Service provider teamwork now crucial to offshore fund appeal

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In an environment in which investors are less willing to take the honesty, investment expertise and operational efficiency of fund managers at face value, the interaction and collaboration of independent service providers is more crucial than ever to maintaining the appeal of offshore funds to institutions and other sophisticated investors, according to speakers at recent seminars in Zurich and Frankfurt on the outlook and opportunities for the industry in the wake of the financial crisis of the past two years.

The seminars, organised by international fund administrator Ifina and featuring speakers from service providers including law firms, auditors, banks, brokers and derivatives exchanges, as well as a leading offshore fund jurisdiction, sought to highlight how changes in market sentiment and the global regulatory environment are prompting the offshore fund industry to respond to the new requirements of both investors and supervisory authorities.

The offshore financial sector as a whole has found itself on the defensive amid moves by groups such as the G20 countries and the European Union that have insinuated – arguably quite wrongly – that it was at least partly to blame for the recent market turbulence and demanded greater transparency and better regulatory oversight of the industry.

In tandem, the Organization for Economic Co-operation and Development has led a drive to achieve global compliance with its standards of transparency and exchange of information on tax issues, to which offshore jurisdictions have responded by signing co-operation agreements with key onshore markets.

Yet offshore funds and the jurisdictions where the industry has made its home continue to appeal to managers and investors alike because of the tax neutrality that facilitates the pooling and deployment of capital by investors from different countries and subject to different tax regimes, a regulatory environment geared to the needs of sophisticated rather than retail investors, and the accumulated experience and expertise of offshore service providers.

“The tax neutrality of offshore funds is one of the most compelling factors,” says Simon Schilder, a partner with offshore law firm Ogier in the British Virgin Islands. “It means that the funds themselves pay no tax in their home jurisdiction, providing a level playing field for international investors.

“Another factor prompting the choice of an offshore jurisdiction is an appropriate level of regulation. Investors in offshore funds are typically institutions and high net worth individuals that are big enough and experienced enough to look after themselves. They don’t need the heavily regulated products that are typically set up onshore but prefer offshore products with a lighter regulatory touch. Finally, as a consequence of these factors, the expertise and sophistication of local service providers tends to perpetuate the use of offshore vehicles.”

According to Ifina director Derek Adler, the decision to highlight the qualities that offshore funds bring to the global investment market to professionals in two leading European financial centres was prompted by the scapegoating of the industry by politicians onshore. “There was a lot of wailing and gnashing of teeth directed particularly at offshore centres and hedge funds – blaming others in order to divert attention from being focused on some of the real issues,” he says.

“We decided that all of us had a duty and a responsibility to stand up for the offshore fund industry by organising a forum to review what went wrong during 2008 and how to avoid some of the obvious errors in the future. In addition, we wanted to give serious thought to some of the current proposals that might affect our industry. Some of the ideas under consideration make good sense, but others are clearly satisfying political imperatives without any real knowledge or understanding of the industry.

“It’s ironic that politicians in the US and Britain should complain about offshore centres when most of the scams and fraud in the industry have occurred in the US, because there are far less stringent rules in the first place and little monitoring thereafter. Moreover, it’s very irritating that offshore centres are portrayed as being just about tax and trusts. For example, the BVI runs a highly regulated and very efficient financial services centre. If anyone thinks that licences for mutual funds are just handed out on a plate, they are very much mistaken.”

One of Adler’s central themes is that the offshore fund industry can defend its international standing by emphasising the key elements that ensure probity and protection of investors, transparency, control and interfacing between the various third-party providers that serve the fund. One of the core elements is third-party administration, long a staple feature of the offshore world but which is only now being recognised as the ideal in North America.

“Many of the problems that have occurred with funds would never have happened had they been policed by a third-party administrator like Ifina,” Adler says. “This is being recognised by some of the larger banks, which now accept that administering their own funds can be somewhat incestuous and might cause problems at a later date.

“We are already undertaking administration for very large institutions, which is the sensible approach and demonstrates outside control for the protection of investors. Ifina reconciles the fund’s trading every day with the investment manager, the broker and the bank, and co-ordinates every aspect of the fund’s operations. We cross-check everything on a daily basis and are also the counter-signatory to the fund’s bank account.

“If something seems about to go wrong or seems at all out of the ordinary, Ifina will be the first to know. In that event, we will investigate and if necessary ring the alarm bell. We also insist that our calculations are audited. If a prospective client does not want to accept these conditions, we will not accept the client.”

For years the Cayman Islands have required that funds domiciled in the jurisdiction have a local audit sign-off, and the trend is spreading to other offshore jurisdictions. At present the BVI imposes an audit requirement only on public funds destined for the retail market, but this may be extended to professional and private funds, the categories into which most alternative funds fall, when the Securities and Investment Business Act replaces the existing Mutual Funds Act, possibly next year.

Already many new funds are opting to be audited even without the legal requirement, according to Nigel MacPhail, audit director at the BVI’s longest-established public accounting firm, Baker Tilly. “Transparency is the theme of the moment,” he says.

“If you look at recently-uncovered frauds perpetrated by the likes of Bernie Madoff and Arthur Nadel, either they weren’t audited at all, or the auditors were compromised in some way. In several cases the frauds only came to light when independent audits were demanded by other members of the board.

“All these scandals have highlighted the benefits of another set of eyes that understand the numbers, but the need is also greater than ever to pick up accidental accounting errors. It all ties in with the way the industry’s going in its attempt to become more transparent in using third-party service providers wherever possible, including administrators, auditors and others.”

MacPhail notes that auditors themselves are under pressure to ensure that they uphold the highest professional standards. “The International Ethics Standards Board for Accountants has issued a revised code of ethics for professional accountants that tightens the independence requirements for auditors,” he says. “These include the extension of partner rotation requirements and strengthening rules restricting the provision of other services by public auditors to their clients.”

Banks are also part of the new networks of co-operation required of independent fund service providers. “Now more than ever, there must be a more collaborative, proactive approach to ensure that banks and administrators deliver added value to clients and investors,” says Steve McCafferty, head of the Isle of Man-based intermediary and institutional wealth solutions team at Barclays Wealth.

He stresses that good communication between the respective specialist teams in banks and administration firms is critical: “It’s attention to detail that makes us both look good to our clients.” McCafferty adds that the banks also need to have confidence in their fellow professionals. “Barclays sees the biggest issue in the market as reputational risk, and we go through very thorough money laundering and due diligence assessments on the administrators,” he says.

“There are many crucial counterparties and professionals involved with new and existing fund structures, but the banker-administrator relationship should be a key long-term partnership that adds value to the business. Managers should be asking themselves whether this is the current experience they are getting from their banker and administrator, and if not, why not;

James Rowsell, managing director for Europe at MF Global, the derivatives brokerage that spun out from Man Group two years ago, argues that many of the changes being pushed by organisations such as the G20 are already taking place not as a result of legislation or regulatory fiat but because investor expectations are driving best practice among industry participants.

“A lot more transparency is required, involving not only fund managers but administrators and broker, which actually supply the real-time information required for functions such as valuation. The events of the past two years have led to the realisation that this was best practice, rather than it being mandated.”

A common factor in many of the problems that have come to light over the past couple of years, Rowsell says, is the weakness of governance structures – an issue that he argues should be addressed at the start, when a fund is being set up.

'Ideally funds’ governance should be spelled out in the prospectus or articles of association,” he says. “The governance structure should clearly define the roles and duties of the broker, the independent administrator and the fund manager, to ensure that the administrator can monitor all aspects of the fund.”

MF Global is more comfortable dealing with funds that have rules in place setting a maximum level of leverage and stop-loss mechanisms to halt or curtail trading beyond an agreed level of losses, and that this should be in the hands of an administrator with which the broker enjoys a good working relationship. “We deal with many new managers,” Rowsell says. “If we can talk with them about governance early on in the process of setting up a fund, we have a lot more comfort about taking the business onto our book.”

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