
Reviewing the private equity model in the new financial world

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How specialist financial
centres compare



Executive summary

In the new financial world that's followed the credit crisis, financial services companies including private equity are making sure that they're fit for the more regulated, transparent environment. New regulations and tax scrutiny have triggered these reviews. But intense political pressure has added the threat of reputational risk.

As pre-credit crisis funds reach maturity, private equity firms are launching new funds and reassessing the construction of their investment vehicles – including the advantages of centres historically called 'offshore'.

But when making these assessments, we believe that it's no longer useful to describe centres as 'onshore' and 'offshore'.

Increasingly uniform regulation and tax transparency have made this distinction too crude. It's more appropriate to think of specialist international financial centres, which have evolved to serve niche financial sectors, and to compare them according to their respective merits. The only sense in which some remain 'offshore' is that they're islands.

The obvious questions are: Do the historic benefits of the largest specialist private equity centres remain? Or have today's regulatory, fiscal and reputational changes shifted the balance in favour of other jurisdictions?

Our analysis shows that the most progressive specialist private equity centres, on balance, still give Limited Partners (LPs) and General Partners (GPs) a distinct advantage -- taking regulatory, tax, reputational and practical considerations into account. But this depends on selecting a forward-looking centre that's working closely with all relevant governmental and inter-governmental organisations, across the European, US and BRIC regions, to offer transparency and to adapt to the evolving regulatory and tax environment.

When judging the merits of one jurisdiction over another, private equity firms rightly put their investors' needs first. In the tough fund-raising climate, investors call the shots and this is unlikely to change. For investors, the best specialist financial centres offer tax neutrality and regulatory flexibility, which will allow them to market into Europe without suffering a disadvantage when seeking investors in the US or BRIC markets.

The most forward-looking specialist centres have moved quickly to adapt to the changing international regulatory and fiscal environment – seeking to balance the concerns of inter-governmental associations with the needs of the private equity industry and its investors.

In our analysis for clients – which we have sought to keep objective – we have concluded that for almost all private equity firms the most evolved specialist centres such as Guernsey and Jersey remain the best option.

Having moved quickly to adapt to regulatory and tax changes since the 2008 crisis, the Channel Islands rank as specialist centres that differentiate themselves through offering private equity the flexibility to operate in the emerging multi-polar global market. In this global market, private equity managers need the flexibility to adapt to the rise of the fast-growing economies of South America, Africa, Asia and the Middle East, both to make investments and to market to their fast-growing sovereign wealth funds.¹

Our paper examines how jurisdictions compare in the post-credit crisis world, and sets out how the Channel Islands measure up.

¹ Rise and connectivity of the emerging markets (SAAME), 2012. PwC Project Blue.

The context

Private equity's place in the post crisis world

Governments are tightening regulation of private equity and increasing tax scrutiny. In doing so, they've the backing of public opinion, which fervently believes the financial sector doesn't contribute sufficient economic value to society. In Europe, the collision of Anglo-Saxon and continental European socio-economic models has fed criticism. But even in the US, the 2012 presidential campaign has focused specifically on private equity's socio-economic value.

The European Union's (EU's) Alternative Investment Fund Managers Directive (AIFMD), which is being introduced from July 2013, potentially has far-reaching implications for all aspects of private equity managers' operations. Across the Atlantic, the US Dodd-Frank Wall Street Reform Act will force managers to register with the Securities & Exchange Commission (SEC) during 2012. Both regulations substantially increase managers' compliance obligations.

Governments around the world are also seeking to increase their tax revenues at a time of crippling public sector deficits in the West. Notably, the US Foreign Account Tax

Compliance Act (FATCA) has been introduced to clamp down on US nationals seeking to avoid tax on US-sourced income, with implications for financial services companies worldwide. But also, some national tax authorities are seeking to make sure that all resident entities are paying tax. So, in cases where investment funds' operations stretch across several jurisdictions, they're beginning to challenge tax structures.

In this politically charged atmosphere, and as regulations and tax practices evolve, the facts regarding private equity's actual contribution to economies are often overlooked. In Europe, private equity firms are funnelling billions of Euros every year into businesses at a time when bank loans, the traditional source of funds, are hard to come by. According to the European Venture Capital Association:

- Private equity and venture capital firms raised €40bn in 2011 for investing in European companies
- In total, €45.5bn was invested in European companies during the year

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- 85% of the European companies backed were small-to-medium sized enterprises, and nearly half of them employed less than 20 people.

What's more, the industry is moving to embrace 'responsible' capitalism, acting as a pioneer for others to follow. In a recent PwC survey, 94% of private equity respondents stated that they believed environmental, social and governance improvements created value in their portfolio companies.² Private equity firms are using ESG factors as a way to differentiate themselves and gain access to capital.

Forward-looking specialist financial centres are adapting to the new regulatory and taxation world. From a regulatory perspective, the AIFMD lays down specific conditions that jurisdictions' regulatory authorities will have to meet if they want to continue to be recognised as bases from which alternative investment managers can market into the EU.

Some jurisdictions will find it harder to meet these conditions than others, simply because they have let funds operate largely unregulated to date and the change might be too great.

Indeed, the overall effect of the new world will be to increase private equity managers' administrative operations within offshore centres, as both regulators and tax authorities want to see more evidence of 'substance' in their local activities. Factors such as the transparency of tax affairs and quality of regulation are becoming more important. But also tomorrow's offshore jurisdictions will have to have solid infrastructures of skilled professionals, who can perform the functions increasingly needed at a reasonable price.

² Responsible investment: creating value from environmental, social and governance issues www.pwc/sustainability.com March 2012.

Comparing International Finance Centres

We are helping several private equity firms to assess which jurisdictions will serve their needs best, either for their GP or for a particular fund. In doing so, we are balancing the full range of factors that affect their interests – and crucially those of their investors.

The range of factors is:

- Tax neutrality
- Progressive regulatory position
- Governance
- Infrastructure & geography.

Each private equity firm will award different weightings to different factors, depending on its specific set of circumstances. But in the eyes of private equity investors, which ultimately wield the power in the private equity industry, strong governance and tax neutrality are the most significant factors. Evidently, taking a proactive approach to adapting to AIFMD is also important.

In particular, we found those specialist financial centres emerging as the most attractive in the new world have adapted their historic tax and regulatory ‘neutrality’

to the new environment. This is viewed as a significant advantage. In particular, investors value the tax neutrality of LP structures, which allow them to be taxed wherever appropriate depending on their own specific circumstances.

But the practicality of operating from specialist centres is also critically important. Private equity firms want to be based in locations only a short distance from major regional financial centres such as London, with reputable governance regimes, strong service infrastructures and low costs.

i. Regulation

Changing regulation, and especially Europe’s AIFMD, is one of the main catalysts making private equity firms re-evaluate their business architectures. The AIFMD presents a significant challenge to private equity firms – potentially preventing them from marketing to European investors unless the jurisdictions they’re based in comply with the directive’s key conditions.

Once the directive has been implemented in July 2013, private equity firms will have to choose whether to market within the EU using the partial ‘private placement’ or full ‘passport’ method. The latter gives unfettered access to Europe’s investors but on the condition that private equity firms make changes that reach to the core of how they run their businesses. The former involves far fewer changes, but firms will likely have to register in each of the countries where they wish to market.

Some finance centres are taking a ‘dual approach’ that gives private equity firms flexibility. This means private equity firms will have the choice of marketing in Europe through private placements, or through a full passport when these are available to non-EU countries from 2015.³ When marketing in the rest of the world, they can remain as they are.

Different private equity firms are likely to select different regulatory routes to market, depending on their priorities. Applying for a full passport would involve far-reaching

³ Passports are likely to be in place from 2015 for third countries (i.e. those outside the E.U.). The European Commission will review the private placement regime in 2017 to see whether it should remain in place, or whether all jurisdictions should move to the full passport from 2018.

changes in a private equity firm’s operations, for example leading to the establishment of a dedicated risk management function and disclosure of senior executive remuneration. But some institutional investors might make AIFMD passports a pre-condition for investment, taking the view that they wished to invest in a regulated product. By contrast, funds marketed through private placements might have lower fees, reflecting the lower costs of not having to comply with the AIFMD, and more investment freedom. Some private equity houses are already offering both options to investors when raising a fund.

The Channel Islands are also an attractive jurisdiction for registering with the SEC under the Dodd-Frank act. Most private equity firms based outside the US will register as Exempt Reporting Advisers, and the Channel Islands effectively allow them to do so without adverse tax consequences.

Considerable uncertainty still surrounds the issue of regulation and especially the AIFMD. The finance centres with governments that work closely with the EU’s respective regulatory bodies to make sure that everything is in place as the Directive is implemented, will give greatest confidence to promoters and investors.

ii. Tax

Tax collection has become a politically charged issue, causing some private equity firms to re-examine their tax structures. They're asking whether the advantage they gain from a tax-neutral structure adequately mitigates the potential damage to their reputations caused by some European governments' concerns about transparency.

Private equity firms are being squeezed from all sides. Governments want to make sure as many businesses as possible are fully tax resident in their countries as they seek to boost tax revenues. But investors quite legitimately want to avoid paying tax twice – they just want to pay it once in the jurisdiction that is most appropriate given their legal status.

Almost all private equity firms have chosen to respect investors' wishes and base their funds in specialist financial centres that make LP structures available, which are tax neutral. This neutrality has the effect of making sure they just pay tax once.

Progressive jurisdictions' governments and private equity firms are working hard to make other countries more comfortable with the concept of tax neutrality. The Organisation for Economic Co-operation and Development has rewarded a number of

jurisdictions by placing them on its 'white list' and many jurisdictions also have growing numbers of Tax Information Exchange Agreements.

For their part, private equity firms are increasing the scope of activities performed in the specialist jurisdictions, mainly for governance purposes and to comply with regulations. This trend is increasing the 'substance' of their local operations, which is likely to mollify the tax collection agencies of overseas governments.

While the new US FATCA legislation, due to be implemented from 31 December 2013, has no direct impact on the attractions of different jurisdictions, it does show how some specialist centres are proactively working towards becoming part of the new financial world. Some of the specialist financial centres are seeking to follow the so-called 'intergovernmental' approach championed by France, Germany, Italy, Spain and the United Kingdom, which would enshrine FATCA compliance in local law and effectively simplify reporting for local financial institutions.

iii. Governance

Governance is becoming an increasingly important topic. Both investors and regulators want to be sure that Anglo-Saxon jurisdictions with common law, which is less prescriptive than civil law, have adequate protections in place for investors. For this reason, they increasingly expect GPs' non-executive directors to take a strong role in making sure that fund advisers act in line with their mandates.

The specialist investment centres with common law, which most do, need to have a pool of adequately qualified non-executive directors. What's more, these directors should be well-qualified for their roles and equipped to make a practical contribution to GP boards. They should also be independent and prepared to oppose the private equity investment adviser's decisions if these don't appear to be in investors' interests.

In essence, this means that any GP based in a specialist jurisdiction must have directors with the expertise to supervise the investment adviser, administrator and other service providers.

iv. Infrastructure & geography

Private equity firms have always relied on the support infrastructure and geography of specialist international financial centres – but now this is becoming even more essential. Just as regulators want GPs to have more substance in the financial centres, so investors' demands for strong governance and more transparency mean that more functions are likely to be carried out locally.

Jurisdictions must have high-quality service infrastructures with competitive cost bases. They should have extensive networks of specialist service providers – such as administrators, auditors, lawyers and banks.

Finally, regulators and investors increasingly expect all board directors, including investment managers, to attend board meetings. So specialist financial centres must be close to the large regional financial centres – such as London, New York or Shanghai – with good travel links.

How the Channel Islands match up

The Channel Islands are the most established specialist centres for private equity. While they established this position before the financial crisis, they remain highly competitive. Many of the strengths that previously attracted GPs to the islands remain relevant, and the islands' governments are successfully working to adapt to the new world of international finance.

Both Guernsey and Jersey have been among the most proactive specialist financial centres in preparing for AIFMD. They've been in active dialogue with European policymakers and regulators, in order to put the regulatory frameworks in place that will give GPs based on the islands the flexibility of a dual approach.

From a tax perspective, the islands retain the tax neutrality of a LP structure, but have also been signing growing numbers of TIEAs with other governments. With respect to FATCA, they're also looking into following the intergovernmental approach pioneered by the UK and other European countries, which will simplify compliance. What's more, the OECD made both islands early members of its 'white list'.

When it comes to the increasingly important topic of corporate governance, both islands have communities of well-qualified directors. In both cases, the principles of good corporate governance are enshrined in law.

Equally importantly, the islands have strong service infrastructures. The major accountancy and law firms have local presences, as do the international private equity administration companies. There's also a large number of international banks and a big pool of educated financial services employees.

All of this is available at competitive costs. Both office rents and salaries are competitive on the islands.

For these reasons, private equity CFOs continue to favour the Channel Islands. In a recent survey, CFOs ranked Guernsey and Jersey first and second among European private equity domiciles.⁴

⁴ Helping the industry reach new highs. Survey of Chief Financial Officers. 2011. *Private Equity News/State Street*.

Conclusion

While the broad shape of the new financial world is becoming clearer, a lot of important detail remains unclear. Important details of regulations still have to be agreed and the tax positions of different governments are still evolving. Against this background, choosing a domicile for a private equity GP or LP takes foresight.

Each private equity firm will have a different set of circumstances when making its decision. But we would argue that the new world has made two factors supremely important:

1. Quality – Regulation and taxation mean that more of the GP and LP's functions need to be carried out in the specialist centres where they're based – this takes a strong infrastructure of service companies and qualified directors

2. Stability – Continual changes and pressures mean that specialist international financial centres need to have respected governments that have open dialogues with international regulators and tax authorities, and that backing governments must have strong public finances to guarantee fiscal certainty.

The centres historically described as 'offshore' have come under a lot of pressure and criticism since the crisis. The best of them have adapted to offer the qualities private equity firms and their investors need in the new world.

How PwC is helping the industry and helping clients

Our deep and constantly expanding expertise has been gained through working with clients and seconding our people to other firms in the PwC Network and into industry. This approach allows us to understand, anticipate and be well prepared to meet future client needs. We have dedicated specialists able to help with the following:

Executive Tax Services for Private Equity

Proactively addressing clients' UK and International tax planning and compliance needs

Private Equity Risk Management

Demonstrating the value of risk management to investors regulators and administrators

Alternative Fund Manager (check name) Directive (AIFMD) in Private Equity

Regulatory consulting – compliance with emerging regulation for continued pan-European investor marketing beyond 2013

Foreign Account Tax Compliance Act (FATCA) for Private Equity

Understanding and managing the US approach to combating offshore tax evasion

Our support starts with all the core audit, tax and advisory services needed by the PE industry:

- Statutory and non-statutory audit of Private Equity limited partnerships, general partners, co-investors, feeders, holding companies and investment manager entities.
- Agreed upon procedures around carried interest calculations.
- LPA reviews for early identification of fund accounting issues, assistance in accounting policy selection and GAAP analysis.
- Process reviews, accounting impact analysis.
- Tax reporting to Private Equity investors and stakeholders allowing them to meet their UK, US, German and other local tax filing requirements.
- Preparation of tax returns for fund vehicles, GP entities, carried interest vehicles and manager/advisor entities.
- Interaction of fund and portfolio companies. Carried interest arrangements, GP tax position, manager company or LLP taxation – all feeding in to tax position for Private Equity executives and investors.

Why do we do it *How we do it*

Investor demand – Increasing focus, especially from US and institutional investors. Increasingly the quality of tax information reported to investors can impact the relationships a Private Equity manager maintains with its clients (investors require more detailed information than historically).

Legislation – Company Law provides limited exemptions from the audit requirement for corporate entities. Limited Partnerships in the UK and Channel Islands typically have no statutory requirement, although this is subject to change in the UK.

Tax transparency – Private Equity structures are designed to be tax neutral for investors and can provide benefits for the Private Equity manager. These objectives often rely on the use of transparent vehicles but can require more detailed and complex reporting. An understanding of the structure and the objectives is required to deliver the benefits.

Regulation of investment manager – Fund, GP, manager, carry and investors all usually need to report income/gains annually. GFSC in Guernsey (120 day filing), JFSC in Jersey (120 day filing), FSA in UK (80 business day filing of financials plus 4 month filing of client money and assets audit report).

Working with Private Equity manager's finance team, legal counsel, deal teams, third and party administrators.

Investment transaction reviews, capital call testing, distribution testing, reworking of carry calculations.

Valuation of investments, discuss performance of investments, review client's calculation and workpapers and challenge assumptions made.

Review of related party transactions, management fees and investment existence. Our tax teams work with our clients and administrators to ensure efficient information gathering and reliable processing arrangements.

Our outputs are clear, informative, user friendly and tailored to the recipient - be that HMRC, Private Equity management or investors.