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Fund Domiciles and Regulation

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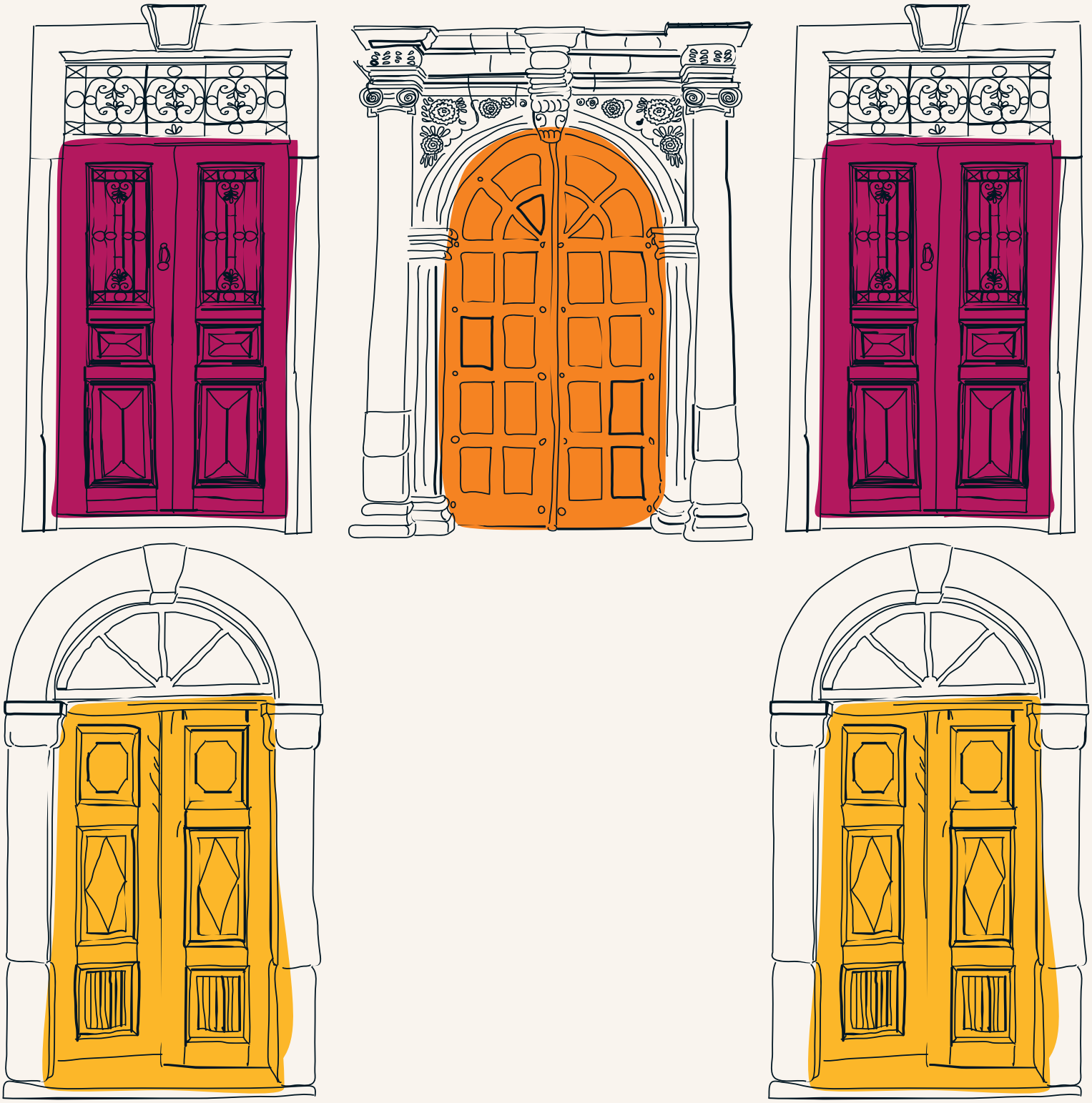

KEYNOTE INTERVIEW

Luxembourg's rolling stone gathers momentum

The Grand Duchy continues to emerge as a strong jurisdiction for managers looking to access European capital and assets, says Nils Mordt of RBC Investor & Treasury Services

With a population of 626,000 people, Luxembourg punches far above its weight in the world of private fund management.

Nils Mordt, director, global client coverage, United Kingdom, at RBC Investor & Treasury Services, explains how factors, including international tax reform, Brexit and the Grand Duchy administration's savvy positioning to capitalize on the regulatory regime introduced under the Alternative Investment Fund Managers Directive (AIFMD), have established Luxembourg as the domicile of choice for European real estate investment and investors.

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Q What trends are you observing in fund domicile choice globally?

Delaware, the Cayman Islands and Luxembourg remain the dominant locations for domiciling private capital funds, particularly real estate funds. Luxembourg has made great strides in gaining market share in the last few years, but it still has some way to go to catch up with Delaware and Cayman, which will likely remain the first choice for most US managers. We see Luxembourg utilized for raising European capital and/or for investing in Europe more easily and efficiently, for funds regulated under AIFMD. Due to the recent political and economic uncertainty, managers have tended to focus on established jurisdictions where they can engage a breadth of service providers with required experience and expertise and access an ecosystem of centers of influence.

Over the past six months the tightening of base erosion profit shifting (BEPS) rules has prompted investors to seek clarity from jurisdictions on the stability of their tax treaties. Luxembourg has benefited due to its clear tax rules and a variety of vehicles available that allow different tax treatments to be put in place. Regulators in Luxembourg and Jersey have been forthright in providing clarity on what is acceptable and what the situation is likely to be in those jurisdictions going forward.

Managers raising capital in North America are most likely to domicile funds in Delaware. However, if they are looking to expand their investor base by accessing European capital then the trend has been to develop increasingly complex structures that involve a parallel fund in Luxembourg, which runs as the same strategy as the main fund. The parallel fund provides their US investors with European exposure while making it easier for European capital to deploy into the structure. It is less common for European managers to launch a fund in Luxembourg and a parallel vehicle in Delaware. On the whole, if they are looking to attain capital from US investors, they establish feeder structures in Delaware instead.

Recently we have begun to see Asia-Pacific-based managers which are relatively new investors into regulated private capital funds, choosing Luxembourg, given its track record and regulatory framework to set up funds or parallel structures. It is important to note Singapore has introduced its Variable Capital Company (VCC) structure, which may appeal to some APAC investors looking to stay local.

Getting the big-data picture

The onus has increased on fund administrators to provide detailed asset-level information to managers, observes RBC I&TS's Nils Mordt

Investors are committing more of their capital to private markets and are increasingly keen to understand how their investments are performing with the touch of a button. This has led many investors to exercise greater scrutiny on domicile fund structures and asset-level performance data. For administrators, that means providing technology solutions that deliver standardized reporting in spite of the increasing complexity of fund structures.

Administrators working with service providers that are able to integrate multiple data sources to provide a full picture of asset performance all the way to the fund structure via data visualization screens or access to platforms and portals will have a competitive advantage. This shift will include a transition from administrators providing large multi-page reports to self-serve and on-demand access to data, including management information (MI) or asset-level data.

Q To what extent do investors influence managers' domiciliation decisions?

Investors had little sway over choice of jurisdiction five years ago but as of late they have been exercising more influence. Investors that previously focused heavily on allocating money into liquid markets are now increasingly committing capital to private capital funds and are demanding a seat at the table when making domicile choices. They tend to have a lot of confidence in sizable and well-known managers which have a strong track record to make decisions about structures and jurisdictions on their behalf.

Investors have the opportunity to exercise more choice when smaller boutique managers are looking to raise capital, investors can exercise more choice, or at least expect to be kept informed on why a domicile has been chosen. As a service provider, we do not directly influence the choice of domicile, but we are frequently asked by our clients what our experience has been in a jurisdiction. For them it is important that we have in-depth knowledge and a strong standing in that market so we can help them access the local service provision ecosystem.

Q Luxembourg has been growing in popularity among private real estate fund managers. What are the key attractions of the jurisdiction?

Luxembourg has experienced a 'rolling stone' effect as major players, whether European or US-based, establish structures in Luxembourg. This helps the jurisdiction win more business as investors and managers coming into Europe emulate what they are doing. The established fund management ecosystem in Luxembourg makes it easier to access local legal knowledge and connect with third-party management companies and individuals at the big four accountancy firms. It is a jurisdiction that has been in business for many years which translates to a breadth of talent within the principality but also attracts from the surrounding countries. Pre-covid-19 it was easy to set up a face-to-face meeting with people with a strong understanding of the structures available and the private capital requirements.

Luxembourg also offers a range of toolkits that enables speed to market for a range of fund requirements so managers are able to launch private fund structures within a matter of a few months. Previously it might have taken nearly a year to create a structure. That speed to market is something Luxembourg has really enhanced over recent years by showing the flexibility and pragmatism needed to launch new vehicles which do not just emulate the offering available in other jurisdictions but actually improves it, such as the Reserved Alternative Investment Fund (RAIF) and special limited partnership (SCSp).

In doing so, Luxembourg has stolen a bit of a march on other jurisdictions in terms of AIFMD-compliant structures. The large number of RAIFs that we have created and launched with managers shows that as an unregulated multi-purpose structure it has really hit the market's sweet spot, while the commitment the principality has made to grow its alternative funds and private capital business, and the training available to keep talent coming through, gives the bigger managers confidence that they will be able to successfully operate and grow in the long term.

> *"Delaware, the Cayman Islands and Luxembourg remain the dominant locations for domiciling private capital funds, particularly real estate funds"*

Q How is Brexit favoring the establishment of Luxembourg-domiciled vehicles?

We are still in a wait-and-see phase for Brexit and although every manager is different, some prefer an Irish or Jersey vehicle. However, UK managers that have existing offshore funds and want to maintain exposure to Europe have been attracted to Luxembourg as an easier domicile choice. In a situation where Brexit has created uncertainty, regulation in Luxembourg provides clarity on the legal framework around structuring and operating Alternative Investment Funds (AIFs) and the corporate governance requirements of the management company.

Luxembourg has clearly outlined the procedures that are required to manage and launch funds, and that provides comfort to managers. In Luxembourg they know what they are going to get. In the face of Brexit, UK managers looking to invest in UK property with aspirations of raising money from European investors still remains a decision to be made. Some may favor sticking with the UK structures that they know and bring in European investors through feeders in Luxembourg, Jersey or Guernsey. We are seeing some of the UK managers holding back on fund launches, not just because of covid-19, but also because of the ongoing uncertainty over whether passporting arrangements that allow UK funds to market to European investors will persist after Brexit.

However, some strategies are built on the back of investments in key assets and if those transactions cannot wait then the decision has usually been taken to set up a Luxembourg structure.

Q What factors will influence domicile choice in the post-covid market?

The outlook is positive for private capital markets. Research shows robust investor appetite for real estate, infrastructure and other private capital asset classes like private debt. While investors may be slowing down their commitments because of covid-19, evidence suggests they will be investing more between 2022 and 2025. We expect to see that allocation growing given the increasing pressure to match returns with liability curves and volatility in public markets.

With all of the market noise generated by covid-19 and by geopolitical turmoil, investors are looking for stability, therefore the big three domiciles are likely to remain popular. Stability in the wider market may not be guaranteed, but those jurisdictions and Luxembourg in particular have weathered the pandemic well so far with business continuity planning enabling activity to continue with most professionals working from home. ■