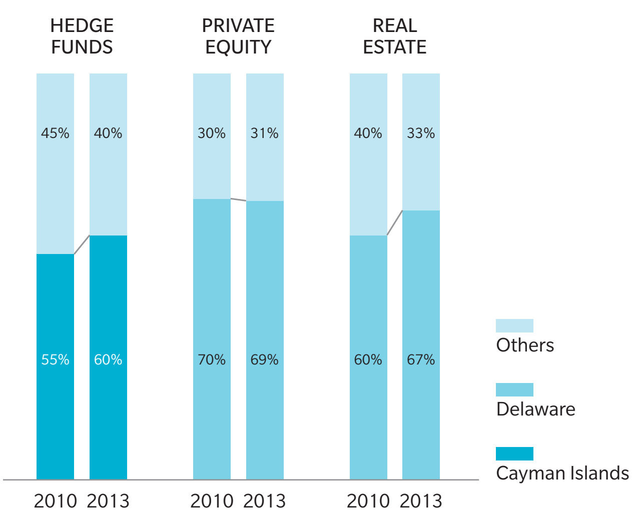
The domicile is equally popular among US and UK fund managers, however with UK based fund managers it is gaining in importance with most inceptions since 2010 coming from UK based hedge funds managers (28% of all inceptions) – US plays a diminishing role (26% in 2010, 17% in 2013). In addition, a robust regulatory regime and no or low entity-level taxation allowed the Cayman Islands to build a long lasting reputation as a global hedge funds hub.

Although the Cayman Islands remain dominant on a global scale, the majority of US hedge funds domicile in Delaware and British Virgin Islands, making these domiciles second and third largest respectively of the analysed hedge funds, both however shrunk during 2010-2013.

Luxembourg and Ireland are popular among UK and European fund managers, however Ireland is experiencing a growing number of registrations from US fund managers, partly driven by structural changes in response to the AIMFD.

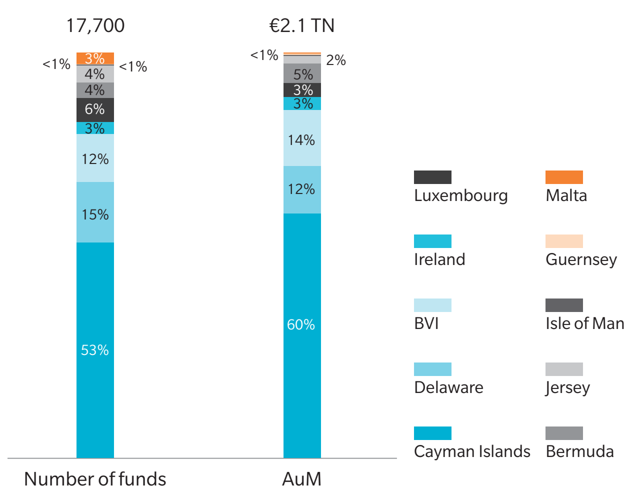
A similar picture can be seen in Malta, where traditionally most fund managers come from the

Exhibit 11: Top domicile per asset class by AuM, 2010 vs. 2013 comparison



Source Oliver Wyman estimates

Exhibit 12: Hedge fund distribution by number of funds and AuM



Note EU numbers for non-UCITS compliant funds only

Source 2013 Oliver Wyman estimates

UK, but the number of US-based fund managers is steadily increasing.

For the European onshore domiciles in scope, approximately half of hedge funds are domiciled in Luxembourg, with the rest split almost evenly between Ireland and Malta.

PRIVATE EQUITY

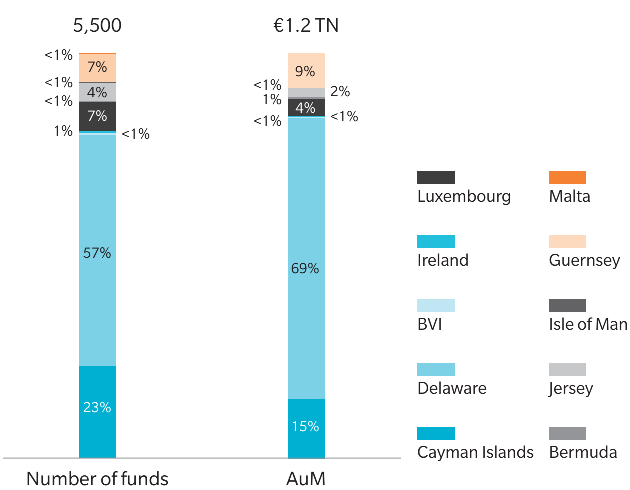
Delaware is by far the most important domicile for private equity funds. We estimate around 57% of the analysed 5,500 funds or 69% of the €1.2 TN assets to be domiciled in the US state. The flexible legal environment and efficient partnership structures are seen as key factors for private equity domicile choices. Most funds are constructed under the Delaware limited partnership or Delaware limited liability company vehicle. Investors, in particular from the US, appreciate Delaware's principle of freedom of contract and the efficient enforceability of limited partnership agreements. Delaware's legal system is perceived as highly specialised in corporate law, with many precedents in legal cases that are widely accepted and used throughout the US and in other common law countries around the world. The flexible fund regime does not require for example a local presence or annual report filing, making the US state the domicile of choice for many private equity fund managers.

Guernsey is the third largest domicile for private equity funds by AuM, seeing high growth in the last four years. Today private equity funds account for nearly three quarters of all Guernsey domiciled funds. In the EU, we see Luxembourg in a dominant position with approx. 90% of the analysed EU funds domiciled in the Grand Duchy.

REAL ESTATE

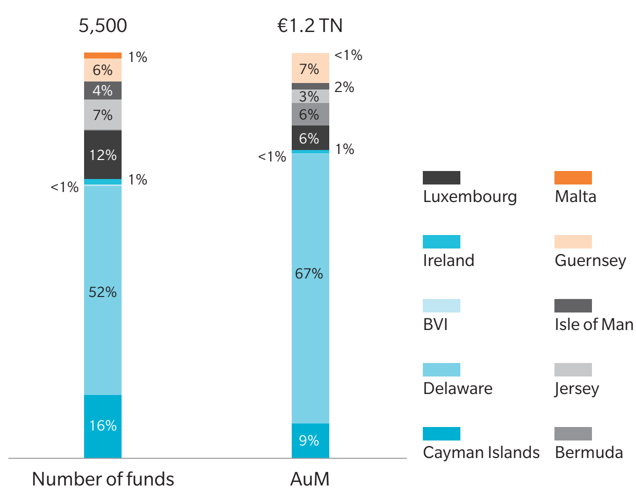
Similar to the picture seen for private equity funds, Delaware is seen as the domicile of choice for the majority of real estate funds. We estimate 67% of analysed assets to be domiciled in the US funds, up from 60% in 2010. Real estate funds show similar characteristics to private equity in terms of fund structures, however with specific tax regimes applicable to real estate only, the choice of domicile is more complex.

Exhibit 13: Private equity distribution by number of funds and AuM



Note EU numbers for non-UCITS compliant funds only
Source 2013 Oliver Wyman estimates

Exhibit 14: Real estate distribution by number of funds and AuM



Note EU numbers for non-UCITS compliant funds only
Source 2013 Oliver Wyman estimates

Increasing importance of Delaware is also the result of diminishing role of smaller domiciles. For example Isle of Man, a domicile that historically had a strong focus on real estate funds, faced a challenging period around 2010 that put asset values under pressure, triggering a negative trend from which the domicile did not recover. In Europe, we see Luxembourg with the highest share of real estate funds among analysed European locations with an estimated 15% of local AIF assets in real estate and rising. In particular the wide range of vehicles offered (e.g. SICAF, SICAV, FCP and newly introduced SCSp) are seen as suitable choices for real estate funds.

SUMMARY OF KEY SUCCESS FACTORS

Across all asset classes we see a list of key success factors that play an important role when deciding where to domicile a fund. Depending on the asset class, some success factors play a more important role than others, but overall the long list remains consistent.

KEY SUCCESS FACTORS	DESCRIPTION
Attractive tax system	• Low tax rates • Double-taxation treaties
Suitable legal environment	• Flexible limited partnership regimes and fund structures • Established and effective co-operations with international supervisory authorities • Adherence and alignment with international standards • Legal environment adhering to investor protection rights
Quality of local services providers	• High number of locally present custodians with global footprint • Skilled and available labour
Consideration of investor requirements	• Easy process for re-domiciliation • Quick registration period • Low registration fees
Responsive authorities	• Flexible, open and approachable • Following 'no-nonsense' approach

4. OUTLOOK

Overall, we expect the demand for regulated AIFs to continue and the boundary between traditional AIFs and mutual funds to diminish yet further. Given the challenging market environment for traditional bond and equity investments, we expect investors demand for alternative investments to remain strong and that they will continue focusing on regulated vehicles. During the pre-AIMFD period, we saw UCITS compliant structures attracting significant investor attention in particular from institutional investors demanding regulated and liquid products. Today, with the introduction of the AIFMD, the market gains access to a new regulated vehicle that allows participants to structure alternative strategies without the investment constraints associated with UCITS mutual funds. We therefore expect the traditional demarcation between regulated mutual funds and non- or less-regulated AIFs to continue to diminish therefore.

In general, we anticipate the AIFMD will benefit the AIFs industry as a whole. AIFMD authorisation is not only about legal affairs or compliance, but in the end defines how fund managers run their business day-to-day. Compliance with the directive signals good corporate governance and higher investor protection (e.g. asset custody), and increased transparency (e.g. reporting). We expect AIMFD compliant vehicles to become the preferred investment regime for investors that look for a combination of both a regulated vehicle and full blown alternative investment strategies.

5. CONCLUSION

In conclusion, we believe most of the existing trends will continue with some of them even strengthening over the coming years, fuelled by regulatory developments and investor demand

- The AIFMD increased the attractiveness of European domiciles, a trend we expect to continue with more offshore funds taking advantage of the regulation
- The choices for onshoring remain wide, with expected favouring of co-domiciliation and clone/master-feeder fund structures between offshore and onshore jurisdictions
- Large domiciles expected to maintain their dominant role within respective asset classes
- Increase in importance of well-established fund infrastructure with local presence, as more and more of the regulatory burden is being pushed down along the value chain from fund managers towards infrastructure providers

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