While Malta may be the smallest European Union member state, it has developed a significant financial services sector and, within that, a growing hedge fund business. The sector should get a significant boost from Europe-wide regulation of the industry, as well as the preference for start-up managers to choose a jurisdiction that offers flexibility and responsiveness, tempered with pragmatism

Panel participants (from left to right):

Custom House Malta
Kevin Caruana, Managing Director

Culross Global Investment Management
Nigel Blanshard, Chief Executive Officer

Valletta Fund Services
Kenneth Farrugia, Chief Officer – Fund Services

GANADO Advocates
Antonia Zammit, Associate

Custom House Malta
David Barry, Head of Sales & Business Development, Asia, Europe & Middle East & North Africa

Malta sees growth for the hedge fund industry

HEDGE FUNDS REVIEW: How has Malta's development as an international finance centre benefited the hedge fund industry? How will it continue to help it grow in the future?

Kenneth Farrugia, Valletta Fund Services: The legislation enacted by parliament in November 1994 paved the way for the positioning of Malta as a financial centre. Over the first 10 years, Malta's development was first driven by the domestic market, and thereon, as a result of European Union (EU) membership, evolved into a regional centre servicing operators in the neighbouring countries. Eventually, the end goal is for Malta to become a centre that services international financial services business.

In fact, a quick review of Malta's history as a financial centre will reveal that, following the 1994 legislative and regulatory developments, a number of domestic financial services operators entered the market by setting up various financial services businesses such as fund management, fund administration, custody operations, wealth management and trusts. As a result, the growth of Malta's fund industry in its first 10 years was primarily led by the domestic market. Post-2004, Malta's fund industry started to experience a paradigm shift from one primarily led by the domestic business to an industry featuring various service clusters predominantly consisting of international financial services operators. Within this context, Malta's EU membership in 2004 was an important catalyst in the development of the industry and particularly the funds sector as reflected in the strong growth traction that the industry has experienced post-EU membership. In fact, so far the Malta Financial Services Authority (MFSA) has authorised no less than 600 investment funds primarily driven by alternative investment funds, but also including Ucits funds.

It is equally important to mention that this development has in turn brought about a strong operational infrastructure as evidenced by the clusters of international financial services operators that have set up in Malta in the fund servicing (27 fund administrators) and asset management space (around 80 category 2 investment services licences issued so far).

Kevin Caruana, Custom House Malta: Malta provided a new option for service providers. Malta became attractive not only to set up funds or structures, but it is also an attractive option for the fund managers and other service providers to use Malta as a base from which to operate.

One of the main attributes was our flexibility, which was perhaps more than they enjoyed compared with more rigid jurisdictions, which hindered the flow and ease of establishment. That was one of Malta's biggest contributions to the industry, especially in Europe. Malta was –and still is – a good step from the non-EU structures into the EU.

Custom House and some of its biggest clients are, in fact, a reflection of that. We started our relationship with these customers in 2006 and some of our major platform clients are setting up shop in Malta.

Antonia Zammit, GANADO Advocates: I agree. Malta took a strategic decision in the 1990s to steer towards becoming a robust financial centre. We focused on getting our laws updated to reflect European Laws – a decision we knew would lead us closer to EU membership – and, as a consequence, our financial services industry took off. At GANADO, we too set up our first fund in the early1990s and have continued to do so ever since. As an industry, we have always worked together for the common good. It has been a collective initiative, right from the start, and we all see the advantages of collaboration.

HEDGE FUNDS REVIEW: Nigel, what first attracted Culross to Malta?

Nigel Blanshard, Culross Global Investment Management: From our point of view, the choice was relatively limited within the EU for reasons already cited. The big attraction of Malta as a jurisdiction is the enlightened and pragmatic approach of the government and regulator.

That makes a very big difference for firms like us. It strongly argued in favour of Malta rather than the few alternatives we considered in Europe. That has not changed and it continues under the same leadership as before. Individuals matter and the individual leadership that has come from the MFSA has been nothing short of exceptional.

> "AIFMD presents challenges and opportunities for Malta. However, I believe that it will continue to grow and attract new and emerging managers to the island, mainly due to the approachability and pragmatic nature of the regulator plus a growing knowledgeable and educated workforce"
>
> **David Barry, Custom House Malta**

HEDGE FUNDS REVIEW: How is this going to push Malta into a new phase of hedge fund development, or into alternatives in general?

David Barry, Custom House Malta: In Europe, the Hedge Fund industry itself is entering a new phase of development, as EU countries come to grips with the new regulation, in particular the Alternative Investment Fund Managers Directive (AIFMD).

How Malta will benefit or improve from this, only time will tell. As Nigel has said, the choice is relatively limited in Europe and there are probably only three main funds jurisdictions at the moment: Luxembourg, Ireland and Malta.

The initial AUM will have a major impact on where funds are domiciled as costs become more relevant. This will, inevitability, push certain managers to Malta, which is a positive thing, as there is a large proportion of the managers that are sub-$100 million in the market.

AIFMD presents challenges and opportunities for Malta. However, I believe that it will continue to grow and attract new and emerging managers to the island, mainly due to the approachability and pragmatic nature of the regulator plus a growing knowledgeable and educated workforce.

The biggest challenge facing Malta today is the shortage of custodians. I believe Malta was the first country to allow alternative investment funds to appoint a custodian from any EU member state. This exemption ends in 2017, by which time we hope the issue will be resolved. Malta has been unfairly criticised on how it has implemented the directive, particularly around the remuneration rules, however, this gives Malta a further competitive advantage and could be the deciding factor for some managers.

Antonia Zammit: I agree completely. Malta has, from the start, targeted niche markets within the hedge fund industry. If we continue to focus on such areas, I believe we will continue to experience steady growth, especially in the fund management sector.

The AIFMD has its advantages just as it has its disadvantages, so it is not all negative. We do acknowledge that we may have a potential issue as of 2017 with regard to the local depository requirement, but we also have alternative structures available for the smaller start-up funds that would not fall within the parameters of the AIFMD. We are heading in the right direction.

HEDGE FUNDS REVIEW: Concerning sub-$100 million funds, is there a danger Malta is going to be pigeonholed into that sector?

Nigel Blanshard: You could think that is going to be a risk and Malta becomes known as the place for sub-$100 million funds to go to – that Malta ends up only having sub-$100 million funds.

That is a seriously flawed line of thinking. I would liken it in retail banking to finding 18-year olds to be your new clients. If you can get them young and get them in, all the evidence says they will stay with you forever – unless you do something deeply offensive to put them off. The same is true with fund jurisdictions. Once you're in, as your fund grows, you stay. The vast majority of new fund launches are sub-$100 million, and these are the funds to catch. That's not what the media focuses on, however, because they're only interested in telling you about the $500 million launch with Mr X from investment bank Y.

The real business always starts in the sub-$100 million zone. Malta is very intelligently focusing on that area. If it builds out its capacity to service bigger funds, by that time these sub-$100s will be bigger funds. That is a smart move.

Kevin Caruana: Linking this, rather than to the risk of the sub-$100 million, Malta's biggest challenge in terms of opening itself up to larger structures is that, while doing so, it should not jeopardise its current strengths. It can never underestimate the importance of its strong points.

It is no coincidence that the sub-$100 million funds are looking at jurisdictions like Malta, because sub-$100 million funds are looking for pragmatism, practicality, for a controlled cost base and that is, at the moment, also one of the advantages for Malta.

While we develop and enhance ourselves, we cannot risk jeopardising what we already have and that is, again, the pragmatism, the practicality of our institutions, the cost base and the availability of our resources – whether it's human capital or infrastructure. From there we have a strong base and we can take on the next flow of clients – whether they start off as sub-$100 million or not. We must build on what we have here and go from there.

Nigel Blanshard: There is a point to make about cost. This can be discussed in totally the wrong way. When a fund is setting up, they are looking for a low-cost solution, but not because the managers are paying that cost. They don't. It is paid for by the fund and, therefore, the investors in that fund.

The key here is that we all now live in a world where cost is a primary concern to investors. It would be irresponsible and a failure of a manager in their fiduciary responsibility to select a high cost centre on the basis that 'because I'm paying more, it must somehow be better'.

Cost matters, and managers should execute their fiduciary duty to find the lowest-cost professional solution. It is a shame that this can often be associated with the wrong things: that the services being provided aren't good enough, for example. We all know that, like all things in life, these two things aren't well correlated.

Kenneth Farrugia: Malta is clearly highly cost-competitive, and this feature has become increasingly important in view of the heightened sensitivity to set-up and operational costs. On the issue of a big/small fund manager or fund, one can draw an analogy to acorns and oak trees. The regulatory developments that have been introduced so far and those planned going forward have brought with them significant cost burdens, and this may in a way hinder the development of new or emerging fund managers who have the potential to become star managers going forward. Malta's recent entry into the international funds arena has brought to the marketplace a fresh and robust value proposition for small and start-up emerging managers that are conscious of the importance of time-to-market by way of the jurisdiction's responsiveness and the need to contain operational costs. It is my view that Malta ticks these boxes and is today a compelling proposition for these fund managers.

Malta's domicile proposition is equally attractive when one considers the accessibility and the pragmatism of the MFSA, as well as the presence of a sound operational infrastructure as evidenced by the presence of the Big Four (audit firms) and a suite of reputable law firms having significant expertise and depth in the financial services business. Today, Malta's fund industry, which started from very humble beginnings in 1994, accounts for more than $13.5 billion in assets, with some funds that have seeded their funds with just $10 million to $20 million. As a result, Malta is very appealing to start-up managers who wish to establish their own private label fund.

"We have a strong base and we can take on the next flow of clients – whether they start off as sub-$100 million, or not. We must build on what we have here and go from there"

Kevin Caruana, Custom House Malta

David Barry: I don't want to give the impression that Malta can only service smaller managers. In fact, back in 2006, Custom House did assist a client in establishing a now billion-dollar-plus Maltese umbrella structure. Malta is well equipped to service both the emerging managers and the larger, more established managers.

Custom House has built its business through assisting and servicing these smaller managers who effectively become larger managers. Internally, we use the example of Winton Capital, which launched with us with $5 million back in the early 1990s. As a jurisdiction, and as a company, we see the value in start-up managers because as they grow, we grow. Who knows which one of those managers will be the next Bridgewater or Winton?

HEDGE FUNDS REVIEW: Turning to AIFMD, where do you think this regulation is going to take Malta?

Antonia Zammit: In every challenge lies an opportunity. We must extrapolate these opportunities and exploit them. For example, US managers are likely to want to set up here in Europe. Malta is an ideal place to do this, and we will definitely benefit from this.

Kevin Caruana: A lot has been written and discussed about AIFMD at conferences. Firstly, looking at the number of licence applications that are being processed in Europe, the regulators are somewhat disappointed that the take-up has been so slow. It will probably gain traction and pace in the next few quarters.

Nonetheless, there are a number of fund managers that are quite happy with the private placement rules. As long as those remain in place, I don't think they will be compelled to go through the licensing process. They are happy to retain their assets at $100 million or less. There will be a number of those.

There will be others who will want to align themselves with the AIFMD. You will have different scenarios, and different fund managers in Europe who have funds in the Cayman Islands, for example. Whether they want to create fund structures in Europe or not is an open question. Will Malta be a great home for that? Would they want a low-cost fund set up whereby they can promote their funds to investors in Europe?

You will also have managers in distinct markets such as the US or Middle East who want to use an operation in Europe. They will look at the options, so they would look at Luxembourg, Dublin and Malta. Maybe they would want to start in the bigger jurisdictions, because they have been around for decades, or they may want to be smart in a lean way and see Malta as a fit for them.

We have different situations and we still haven't seen managers make these decisions. The MFSA has issued a warning to say there is only six months [left] to license here, so make sure you get your applications in.

"We've seen the ease of fund managers selling Ucits products in non-EU countries, and quite a lot of market operators – even those in the EU – equate the Ucits Directive and the Ucits label as a quality mark facilitating the ease of access to non-EU markets. Eventually – though it will not happen overnight – AIFMD will hopefully have the same status"

Kenneth Farrugia, Valletta Fund Services

Antonia Zammit: To be fair, there was uncertainty and apprehension about the AIFMD from our clients that fall above the required threshold but they have all seen the benefit of being authorised as alternative investment fund managers (AIFMs) and have all taken the plunge and are all in the process of submitting their applications.

David Barry: The AIFMD came into effect on July 22, 2013, with most regulators applying a transition period of a year. For the UK Financial Conduct Authority, applications need to be received by January 22; for the Central Bank of Ireland it's February 22; and in Malta it's March 31, 2014, so we're really not going to see how many managers are opting to become AIFMs until those dates.

It was mentioned at the Bloomberg conference recently that AIFMD is a good thing for managers starting out because they now have a regulatory framework within which to operate. They now know exactly what they have to do.

However, I don't envy a manager who is just starting out. There are many things to consider, such as do we have the capital to obtain our full AIFMD licence? Should we go under an AIFM umbrella solution? Do we set up outside of Europe? And let's not mention how difficult it is to raise capital these days.

Nigel Blanshard: As a practitioner, I can tell

you what we have done. Like many firms, we take the view that regulation is there for a good reason and complying with and participating in the regulatory environment is a good thing.

It's grossly misrepresented when people talk about the expense, the difficulty and all of these other very negative things. In my 25 years of experience of dealing with regulators, it is just not true. There is an expense, but it's a moderate expense. In exchange they have implemented a tremendous number of worthwhile changes in the fund management industry. So we took the view with our Malta regulatory licence, when the AIFMD appeared, that we would apply for an AIFM licence. We have just done that and, obviously, we hope that will be considered favourably next year.

It did throw up one issue for us, which was the risk management feature of the Maltese regulations, which calls for a permanent risk manager. We have permanent staff on the island, but they don't happen to include our risk manager, because he sits in our London office.

The short answer to the question is that we've embraced the regulations. It's an essential part of ensuring that your business adapts and survives into the next generation. For those who want to use the duck-out clauses in regulation, their life will be short. That would be a business approach that is likely to lead to failure because you've got to look at the trend of change, and the trend of change globally is towards regulation, onshoring and knocking out the old offshore industry, for good reason. You either join in or become pressured.

David Barry: Do you think becoming an AIFM will help you in terms of your marketing to investors? Do you think investors will say, 'yes, you're AIFMD, you tick the box'?

Nigel Blanshard: You're absolutely right. The world we live in is one where people are looking to tick boxes. They start the meeting by asking: 'are you regulated?' Tick. 'What sort of regulation have you got?' 'How many people do you have?' 'What are your assets under management?'

If their decision is between fund manager A and fund manager B, and A is an AIFM while B is not – you do not have to be a genius to know which is going to be chosen. That is the way of institutional money management. An individual may of course act differently.

David Barry: Where does that leave the emerging managers we talked about earlier that are sub-$30 million? Will they ever get an allocation?

Nigel Blanshard: They tend not to get allocations but, given that we have always specialised in looking at that community – smaller managers around $100 million – what we want to hear and see is the manager saying that they have a clear vision of how they are going to turn into a proper institutional business, rather than remain a cottage industry. That is good enough for us, and it will be good enough for most investors I can think of, including some big institutional investors.

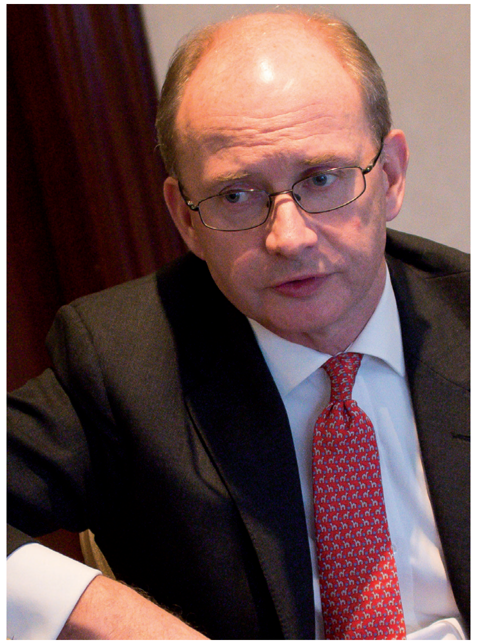
Antonia Zammit: An alternative investment fund can only target professional investors, while anyone opting to set up a structure using the Professional Investor Fund regime will be able to offer this to a wider spectrum of investors. That is where the smaller players would be able to benefit.

Kenneth Farrugia: The merits of the AIFMD are reflected in the ability to promote funds managed by AIFMs cross-border in Europe. This benefit is already reflected in the Ucits space, wherein Ucits asset managers may promote their Ucits funds cross-border in Europe. The appeal is even wider when one considers that there are a number of non-EU countries that allow the promotion of Ucits funds in their home markets. On the other hand, this new directive may not be that appealing to asset managers that are targeting high-net-worth (HNW) individual investors on a private placement basis, so the new directive might not be appealing in view of their business model.

Kevin Caruana: Surely, there would be some US managers who are potentially not interested. Some might say 'it's not worth it for me to market in Europe; I'm going to stay where I am'. In the same way, we also saw this with the offshore regime realising that it needed to look into an onshore jurisdiction. They had to adapt because that is where the ball game had shifted.

It could be a similar situation, but maybe fund managers today are not so keen on it. We might see eventually that the tables have turned and it is something they need to look at.

Kenneth Farrugia: We've seen the ease of fund managers selling Ucits products in non-EU countries, and quite a lot of market operators – even those in the EU – equate the Ucits Directive and the Ucits label as a quality mark facilitating the ease of access to non-EU markets. Eventually – though it will not happen overnight – AIFMD will hopefully have the same status. One key difference between the Ucits directive and the AIFMD is that the Ucits directive has evolved over a 25-year time frame: through the Ucits Directive in 1983, then Ucits III and Ucits IV, and now plans are under way for Ucits V and VI. On the other hand, insofar as the AIFMD is concerned, one may state that the European Commission drafted one of the most ambitious and complex regulatory reform agendas ever introduced into the asset management industry in the form of the AIFMD after an intense, often controversial, and highly political debate. What I fail to understand is the depository issue. It's clearly discriminatory that the depository/custodian needs to be in the same domicile of the fund. That was the issue with Ucits managers prior to the introduction of Ucits IV, where a Ucits manager in, for example, Luxembourg who wanted to set up a Ucits platform in Malta, needed to set up a Ucits management company in Malta, which in essence went against the fundamental principle of the freedom of movement of services and, consequently, the single market.



"If their decision is between fund manager A and fund manager B, and A is an AIFM while B is not – you do not have to be a genius to know which is going to be chosen. That is the way of institutional money management"

Nigel Blanshard, Culross Global Investment Management

Antonia Zammit: They don't want to introduce the depository passport as they say that too many regulators would have to liaise in respect to each structure. However, this, in my opinion, is not a good enough excuse.Why have institutions like the European Central Bank or the European Securities and Market Authority been established if not for such scenarios? There is absolutely no excuse, in my view.

HEDGE FUNDS REVIEW: Nigel, you mentioned that US investors are seeing the value of AIFMD-compliant funds. Do you think AIFMD will encourage European investors who are not putting money into funds?

Nigel Blanshard: That's a very difficult question to answer. The appetite in Europe for hedge funds is not that good. Retail has had hedge funds rather poorly explained to them and there is remarkably little effort made, or facility provided, to educate retail.

They're often not educated properly by their financial advisers. There's a tremendous amount of prejudice, so the crimes of the few cause harm to many.

Then there are specific European regulator attitudes towards hedge funds. Their attitudes have not been harmonised even if the rules might have been. That makes for a very uneven landscape in Europe for hedge fund appetite.

Marketing hedge funds in Europe to professional investors is considerably easier than to retail but that's not to imply that all professional investors regard hedge funds favourably. They don't, but there is more understanding because they've been properly taught the purposes and the goals of different hedge fund approaches.

David Barry: I agree there is certainly further education needed to restore investor confidence in hedge funds, and AIFMD may prove to be the catalyst. However, at a recent conference in London, it was stated by the seeding panel – which consisted of a large European institutional investor – "we don't particularly care whether the manager is AIFM or not, this is a politically driven regulation that we never wanted."

This was slightly disappointing to hear because, for me, the main points of AIFMD were to protect investors and rebuild their confidence in hedge funds. The directive should tick the box and provide the comfort investors want.

My point is that, as much as AIFMD has caused a lot of headaches for everybody in terms of implementation, cost, etc., I have no doubt that the AIFMD will benefit the industry in the long term. Let's be honest, nobody likes regulation, but it is going to give investors that extra boost of confidence. We will then start seeing greater allocation to both medium-sized managers and particularly to AIFMs – and not just the top ten fund managers like we have seen over the last few years.

Kenneth Farrugia: It is important to mention that the industry went through

"As an industry, we have always worked together for the common good. It has been a collective initiative, right from the start, and we all see the advantages of collaboration"

Antonia Zammit, GANADO Advocates

a decade of self-regulation, and now the new regulatory paradigm is one heading for re-regulation. There are clearly a number of benefits by way of the increased transparency and governance requirements but, as with all regulation, we will come across the incidence of unintended consequences that might have a diametrically opposite effect to what was intended at the outset.

HEDGE FUNDS REVIEW: Do you think Malta is going to be the logical selection for people such as US managers?

Nigel Blanshard: London is pretty tempting. London has a special magnetism for pretty obvious reasons. A lot of those North American managers looking at Europe will say 'I don't care what it costs. I am going to London'.

David Barry: Also, the US and Ireland have deep historical and family ties, so I think Ireland would be an ideal place for US managers to set up shop. We have discussed the appeal of Malta and the various added benefits, but the larger US managers tend to favour London or Ireland.

In relation to fund domiciliation, investors can often dictate where to locate the fund. US managers are more likely to choose Ireland. It will depend on what their drivers are. If costs are a factor, then managers might look at Malta.

Kevin Caruana: What is important is that Malta doesn't just sit back and wait and assume that these players will look at Malta. We make sure that we are actually out there so when these players are thinking about this, Malta is included as one of the options, whether it is through the players themselves, the regulators, or through FinanceMalta.

Malta was listed as the jurisdiction of choice in Europe. We have law firms that are already establishing themselves. The fact we are attracting the big players into the jurisdiction, whether they are fund administrators, fund managers or others.

Antonia Zammit: There are those promoters who have their minds set and just want to be based in London, but then there are those who want to spend less. In such cases, Malta would be ideal. Also, individuals moving here can benefit from favourable tax regimes. From our experience, these initiatives have all proven to be attractive.

Nigel Blanshard: But those personal tax incentives won't work for Americans, that's the catch. For Americans, everywhere in Europe has the same tax rate, so you might as well go to London.

Kenneth Farrugia: The market itself is diverse and will attract different players. So far we've built a very compelling proposition for managers to set up funds here, as well as fund management operations. A number of factors have contributed to that. We've mentioned regulatory framework, we've mentioned the ease of travelling to Malta, which is well connected to the main European cities. Recently Malta was recognised as the most favoured European fund domicile, which is an important achievement driven by the various initiatives undertaken by the various stakeholders of the industry to include the practitioners, the financial services operators, FinanceMalta, by the regulator and, last but not least, by the Government of Malta. Clearly we must strive to sustain our competitive factors in perpetuity. Innovation will play an important role in the process, and Malta's size allows it to be very nimble and proactive in this respect and clearly at an advantage in terms of time-to-market.

HEDGE FUNDS REVIEW: Malta is geographically limited. Where are you going to get the qualified staff to support growth?

Antonia Zammit: There are about 10,000 people who are employed in this industry in Malta. Governments acknowledged that our limited human resources could stall the growth of the financial services sector in the future and have therefore created further opportunities to encourage people to specialise in these areas. In the law course I took 10 years ago, for example, there was no particular emphasis on the financial services industry. Today, things have changed due to the demand.

There are many other initiatives taken by various players in the industry. For example, the Institute of Legal Studies, which provides training on various topics and are specialised in and lectured by practioners.

The MFSA also provides frequent training sessions on various topics. Ultimately, I would say that we do have the human resources to cater for the needs of the industry. Of course, due to our size, there are some limitations in certain areas. It is also important to note that many Maltese nationals who relocated years ago and who have acquired a number of years working in this industry overseas are now returning. This not only adds to the numbers but also to the level of experience of our workforce. It is important that we always keep one step ahead. You can't think short term. If that had been the decision taken 20 years ago, then we wouldn't be where we are today.