

Strongly placed for funds targeting European investors

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Talk about the elephant in the room. The Alternative Investment Fund Managers directive surely has the largest ears and the longest trunk of the species. For hedge funds and their advisers, no proposed law has ever had anything like the potential of this set of regulations to change the game. Or, more precisely, to dramatically restrict the parameters within which the game is played.

As Chris Bond, head of global banking and markets at HSBC in Malta, says: "In essence, the draft directive prevents non-European hedge fund managers from selling to European investors."

In other words, as the directive currently stands, there is a strong incentive for funds with or targeting European investors to move partially or wholly onshore. But is the AIFM directive actually starting to create a wave of redomiciliations and a move to Newcits funds (funds regulated under the Ucits kitemark that mimic many of the characteristics of hedge funds)? If so, will Malta be able to use its growing reputation to benefit from this shift in sentiment?

Tonio Fenech, Minister of Finance, Economy and Investment, believes it is too early to tell. "The directive has its good and bad provisions for business ,however, let's wait and see what the final version is." He is not convinced that Malta will be a particular beneficiary of any move onshore by managers. "Whether it is going to present an opportunity or a loss, it won't be solely for Malta but for the whole of Europe," he says.

Nevertheless, current Maltese regulation places it in a strong position to pick up redomiciled funds from the Caribbean and elsewhere. Joseph Saliba, a partner at Mamo TCV Advocates, says: "We have had redomiciliation legislation in Malta since 2002, and it is a straightforward procedure for both trading companies and funds to migrate."

A number of fund managers have already moved to protect their businesses. "Some funds have already taken action and have gone for a parallel structure, others have simply migrated onshore," says Saliba. "The majority are keeping their options open."

Aquila Group and its asset management arm Aquila Capital this year announced it would leave the Cayman Islands and move all its offshore operations to Malta. It cited the flexibility, robustness and cost effectiveness of the Maltese funds regime, as well as the threat of the AIFM directive to its marketing. Bond believes this is just the tip of a substantial iceberg. "There has been a significant increase in funds redomiciling here or looking to," he says. "We have never had such a large pipeline at HSBC in Malta of funds looking to redomicile, mainly from offshore centres."

There are barriers to redomiciliation though, particularly for smaller funds, as Nick Mahy, managing director of Praxis Fund Services, points out. "Redomiciling is happening, but the fund has to have at least \$100m for it to make sense in terms of the exit and entry legal fees. Many of the funds in Malta are in the sub-\$20m range, so Malta is not going to be a big beneficiary of this shift. " Mahy believes many would be better off setting up an entirely new fund and paying just £20,000-£30,000 in set-up fees.

Perhaps the bigger business opportunity for Malta will be the launch of an increasing number of Ucits hedge funds, or Newcits. They are allowed to use many , but not all, of the instruments and techniques employed by traditional offshore hedge funds, but carry the European Union kitemark, which ensures there is little problem marketing them either in Europe or anywhere else in the world.

"AIFM has been pushing people to look at Ucits as a refuge, leading to the Newcits concept," notes Simon Tortell, founder of Simon Tortell & Associates. "People have been coming to us saying they have a structure in the Caymans or Bermuda and want to know what will happen when AIFM is implemented. They may want to keep their Caymans structure but are looking at whether Ucits

funds can accommodate their strategies." Aquila has certainly embraced Newcits funds, recently closing the offshore versions of its Statistical Value product and migrating investors to a Ucits alternative without losing any of its main investors.

Tortell says that Ucits hedge funds not only have regulatory certainty but a larger universe of potential investors. He says: "Ucits has the added advantage in terms of free marketing within the EU through passporting rights under the EU legal framework, which is fully adhered to by Malta."

Nevertheless, Malta has a considerable disadvantage compared with Luxembourg and Dublin, which are the acknowledged specialist Ucits centres. As Tortell says: "We are at the stage that Ireland was in 1990 and Luxembourg in 1985." There are good reasons, though, for funds to launch both Newcits and redomiciled and/or mirror funds in Malta rather than in Luxembourg or Dublin. "Promoters are considering Malta because of the advantages of cost, available resources and the approachability of the regulator," says Saliba.

An added attraction of Malta is it is politically geared and geographically well-positioned to do business with North Africa and the Middle East. Saliba says: "European and overseas entrepreneurs have been using Malta as a stepping stone for doing business with the MENA region for a long time."

Tortell says interest in Newcits is high. "We are working on three new funds at the moment. They can be set up for just a handful of investors even though they were conceived as mass market mutual funds."

However, Malta will only enhance its attraction once it can boast a fuller complement of custodians: at present there is just a handful, including, notably, HSBC, compared to around 45 in Dublin. The island is making a concerted effort to attract more by hosting a series of conferences.

Fenech says: "There is currently no requirement in any domicile for hedge funds, particularly the Qualifying and Extraordinary Investor Regimes in which we have seen most growth, to appoint a custodian. However, this scenario is changing, with the AIFM directive possibly imposing a requirement for a custodian. I understand that our regulator has had discussions with a number of global custodians."

The issue could stall the Ucits bandwagon, according to Praxis. "Under Ucits, you need a local custodian and there are simply not enough here," says Mahy. "When there are, we could become a powerful Ucits jurisdiction and compete head-to-head with Luxembourg and Dublin."

But he admits attracting custodians is tough in the current environment. "You would have to be a good salesman within your company to justify setting up a new business here when existing custody services are already under pressure."

Nevertheless, an influx of larger custodians is likely to be critical as the provisions of the AIFM directive place smaller local ones under increasing pressure. Bond notes: "One of the consequences of AIFM in its current form is that the strict liability rule will be applied to custodians and depositaries. This will drive up the cost of custodian services and could lead to consolidation and even less choice for funds."

Whether large custodians are attracted to Malta or not, some doubt that Newcits actually represent a significant growth opportunity at all. "I am not convinced by the Ucits story," says Dermot Butler, chairman of Custom House Global Fund Services. While the Ucits brand has been wildly successful since it was launched in 1985, there are problems with extending it to quasi hedge funds, he believes. "You can't do true hedging like going long BP, short Shell," he argues.

Mahy agrees: "Hedge funds in Ucits strategies don't quite fit. Some will change their investment processes and parameters, but they are really trying to gather assets rather than improving performance."

In addition, the costs of setting up and operating a Ucits fund are higher than for the Professional Investor Fund. So European investors will be less impressed with returns than their counterparts in,

say, the BRIC countries, which are mainly being served by Cayman funds, Mr Butler says. He also questions whether Ucits actually provide investor protection, a big factor in their popularity. "The fact is that four Ucits funds invested in Madoff," he says "Crooks are only crooks because they break the rules. So regulations don't stop crooks, they just make it easier to convict them." In fact, he argues, investors in Ucits may be tempted to conduct less due diligence overall, believing too fervently in the brand. "Ucits does nothing to protect you from the incompetent manager," says Butler.

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Nevertheless, there will undoubtedly be further Newcits launches, more redomiciliation of funds and a steady stream of new launches of small funds. All of which will buoy Malta as its reputation and profile grows.

With the flexibility of its regime, it is poised to pick up market share whatever the final shape of the AIFM directive and of other future regulation.

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