IFCs and the Changing Environment

Jersey confident in island's offering to hedge funds

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Hedge fund managers come from many countries – with some large firms employing dozens of nationalities – and can hop around multiple countries over their careers. Says Jersey Finance Deputy Chief Executive, Richard Corrigan, "Hedge fund managers are under increasing scrutiny by regulators and tax authorities. An offshore standalone alternative investment management company may not have enough substance, based on the facts and circumstances in each case". That could, for instance, restrict their ability to make use of transfer pricing to allocate profits to an offshore company that has insufficient substance. Meanwhile, an onshore structure can be slow to set up. The UK regulator, the FCA, has sometimes taken as long as nine months to approve a new management company. Multi-month lead times are also normal elsewhere, partly because regulators have a heavy workload of new regulations to implement, and there can be multiple divisions to deal with.

In contrast, "a Jersey manager entity is simple and cost-effective," according to Corrigan, who claims that "the JFSC's fast-track licensing regime is the envy of many offshore locations and can award licenses in a matter of weeks". Over the years Corrigan has found the JFSC "a very good and effective regulator". What makes ongoing dialogue with the JFSC so much easier to handle is that "when dealing with the regulator you deal with the same one person every time, rather than different people for every area." The JFSC has just under 200 staff and a reputation for efficient regulation. "Everyone does what is expected of them and the JFSC is more efficient and on the ball than other regulators," claims Corrigan. An IMF review in 2009 endorsed the quality and transparency of local regulation.

Macro and CTA strategies

Jersey is currently home to around 23 hedge fund management companies, mainly following a mixture of discretionary, quantitative, and systematic, global macro, managed futures and CTA strategies. The largest three, measured by assets, are Brevan Howard, BlueCrest, and Systematica (which established in Jersey in January 2015 as a spin-out from BlueCrest), all of which belong to *The Hedge Fund Journal's* 'Europe 50' listing of the largest 50 managers in Europe. There are also medium-sized managers with track records well beyond 10 years, including Paul Brewer's Rubicon and Stephen Hedgecock's Altis Partners. These managers tend to have multiple offices globally, but there is a growing groundswell of start-up managers choosing to be largely – and sometimes exclusively – located in Jersey. For instance, in 2014 local firm BlueCrest spawned macro and relative value shop SnowStream, started by Daniel Ridgway. Others have moved to Jersey to start up managers, funds and managed accounts. Jersey has recently made it easier for hedge fund managers to advise managed accounts, without the need for a fully fledged investment management business regulation.

Figures for September 2015 show that the net asset value of funds under administration in Jersey (across all asset classes and strategies) increased 6.5% year-on-year to stand at £218.8 billion, the third highest level since December 2008 and 6.5% higher than the figure from September 2014,with total alternatives business, including hedge, growing by 11.5% year-on-year. In addition, the trend is towards significant future management substance in Jersey, with the jurisdiction now being home to around 125 fund promoters, up from 70 five years ago.

The momentum that Jersey has gathered in recent years shows no signs of letting up. "A strong pipeline of macro and CTA strategies are looking at us as a location," enthuses Corrigan. They tend to be focused on exchange-traded markets rather than on over-the-counter (OTC) markets. The preponderance of these particular strategies may be due to them being "the most easily movable," says Corrigan, as they generally have no need to make regular visits to investee companies or stick to the most well-trodden paths for corporate roadshows. Corrigan reckons that statistical arbitrage is another strategy that can be agnostic on locations. Even within the equity long/short space some managers with more concentrated portfolios, and longer holding periods, such as activists, might not need to make large numbers of site visits to investments. Separately, managers of shorter-term trading strategies could be particularly vulnerable to possible UK changes to the taxation of performance fees, discussed below.

This hub of macro and CTA activity is now sufficient to warrant allocators adding Jersey to their travel schedules, for purposes such as carrying out operational due diligence site visits. The number of allocators coming through the island is of benefit to managers of all sizes.

BEPS

The OECD's Base Erosion and Profit Shifting (BEPS) project has been written about in *The Hedge Fund Journal* by contributors including Adam Miller and Stuart Chalcraft of EY. Opinions differ over which entities should be domiciled in which places, under various possible BEPS scenarios, but it is clear that BEPS has potential implications for hedge fund managers. BEPS applies to all OECD countries, including Jersey – and to all companies, including investment management companies. It is creating more interest in Jersey, according to Corrigan. Of 15 OECD action reports, each of over 100 pages, he homes in on "BEPS Action 6: Preventing Treaty Abuse". Instances of 'treaty shopping' for Double Taxation Agreements (DTAs) resulting in no taxation are perceived to be an abuse, and an unintended consequence, of some DTTs. However, the report does not conclude on how to provide treaty benefits for unregulated funds. Recommendations will need to be developed that protect against the perceived misuse of unregulated funds to obtain treaty benefits.

The OECD has published the comments received on its revised Action 6 Draft, but the whole industry, globally, awaits further clarification on how Action 6 may impact the alternatives sector. Even when the OECD eventually makes its recommendations, the OECD itself does not make hard laws, so countries will need to decide how they implement the action points into their national laws. The OECD website states that "not all BEPS participants have endorsed the underlying standards on tax treaties or transfer pricing," so there may be some variation in implementation.

BEPS is, of course, an enormous and wide-ranging project with multiple areas, including taxation at the fund or investment vehicle level, still to be decided, and these could impact fund managers wherever they locate. Whether AIFMs are classified as Collective Investment Vehicles (CIVs) or non-CIVs has not yet been determined. Under Action 1, a virtual presence in a country, known as 'virtual permanent establishment', such as servers located adjacent to exchanges, might also lead to tax liabilities in that country, as may a 'significant digital presence', and the location of customers could also become a criterion for taxation.

Taxation: stable or changeable?

Corrigan is surprised that "few UK hedge fund managers and non-domiciles have yet reacted to proposed tax changes – but they are starting to." Corrigan points out that "the UK consultation on performance fees could lead to increased taxation, particularly for shorter-term managers such as CTAs". The proposal is that 'trading' profits be taxed as income, which currently means a tax rate of up to 45% in the UK, plus employers' and employees' national insurance; capital gains, in contrast, is taxed at up to 28%. He cautions that changes can come suddenly and without warning, citing how the tax on carried interest was changed in July with immediate effect. The UK government has not yet finalised legislation on performance fees. Nor has the regime been decided for non-domiciled persons (non-doms). According to Corrigan, the indications are that, though inbound non-doms may be able to benefit from the regime, the longer-term UK non-doms who have been resident for 15 out of the last 20 years do look likely to be deemed UK-domiciled for tax purposes (with possible exemptions for some offshore assets). Thus the permanency of, and ability to bequeath, non-dom status could be ended. Jersey sees a regular influx of UK non-domiciles, from multiple industries, and Jersey Finance gets involved with those who work in finance.

Tax on high-net-worth individuals in Jersey can be 20% up to £625,000, equating to a £125,000 liability, and above that the rate is just 1%. For companies, the general rate is zero, including for fund management businesses. Some financial entities, such as banks, trust companies, fund administrators and custodians, pay 10%. A rate of 20% for property development profits is rarely relevant to hedge fund managers. Being outside the EU, Jersey has no need to levy VAT and the local GST for local businesses is 5% – but those businesses servicing non-residents are exempt. Jersey has never had inheritance tax or capital gains tax, and the basic rate of income tax has been 20% since 1940. In contrast to the big changes being seen elsewhere, taxes are predictable in Jersey.

Flexible structures for substance

Against this backdrop, says Corrigan, "Jersey is highly regarded for its strong and stable government. The JFSC is considered one of the best regulators in any jurisdiction. Amongst service providers, the island has a deep pool of expertise in tax, administration, depositaries, AIFMD-compliant management companies, and governance. There are many experienced fund directors, both executive and non-executive, with strong knowledge of risk and portfolio management." Directors can be drawn from both Jersey residents and non-residents.

"Jersey is seen as a specialist centre for hedge fund servicing and management, in a post-AIFMD world," says Corrigan. Jersey hedge funds are far from letterbox entities. "Brevan Howard has 80 staff, and two funds set up in 2015 that started with four staff each now have 20-plus apiece," adds Corrigan. Levels of staffing reflect the size and strategy of the fund, and there are some smaller funds where one principal might relocate to Jersey while another principal stays put.

Flexibility is crucial, too. Jersey recognises that it can take time to recruit and train up local staff, so some firms have relocated senior traders and principals, as well as hiring locals. Jersey is keen to attract employers for the tax revenues, as local employees' salaries are subject to social security and income tax, and spending in the local economy also generates tax revenues. The Jersey population office looks favourably on business plans that include hiring locals.

Regulation inside and outside the EU

Though Jersey did not conceive or shape AIFMD, it has turned out to be beneficial to the island. Inside the EU, to be outside the scope of AIFMD hedge funds would generally need gross assets, including leverage, of less than €100 million, which can imply a much smaller level of net assets, particularly since the AIFMD definitions of leverage can result in huge figures for some strategies. In Jersey, managers of any asset level could be outside AIFMD if they have no EU investors or market into Europe under the national private placement regimes (NPPRs). Corrigan points out that "if funds are not being marketed to EU investors, there is no point in being based in the EU and facing extra rules and regulations". But Jersey (like Guernsey) operates a dual regime where managers can opt in, or opt out, and can even run some funds under AIFMD and others outside it. They could set up their own AIFMD-compliant management company, or they could operate under the umbrella of other such structures.

A number of firms have been quick off the mark in eyeing the opportunity. Carne, for instance, established a presence on the island in June 2015 and swiftly set up the very first independent AIFMD-compliant management company (manco) to obtain approval outside the European Union. Mark Hodgson, managing director with Carne in Jersey, said: "The presence of an independent AIFMD-compliant manco in Jersey is of particular interest to the growing number of managers who are interested in meeting the Directive's requirements, but do not want to have a structure in the EU. An independent solution like Carne's is also attractive because it allows the manager a choice from the wide range of Jersey service providers available." So managers now have at least five choices: marketing into the EU using the NPPRs; AIFMD inside the EU; their own AIFMD manco outside the EU; another AIFMD manco outside the EU; or non-AIFMD outside the EU. Some Jersey managers are indeed setting up AIFs under AIFMD: for instance, there have been 22 depositary notifications from seven separate Jersey AIF depositaries as of September 2015.

For those that want to go down the AIFMD route, the advice of the European Securities and Markets Authority (ESMA) concluded there are no obstacles for Jersey to obtain a non-EU third countries AIFMD passport (along with Guernsey and soon Switzerland). "This was a big vote of confidence in us," says Corrigan. It confirmed that ESMA and national regulators felt comfortable that co-operation and dialogue were running smoothly with Jersey. The issues disclosed by ESMA that have, at least initially, prevented the US, Hong Kong and Singapore from access to the passport do not apply to Jersey. Reciprocal market access currently appears to be a notable sticking point for the other three jurisdictions, whereas Jersey seems to offer a level playing field for its local wealth managers and other allocators to select funds from multiple domiciles. When and if NPPRs are ever phased out, the passport could provide a backstop for EU distribution. However, Corrigan does not think many managers will in fact make use of the passport, at least for now – for both positive and negative reasons. Corrigan finds that US managers are loath to comply with AIFMD strictures on disclosing remuneration. But the reality is that many managers that can continue to make use of NPPRs, under Article 42 of AIFMD, may have no need to avail of the AIFMD passport. "For some of our US managers, 70% of their assets come from the UK and the Netherlands, which are easily accessible via private placements," he says. Additionally, Sweden, Finland and Norway have huge pension assets and easily accessible NPPRs that impose reasonable AIFMD-NPPR requirements. Of course, to access those jurisdictions that have 'gold-plated' their NPPRs, including Germany and Denmark, help is on hand from local service providers such as depositaries, which can meet the 'depositary-lite' requirement in Germany and Denmark, for instance. Other markets that Jersey managers intend to distribute into include Belgium, Ireland, France and Luxembourg.

The option of continuing to use NPPRs will continue at least until 2018 because the commitment is for NPPRs to extend three years beyond the date of a passport grant. Already 205 Jersey funds are being marketed into Europe through NPPRs, up 10% since December 2014. The number of private placement authorisations has grown even faster, up 40% to 84 in the first half of 2015. NPPRs can be used for master or feeder funds domiciled inside or outside the European Economic Area (EEA). Systematica legal counsel Ben Dixon sums it up, saying, "Jersey puts us in the best of both worlds – accessing non-EEA/EU investors with non-AIFMD structures *and* accessing EEA/EU investors using the private placement regime and the passport when available." He adds that "the JFSC recently concluded a MOU [memorandum of understanding] with Switzerland's FINMA, which in turn enabled our application for our Geneva branch here to be regulated by FINMA to be finalised and approved." This is one route for distribution and marketing in Switzerland, which has developed its own regime that can require a local presence or a local representative.

Fund domiciles

Management companies in Jersey are under no obligation to domicile funds locally: "our primary objective is to get management companies to relocate," states Corrigan. Some managers with Jersey offices, including Systematica, have launched UCITS, though there are not currently any Jersey-domiciled UCITS funds. That few Jersey-based managers have, so far, run UCITS fits in well with the traditional focus on institutional investors. But Corrigan points out that besides UCITS, there are other ways to access retail investors, such as exchange-listed closed-end funds, including BlueCrest's London Stock Exchange-listed Allblue. BlueCrest's relocation to the island is a source of pride for Jersey.

In a complex landscape where substance is key, Jersey is broadening its reputation as a centre for hedge fund servicing, and is becoming a credible player in the fund management arena, too. **THFJ**