

# Adding an offshore vehicle to your fund structure

*Philip Graham, of Harneys, examines how managers can bolster their service provision*



**I** write this article just after Hedge Fund Research Inc. announced that Q1 2019 was the strongest quarter for hedge funds in almost a decade. Managers returned 5.9% on a fund-weighted basis, with the very traditional long-short strategy leading the pack with a gain of almost 8%.

Clearly, while high fives are being handed out in some areas, the cynics immediately point at the S&P returning 14% through March; it is probably fair to say that this actively shows a slight reluctance for managers to return in full to stocks and shares after a brutally volatile 2018.

However, there is absolutely no doubt that high-net-worth individuals, family offices, and institutional investors alike, are back and squarely looking to allocate this year.

So with that in mind, I wanted to address one of the most common scenarios we encounter, a US-based manager who initially (and very logically) established a domestic fund to attract US taxable investors. With



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the performance and track record going in a very healthy direction, the manager begins to turn their attention to US tax-exempt investors, such as charities, pension funds, and university endowments, as well as investors based overseas, who like the strategy as set out in the pitch book and want to invest.

However, to avoid potential US tax exposure that could result from direct investment in a US pass-through entity such as a US limited partnership or US limited liability company, US tax-exempt and non-US investors will want to come into an offshore "blocker" vehicle and that's where we very much enjoy speaking to managers and discussing the plethora of options available to them.

In the interests of brevity, let me quickly highlight the two most common structural options selected, which are the master-feeder and the mini-master.

## **The establishment of a master-feeder structure**

In the master-feeder structure, we would create two new vehicles, an offshore feeder and an offshore master. The existing US fund will then contribute its assets into the offshore master upon the launch of the new structure, and the offshore master will make all of the investments on behalf of both feeder fund vehicles from this point forward, creating a collective investment offering in the most tax efficient manner.

If we are asked which jurisdiction it should be domiciled in, there is absolutely no doubt that the Cayman Islands is the global jurisdiction of choice for investment funds.

There are more than 10,000 funds registered in the Cayman Islands (with probably a similar number of unregistered funds). The financial

services industry in the Cayman Islands is highly developed and there is a deep bench from which managers can choose their Cayman service providers. With over 30 years of servicing the funds industry, the Cayman Islands have grown through innovation and forward-looking policies which have served as models in other jurisdictions. The Cayman Islands Monetary Authority (CIMA) promotes a pragmatic regulatory environment for investment funds and the courts of the Cayman Islands have a specific financial services division, which allows for quicker resolution of fund disputes than some other notable onshore centres. A quick launch and registration process for investment funds and fund managers, which is noticeably robust, allows managers to get their offshore fund and management vehicles up and running quickly to take advantage of market opportunities. Most importantly, a Cayman Islands feeder fund will be recognised and accepted by every type of investor throughout the globe, which means one less question on those pesky DDQs.

### **The mini-master alternative option**

That said, we do hear very regularly from start-up and emerging managers that they feel the price point for going down this route is too prohibitive. They are faced with the classic 'chicken and egg' issue; they need an offshore vehicle to begin expanding their marketing focus, but do not want to undertake the cost of establishing the structure unless at least one significant investor is in place to justify imposing the additional cost upon their existing AuM. Although this structure could also be established in the Cayman Islands, to maximise cost savings, the British Virgin Islands (BVI) could be the perfect solution.

There are a number of reasons why the BVI would be the right jurisdiction for the manager to domicile their offshore fund and over 5,000 funds have chosen to have their home in the BVI. Like the Cayman Islands, the BVI is a tax neutral jurisdiction which is perfect for any type of investment fund vehicle. The laws of the BVI and the Cayman Islands

are derived from English common law principles and supplemented by bespoke and cutting edge local legislation, ensuring that BVI funds are also widely accepted vehicles on the international stage and still the second most common in the global marketplace.

There are two primary reasons we see managers elect to use the BVI; firstly, it is undoubtedly more cost effective to establish a fund in the BVI than the Cayman Islands, and secondly, there are also more flexible regulatory requirements, for example, the lack of a local audit sign-off or a directors registration process. In

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the era of heavily enforced AML policies and procedures, the BVI is also a true leader in its legislation, with a recently enacted set of laws to enable biometrics to be used to collect personal information from prospective investors, rather than the traditional and much more cumbersome paperwork process. We are proud to say that Harneys has already established an app to cater for clients who are interested in this technology. The BVI remains appealing to our long-standing institutional managers and there are a large number of master-feeder structures in the BVI as well. Nevertheless, for all of the reasons set out above, the BVI mini-master is extremely attractive to start-up and emerging managers who are looking to find cost savings and flexibility in every aspect of their launches, allowing them to grow their asset base as quickly as possible without being burdened by unnecessary cost.

In a mini-master structure, we only need to create one new offshore vehicle (again saving cost, both on formation, but also in terms of upkeep) which invests directly into the existing US fund. This domestic vehicle will now act as the master fund for the US non-taxable

and foreign investors but will also remain as the fund into which the US taxable investors will continue to invest. This provides two additional obvious benefits; firstly, the existing US-taxable investors will not need to be moved, and secondly, the existing assets of the domestic fund can also remain where they are. Both of these factors vastly reduce the administration around the restructuring and therefore reduce the cost as well. Whilst there are some tax consequences to be discussed around the use of this structure, it has proved to be very appealing to those looking to dip their toe in the waters of offshore vehicles.

With that in mind, the BVI has a regulated vehicle called the 'Approved Fund' which is precisely designed to allow for a lightening quick mini-master structure to be established, in some cases, in a matter of weeks from the initial instruction. The existing administrator can be appointed over the new offshore vehicle as well, and it is not required to be audited under BVI law, again possibly saving additional cost (although this might be something that the manager is required to do by US regulations, or investor demand).

### **Conclusion**

While there are many other options available to a US manager in this situation, both of these cover a large segment of the market and should give anyone reading this article a great platform to begin their discussions with their US and offshore legal service provider. One aspect that should be noted though, as a final point, is that if consideration is being given to marketing into the EU, the manager will need to seek advice on the marketing restrictions within this region. While both the Cayman Islands and BVI vehicles continue to operate under the long-standing EU national private placement regimes, managers need to be very clear regarding their EU marketing strategy. With that in mind, we are very proud to announce that Harneys has opened an office in Luxembourg, which is undoubtedly the pre-eminent European funds jurisdiction and has a wide range of structuring solutions for a manager looking to attract EU investors. **HFM**