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The Domicile Choice Shan't Raise Eyebrows

By Eugeniu Guzun – HedgeNordic

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As alternative asset classes are becoming less 'alternative' for investors, more and more private markets-focused managers are coming to the alternatives scene. Choosing the right domicile – as much as choosing the right team, strategy, partners, etc. – can be vital for the success of an emerging manager. In theory, private market managers have a wide range of domiciles to choose from around the world. In practice, emerging managers are impelled towards certain jurisdictions by a host of considerations such as the nature of their target investors and their preferences, among others.

"The answer to the question of 'who are your investors?' is the main criteria that influences how one structures a fund and determines the choice of the domicile," explains Kerstin Lindgren, Director of Client Coverage in the Nordics at RBC Investor & Treasury Services. "Who do you want to raise capital from?" is one of the first questions a manager should answer, according to Lindgren. The answer to this question should offer a better understanding of the target investors and their requirements, concerns, needs, and preferences that stem from their geographical location, type of organization, their investment goals, and other factors.

Kerstin Lindgren, Director of Client Coverage in the Nordics – RBC Investor & Treasury Services.

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The pursued strategy and targeted asset class also bear importance in the choice of domicile. "What the manager wants to invest into, of course, is another driver of domicile choice," says Lindgren of RBC Investor & Treasury Services, an asset servicing organization supporting managers with administrational, banking, depositary services and many other functions that managers need for their funds to work. "When managers have an idea of the strategy they want to pursue and of the investor segment that may be interested in allocating to that strategy, there is a set of factors that will drive the decision for what domicile and setup to choose."

Legal flexibility, range of structures, expertise and competition among service providers, taxation framework are just some of the key factors to keep in mind when looking for fund domiciles. "Which toolbox can you find, what legal structures are there, which service providers can you find, what type of experience and expertise can you get, how does the taxation framework look like, what is the regulation around, how safe do the investors feel," are several of the many questions managers need to answer when deciding on where to host the fund, according to Lindgren.

Most importantly, however, "after analyzing all decision drivers and factors, managers should choose the domicile that will cater best to their strategy and their target investors," according to Lindgren. Evaluating all factors such as tax implications, costs, time to market, distribution channels, reputation, and ability to implement strategies is indeed important. Nonetheless, soft factors such as investors' personal experience and familiarity with a certain jurisdiction also tend to influence a manager's choice of fund domicile.

"The best situation for fund managers going out to speak to potential investors is when the fund's structure and domicile are not a topic of conversation," considers Lindgren. "Ideally, you want to pick a structure that your investors have already invested into before," she elaborates. "You may have a very new and interesting investment strategy that requires something different, and can justify a slightly different structure. But you typically want to pick a structure that investors are familiar with, where you have well-known service providers that raise no eyebrows."

MAJOR TRENDS

The Alternative Investment Fund Managers Directive (AIFMD) introduced in 2013 was one of the most significant changes to the regulatory framework around investment vehicles, including those focused on private markets. This directive led to the creation of the AIFMD marketing passporting that enables barrier-free access to all funds registered and domiciled in the European Union across the entire EU region. "The private capital space had been largely unregulated before the introduction of the AIFMD," says Kerstin Lindgren. "There wasn't a drive for regulation that came from the fund industry itself," she points out. "These days managers are, to a large extent, looking to launch funds that are in the scope of the AIFMD."

"Thanks to the AIFMD passport that comes with this increasingly well-known regulatory framework, managers no longer look to stay out of the scope of the AIFMD," Lindgren discusses one of the major trends related to the choice of domicile in the European fund industry. Another major trend is the democratization of private markets, according to Lindgren, referring to a development that is enabling smaller, non-professional investors broader access to investment opportunities in the often-inaccessible private market space.

"The popularization of what we call private capital is an important trend that we observe," says Lindgren. "Although there are still challenges to overcome, this democratization process enables broader access to illiquid alternatives and makes such an interesting group of asset classes more accessible for a wider range of investor types," she elaborates. High-net-worth individuals and private individuals, who may not traditionally have had the opportunity to invest in the asset class, are increasingly gaining access to investments that had previously been restricted to institutional investors and only the most affluent individuals and family offices. "We see more and more managers coming with offerings relying on fund structures with lower investment thresholds in an attempt to reach out to smaller family offices, private banks and investors."

THE GO-TO DOMICILES

Although Luxembourg has been a "go-to" domicile for real estate funds and private equity funds for decades, the Luxembourg Partnerships, the simple partnership (société en commandite simple, or SCS) and the special limited partnership (société en commandite spéciale, or SCSp), introduced in 2013 made the Grand Duchy an even more popular domicile choice. "Luxembourg put in place the limited partnership law in 2016 and that was really what was missing before," considers Lindgren. "The go-to structures for private capital managers before had been the UK and the Channel Islands." The Luxembourg Partnerships filled a gap in the Luxembourg domicile space.

Luxembourg Partnerships setup as RAIFs have become very popular private fund vehicles since their introduction in 2016 due to their flexibility – to invest in all types of asset classes – and agility – in going to market without prior approval by the CSSF. "The RAIF has been a very competitive vehicle, which combined with the fact that Luxembourg is such a well-known domicile brand all over the world, has increasingly made Luxembourg a go-to place for private capital managers," according to Lindgren. But there is a new Irish structure – Irish Limited Partnership (ILP) – that is also attracting some interest.

"Ireland is also a well-known domicile that is very well respected, and has a very strong industry," argues Lindgren. "The limited partnership, however, had been missing for a longer period," she emphasizes. "A differentiator that remains between the domiciles is the RAIF legislation, which has no equivalent in Ireland. Aside from that, the difference between Luxembourg and Ireland is more a matter of Ireland simply being a smaller domicile, a little bit less well-known depending on which investor segment you are looking at," according to Lindgren. "US and UK investors may be more familiar with the Irish domicile because of its common law system, not to mention the English speaking culture." European and Asian investors, meanwhile, may be more comfortable with Luxembourg because of their familiarity with this domicile.

"Even in the Nordic region, the preference for Luxembourg or Ireland differs a little bit across countries," says RBC's Director of Client Coverage in the Nordics. "We see, for instance, that Norwegian investors have a tendency to lean towards Irish structures, while Swedish, Danish and Finnish investors are going more towards Luxembourg," elaborates Lindgren. "These tendencies stem more from preference and experience rather than technical aspects and differences."

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WHEN TO LEAVE THE DOMESTIC SETUP BEHIND

For emerging private capital managers, choosing the right domicile and structure is a crucial exercise that requires looking well into the future. With a fundamental consideration in the choice of fund domicile representing the nature of target investors, there is little surprise in the fact that some Nordic managers opt for setting up their funds locally. Lindgren sees two main reasons for setting up a fund in the home domicile: reputation and simplicity. "One of the drivers to keep a fund at home has been the reputation of some offshore domiciles that are associated, rightly or wrongly, with the perception of tax avoidance," says Lindgren.

The other reason is simplicity. "Some managers choose a local structure they are more familiar with because they may feel they don't have the expertise to assess how a Luxembourg or Irish structure would benefit them, how it will affect the cost structure of the fund and how it should be set up," considers Lindgren. "As long as you have only local investors or international investors who, for various reasons, have already done the due diligence on local investment vehicles, and if you are not looking for investors elsewhere, you could choose your local structure and domicile," she argues.

But if managers want to reach out to foreign investors or think they might want to do that in the future, then often managers should choose Luxembourg or Ireland as a domicile from the get-go. "It is important to note that these structures are fully accessible to local as well as international investors, so it is a choice that poses fewer limitations for capital raising," says Lindgren. "If you want a structure where you only focus your time and efforts on your strategy by outsourcing the administration and all of those bits and pieces around, there is a good reason to go to Ireland or Luxembourg because there is such a big service provider selection."