

Smith review gives hedge funds sector fresh impetus

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The Isle of Man may trail some of its competitors as a domicile and servicing centre for hedge funds and other alternative vehicles, but the island's financial sector practitioners and regulators are convinced it is on the right track following an extensive review last year. This resulted in a revamp of its range of fund vehicles amid signs that the fund administration sector is continuing to win clients on the back of a reputation for high-quality and personalised service.

In addition, recent changes to the island's personal and corporate tax structure are starting to pay dividends by helping to attract fund managers to base all or part of their operations on the island, an ambition aspired to by many offshore financial centres. Isle of Man Finance, the division of the island's Treasury department responsible for promotion of the financial sector, believes the jurisdiction remains on track, despite the impact of the credit crunch, to reach its goal of USD150bn in fund assets under management and administration by the end of 2010.

The fund sector is a relatively new area of focus for the Isle of Man, whose financial services industry is better known as a centre for offshore life insurance and banking, and also as a domicile for companies listed on London's Alternative Investment Market. But since the launch of Professional Investor Funds in 1995 and Experienced Investor Funds four years later, the island has been gradually staking a claim to be a recognised hub for specialised fund products aimed at institutional and sophisticated individual investors.

From just USD7bn in assets in 2003, the fund industry now services an estimated USD60bn, including a growing volume from funds domiciled in other jurisdictions but administered in the island, as well as exempt schemes with fewer than 50 investors, whose overall volume can only be guessed at since they are treated as private arrangements that fall outside the regulatory ambit of the Isle of Man Financial's Services Commission.

The island has carved out a reputation for providing an alternative to Dublin, where many administrators of alternative funds have focused on large-volume business and are perceived to be less interested in specialist and niche products that require more individualised servicing. That said, the Isle of Man administrators are led by Fortis and HSBC, two of the largest providers of alternative fund services worldwide, able to draw on support for their local operations from expertise across their global networks.

With a population of 75,000 and an area of 225 square miles, the Isle of Man prides itself on having fewer constraints to growth than most island jurisdictions. A work permit system introduced three decades ago is now a pure formality, according to industry members, and the government has not seen the need for the type of segregated housing markets that exist in the Channel Islands. Instead, the island has plenty of room to accommodate economic expansion in the financial sector as well as other areas of the economy.

Indeed, the Isle of Man has flourished on many fronts in recent years, looking to carve out significant niches in areas such as online betting, film production and even satellite communications while reviving traditional activities such as tourism. The island has enjoyed 25 consecutive years of economic growth, and its gross domestic product has expanded by an average of 6 per cent over the past 10 years.

The development of the fund sector since the beginning of this decade has reflected a conscious effort by the authorities to broaden the base of the financial industry, which currently accounts for some 40 per cent of GDP, and which was perceived to be otherwise vulnerable to a slowing of growth in sectors such as the offshore banking industry.

A series of reforms in 2003, which simplified regulation of funds and removed value-added tax on

fund management and administration services, paved the way for the sector's sharp growth in recent years, but last year's report by a committee headed by Paul Smith, the former global head of HSBC's Alternative Fund Services division, was designed to set out a long-term plan to boost the size and scope of the business amid growing competition from other centres around the world.

'In late 2006, we concluded we needed to plan where we would be in three or five years' time,' says KPMG senior partner David McGarry. 'Which way was the market going, what were the market trends, which competitive jurisdictions should we benchmark against?' A cross-disciplinary fund industry review group including the regulator, the Treasury and key industry players and chaired by Smith, who was on gardening leave after leaving HSBC, presented its conclusions last spring.

'The report covered three main areas - regulatory and legal, education and training, and marketing,' McGarry says. 'The first challenge was to change the regulatory landscape for funds in the Isle of Man. We felt that the Experienced Investor Fund regime launched in 1999 had run its course, and it was time to rebase the structure of funds available here.'

Experienced Investor Fund could be launched without prior approval from the regulator and were subject to minimal product regulation so long as funds used a locally-authorized administrator. Since its introduction, the EIF has been the fastest-growing category of funds domiciled on the island, representing 23 per cent of total assets at the end of September 2007 and numbering nearly 140.

Following publication of the report in the autumn, legislation putting in place the new structure was passed last October, establishing the Specialist Fund and Qualifying Fund for institutional and sophisticated individual investors. 'The new Specialist Fund is aimed at high net worth, institutional and pension fund investors and is very close to the equivalent Cayman fund,' McGarry says. The regulator currently lists four Specialist Funds and one Qualifying Fund.

Brian Donegan, director of foreign direct investment for the Isle of Man government, says the new structures offer a wider range of opportunities for asset managers. 'They can now upgrade their EIF to a Specialist Fund, which is aimed at institutions and high net worth individuals and requires a USD100,000 minimum initial fund investment,' he says. 'The Specialist Fund offers more flexibility in management and administration, no restrictions on investment strategies, and only light regulation.'

The urgency of making the island more attractive as a fund domicile was that the non-domiciled funds that traditionally have accounted for much of the Isle of Man's fund services activity could not necessarily be relied upon for the long term. 'There is no time to waste, with business conditions set to become tougher over the next couple of years,' Smith said at the time. 'Up to now non-domiciled funds have made up the bulk of the island's business, but these funds may not be 'sticky'.'

McGarry notes that efforts to encourage the growth of the administration sector have already borne fruit, with the number of service providers on the island now approaching 20 and more in the pipeline. But the authorities are equally encouraged by the progress already made toward attracting fund managers to establish all or part of their business in the jurisdiction.

'Another main thrust of the recommendations was to move the Isle of Man up the value chain and encourage fund management operations to establish here, and particularly to get hedge fund managers to put their front and middle offices here,' he says. 'Why would they do that? There are fiscal reasons with zero tax, along with the attack that some London-based managers have been under from HM Revenue & Customs. The whole residence and domicile debate over the past few months has played toward us as well.'

The standard personal income tax rate on the island ranges from 10 to 18 per cent, with a GBP9,200 personal allowance, and there is a cap on the amount of income tax payable by individuals of GBP100,000 a year. Meanwhile, the corporate tax reform launched in 2006 - prompted by the European Union's insistence that the island abolish the fiscal distinction between ordinary and exempt companies - has resulted in a standard zero rate of corporate income tax except for banking, land and property businesses, which pay a rate of 10 per cent.

McGarry argues that just as important as the legislative and regulatory structure are the island's

efforts to ensure it has the skilled personnel available to service business coming into the island: 'Education and training is a challenge, as in all jurisdictions, to ensure the island has available an experienced and qualified labour force to meet the growth demands of the sector.

'New courses are being introduced at our college and business school specifically to address the needs of the fund industry, and to provide vocational training for people already employed in the sector or in other parts of the financial services industry. This is clearly a long-term project. In the three- to five-year horizon, we expect employment in the funds sector to double from about 1,150 at present.'

As head of the marketing committee of the Isle of Man Fund Management Association, McGarry is also concerned about getting the message out about what the island has to offer. 'We have now set in place a series of initiatives to get the Isle of Man name up in lights, for example as a sponsor of hedge fund forums and conferences,' he says. 'We've also organised round-table events in London and New York involving the chief executives of hedge fund groups, to providing thought leadership on key industry topics but also subliminally to boost the Isle of Man.'

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