Starting an Offshore Fund

By Hannah M. Terhune, Esquire 2008©
Capital Management Services Group

Many countries are competing against each other to provide the best playing field from a legal standpoint for private investment (hedge) funds. For a new, low budget offshore fund, Anguilla or the British Virgin Islands and not the Cayman Islands may well be the best choice. While many countries have increased services to meet the rising need for offshore funds and companies, the lawyers, fund administrators, and accountants in the better-known countries have also increased their fees significantly in the past few years. There is increased use of offshore companies and offshore banking services to protect against identity theft and the loss of wealth due to the global decline of the U.S. dollar. Many are surprised to learn how easy it is to operate offshore.

Experienced investors are not as worried about where the fund is located as you may think. Funds tend to be formed in countries that are relatively interested in helping them set up (meaning that they have good laws and a good reputation as a country to associate with) and operate without a lot of initial and residual expense. Always remember that the domicile of the fund need not be the same as that of its administrator and custodian. In our experience with fund organizers, it is their inexperience with international business formations and bank regulatory matters that causes the most problems in terms of starting and launching the fund in a timely fashion.

For all the rave about the Cayman Islands, it is important to keep in mind that it was a blacklisted country until 2001, about the time when it hired a lobbyist and a public relations firm in the United States to delete the American perception that it was a hotbed of money laundering. In recent years, Cayman representatives have "visited" the SEC, the Senate Banking Committee and the Vice President to promote the image that it is a law-abiding, well-run version of "Delaware." However, it is home some very recent and high profile fund disasters and the 700 or so Enron secret companies. In short, it hosts as much financial crime as the next country.

Best Location for an Offshore Fund. The short answer is no one place is best. You can form an offshore fund in any location that make sense and is affordable. There are many areas of the world that are considered prime offshore centers. The most widely used (and most expensive) locations are Bermuda, the Cayman Islands, Guernsey, Hong Kong, the Isle of Man, Jersey, Luxembourg, the Mauritius, Singapore, and Dublin. These locations provide a welcoming climate for funds in terms of the ample (and pricey) supply of sophisticated lawyers, bankers, and consultants offering legal and accounting advice. To appease the United States and the OECD, many of these jurisdictions have enacted "heavy handed" regulatory schemes which renders the costs of establishing and maintaining a fund in these countries prohibitive to all but the very wealthy.

Anguilla and the British Virgin Islands maintain a minimal regulatory scheme and the costs of establishing and maintaining a hedge fund in these countries are low. These countries (and other offshore financial centers) are no different from Delaware in terms of what they offer a business.

Why Setup Offshore? Many investment fund managers want to know when the time is right to set up an fund? It is best to ask and answer a series of questions: Where are your investors located and what matters to them? If you have a suitable investor base then the time is right to set up offshore. Consider setting up an offshore fund if you manage money for clients outside of your home country. It is that simple. Why would an invest or that does not live in your home country want to pay taxes there (or have to worry about paying taxes there)?

For U.S. based fund managers, also consider setting up an offshore fund if your U.S. investors are tax-exempt person (for example, retirement accounts, pension funds, etc.). Under U.S. law, Tax-Exempt Persons (TEP) investing in a fund that borrows money to trade or generate investment income become taxable on such investment (or trading income) as Unrelated Business Taxable Income (UBTI), despite the TEP's otherwise tax-exempt status. The exposure to UBTI can be managed in many cases by investing in certain types of offshore funds.

Offshore Planning Trends in 2008. As a result of a "tweak" to its laws in November 2006, the Cayman Islands quietly become a much less attractive place to form a small offshore fund (meaning less than $10 million of seed capital). Anguilla (a country near the Cayman Islands) assumed that honor. However, in July 2007, the Cayman Islands again changed its law. Despite the law change published in the Cayman Islands on August 6, 2007 as the Mutual Fund Law (2007 Revision), Anguilla (and the British Virgin Islands)remain one of the best places to start a private offshore fund.

Anguilla. Anguilla enacted its current Mutual Funds Act in 2004. As a country, it offers a low-cost and efficient regulatory environment for private investment funds. The laws of Anguilla allow for three (3) types of investment funds, two (2) of which are important to fund managers starting a small offshore fund (in our experience). Those types of funds are the Private Fund and the Professional Fund. The laws of the Cayman Islands allow for four (4) types of investment funds, two (2) of which are important to fund managers starting a small offshore fund (in our experience). Those types of funds are the Category 4(3) Fund and the Category 4(4) Fund.

Comparison of Mutual Fund Law in the Cayman Islands with that of Anguilla. Below is a modest comparison of the legal landscape of Anguilla with that of the Cayman Islands.

Anguilla Private Fund versus Cayman Islands Category 4(4) Fund

Minimum Investment/Subscription. In Anguilla, there is no minimum subscription amount for investing into a Private Fund. The same is true of a Category 4(4) Fund in the Cayman Islands. However, in Anguilla, a Private Fund can have 99 investors while in the Cayman Islands, a Category 4(4) Fund is limited to 15 investors (all of whom can vote to remove you as operator of the fund).

Audit Requirements. Neither country requires an audit nor the preparation of a prospectus; although most fund operators do so as a matter of practice.

Number of Investors in Fund. In Anguilla, a Private Fund can have up to ninety-nine (99) investors. In the Cayman Islands, a Category 4(4) Fund) is limited to fifteen (15) investors. In Anguilla, investors have no vote in the matters of a Private Fund. You can remain in control of the fund. In the Cayman Islands, you could lose control of a Category 4(4) Fund as investors have voting power sufficient to remove you as the fund's operator.

Anguilla Professional Fund versus Cayman Island Category 4(3) Fund

Minimum Investment/Subscription. In Anguilla, a Professional Fund requires a minimum investment of USD $100,000 (or its equivalent in any other currency). The $100,000 limit does not apply to an investment made by the fund's manager, administrator, or promoter. In the Cayman Islands, a Category 4(3) Fund requires a minimum investment of USD $80,000 and this requirement applies to the fund's manager, administrator, or promoter. Prior to August 2007, a Category 4(3) Fund also required a minimum investment of USD $100,000.

Audit Requirements. A Professional Fund in Anguilla is not required to submit audited financial statements annually to the government. A Category 4(3) Fund in the Cayman Island is required to file the fund's current prospectus with the government, pay a substantial annual registration fee and file a financial schedule. A Professional Fund in Anguilla is not required to issue a prospectus, albeit, most usually do as a matter of practice.

Number of Investors in Fund. Neither the Professional Fund nor the Category 4(3) Fund has any size restriction (but only a minimum subscription amount as stated above). In Anguilla, a Professional Fund is open to "professional" investors, generously defined in Anguilla as a person whose ordinary business involves dealing in investments or who has signed a declaration that he, whether individually or jointly with his spouse, has net worth in excess of USD $1,000,000 or its equivalent.

In Anguilla, a fund may be in the form of an Anguilla domestic company, international business company, limited liability company, limited partnership, partnership, unit trust or protected cell company, protected cell accounts, segregated portfolio company, or segregated portfolio accounts. The corporate entities are extremely useful because they allow for the issuance of series or classes of shares with different rights thus allowing for the creation of umbrella funds and master/feeder structures. The use of an Anguilla domestic company also allows for the use of companies limited by guarantee and shares, as well as private companies.

Always remember that the domicile of the fund need not be the same as that of its administrator and custodian. A fund's service providers can hail from the other side of the world. Moreover, the service providers' location usually is the more important issue.

Why Setup a Fund? Market conditions have never been better for setting up a fund. Investors prefer to have money managed on a personal basis. Investors are trending away from Wall Street and heading toward "Main Street" when looking for help with their portfolios. It is no small secret that customized funds have taken up residence on Main Street and are attracting investors in droves. Traders that only dreamed of making a living by managing money for others are turning those dreams into reality for themselves.