Turning Point: Offshore Law Firms in a Changing World

A REPORT BY JOMATI CONSULTANTS LLP, JUNE 2013

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About this Report

This is a special report by Jomati Consultants on key issues affecting the offshore legal market.

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THE QUEEN'S AWARDS
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2012

Contents

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Introduction

Offshore (adj): 'Made, situated, or registered abroad, especially in order to take advantage of lower taxes or costs, or less stringent regulation.'
The Oxford English Dictionary

The offshore legal sector is at a turning point, both in terms of its opportunities and also the challenges it is now facing. The three main drivers of change among offshore firms are: the rapidly increasing demand from governments and regulators for offshore transparency[1]; the continued globalisation of the offshore sector's client base; and increased competition between rival law firms operating in the offshore space.

As we will explore, each of these phenomena provides opportunities for offshore law firms to differentiate themselves from their rivals and to build increased market share due to a changed environment. However, change to any business environment can also produce serious challenges if not met and adapted to.

Offshore firms so far have managed to respond to the tests a constantly evolving global legal market has presented. They have adapted to increasing scrutiny of the offshore sector. They have understood how globalisation is changing the pattern of capital flows. They have invested in offices in Asia and in the offshore jurisdictions of rival firms in order to offer what clients want: a global, tax neutral, low regulation network of jurisdictions that meet a variety of needs across multiple geographies and time zones. They have also worked hard to compete against each other, never letting peer firms get too far ahead in terms of practice strength or geographic capability.

Because of this determined and pragmatic approach offshore firms have performed very well, riding out the financial crisis with far less pain than many onshore firms[2]. And by meeting changing client demands they have seen partner profits often in excess of the largest City law firms. In this respect offshore firms have been a great success.

But the offshore legal sector should not be complacent, what the rise of the BRICs, as well as global regulatory and tax arbitrage has given, could easily be taken away again by changes in policy, by macro-economic forces, or changing client needs. As we will examine, whether the threats come in the shape of increased capabilities of other firms; or due to changes among the client base; or even because of pressures on the costs of production; there are many ways management can misjudge the direction of the wider market and quickly be left behind.

We hope in this short report to address some of these issues. The report concludes in Chapter Five with a strategic overview of what offshore law firm management teams may want to consider as they plan their path through these turbulent times.

[1] We will examine this in more detail in Chapter Two, however, the British Prime Minister, David Cameron, in May wrote to Crown Dependencies and Overseas Territories saying he wanted to 'knock down the walls of company secrecy' to reveal beneficial owners of offshore structures and was launching a global campaign among the G8 nations against 'aggressive tax avoidance'. Sky News, 20 May, 2013.

[2] Fiduciary services have also helped some offshore law firms by providing an annuity income.

Chapter One: Globalisation and the Offshore World

Right Places, Right Times

The offshore legal sector has been intrinsically part of globalisation throughout its history. Many of today's so-called offshore tax havens are the product of a much earlier period of globalisation pioneered from the 17th century by the mercantile British Empire. When it came time for Britain to give back its acquisitions it wisely held onto 14 Overseas Territories, including Bermuda, the Cayman Islands and British Virgin Islands (BVI). These were balanced on the other side of the Atlantic with the British Dependencies, Isle of Man, Jersey and Guernsey, along with the smaller Territory, Gibraltar. Hong Kong in Asia, though now handed back to China by the UK, remains a critical part of this global offshore network.

Far from dwindling in the difficult post-War years the most creative offshore centres tapped into a growing flow of global capital both out of and into the developed and developing worlds. Leveraging their low or no tax status to avoid double taxation and by marketing their limited disclosure rules, offshore jurisdictions became a vital part of the global economy[3] for everything from family trusts, to hedge fund formation, to now becoming the offshore base of many Chinese corporates.

Following the easing of capital controls in the US in 1974 and UK by 1979, then in the late 1980s with the Big Bang in the City, offshore law firms saw a steady increase in work. But, even these developments pale in comparison to the flows of capital into offshore jurisdictions over the last decade (see table1).

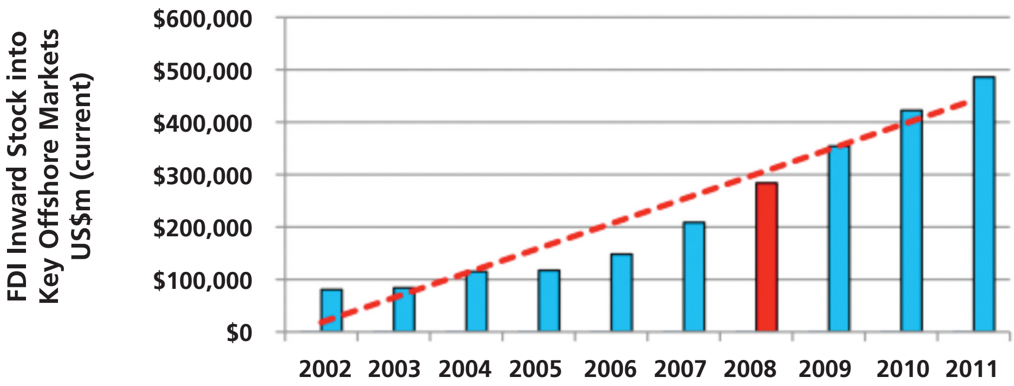

Table 1: FDI Inward Stocks in selection of offshore markets, UN data[4]. Red column 2008 marks beginning of the post-Lehman financial crisis.

As can be seen, the stock of inward FDI across a range of offshore jurisdictions[5] has accelerated rapidly since 2003. This UN data is only for investment into 'enterprises', such as corporate structures, and does not necessarily include capital held in offshore bank accounts, or certain trusts and funds where data has not been collected. Hence the total capital situated or moving through offshore 'island' centres is far greater, estimated to be at least $18 trillion[6], or about a quarter the world's GDP. Nevertheless, the direction of travel depicted by the FDI data is compelling. Between 2003 and 2011, offshore FDI stocks grew by 478%.

[3] See Appendix A in relation to FTSE company use of offshore structures.
[4] Includes: British Virgin Islands, Cayman Islands, Cook Islands, Cyprus, Gibraltar, Mauritius, Netherlands Antilles and Panama. No data given for Isle of Man and Jersey/Guernsey. UN data.
[5] Ibid.
[6] 'Treasure Islands', by Nicholas Shaxson. Data for 2010 derived from IMF analysis.

It is surprising that the collapse of Lehman Brothers and the 'nuclear winter' that followed for the Western economies had little negative effect on this capital stream. Instead, total FDI stocks have kept rising even if US- and UK-operated hedge funds and private equity funds were badly affected. How is this continued flow possible? One answer is that with a lack of investment targets in the West capital has been 'stockpiled' offshore. Another is the rise of the developing world, especially China.

What is especially striking is how important BVI has become, to the point where it is now one of the most important, if not the most important, destination for FDI capital among all true offshore centres[7] (see table 2). Again, the FDI figure is only one indicator among a number of types of capital flow, but the result is noteworthy. BVI has seen massive growth, while Bermuda, the insurance captive centre of the offshore sector, has witnessed a fraction of the FDI growth of its rivals.

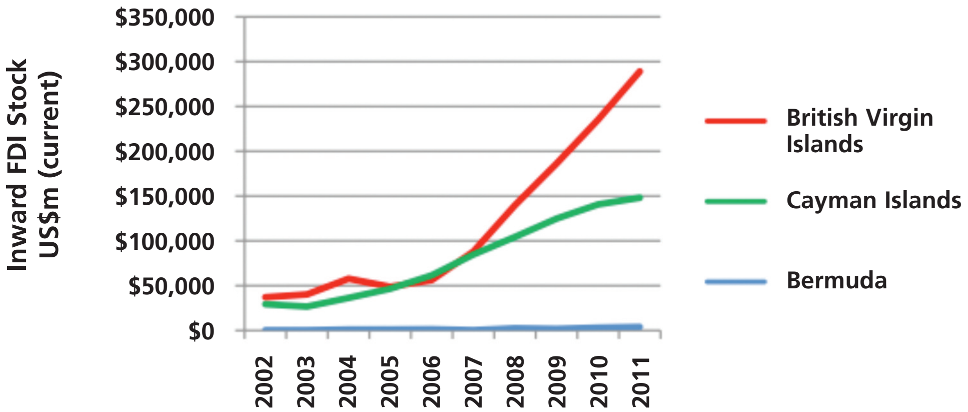

Table 2: Inward FDI stocks in BVI, Cayman and Bermuda. UN data.

Another trend has been the battle between BVI and Cayman to be the most favoured offshore location. In the 1980s, before Brazil, Russia, India and China (the BRICs) began to add to global capital flows, Cayman was the undisputed leader. Then after rapid growth in the 1990s, BVI takes a significant lead. As can be seen, the change for BVI is huge.

[7] I.e. as opposed to low tax onshore centres such as Hong Kong, which understandably has far higher total FDI given the size and breadth of its economy.

(FDI Inward Stock, US$ current)	*1980*	*1986[8]*	*2000*	*2011*
BVI	$1.24m	$38.98m	$32,092.7m	$288,986m
Cayman Islands	$222.3m	$1,493.4m	$25,584.5m	$148,037m

Table 3: Comparison of FDI inward stocks for selected years. UN Data.

Though we must consider US inflation, what started as a relative trickle has become a flood of FDI offshore. Hundreds of billions of dollars in wealth and investment has moved offshore, but also has been earned offshore, in at least as much as certain companies have structured where revenues are accounted for. Even if many billions of dollars of this capital is repatriated each year the remaining net offshore capital stock around the world has risen hugely.

This 'stockpiling' trend is exemplified by the recent $17bn bond issue by Apple in order to pay a dividend rather than repatriate part of its $100bn-plus in offshore cash reserves. This is due to the US 35% corporate tax rate on repatriated profits. But it is not just Apple, Bloomberg estimates that in 2012 alone leading American companies moved or retained an additional $184bn offshore. They estimated that for the 83 companies examined $1.46 trillion was held offshore in total[9]. This has been criticised by lawmakers, most recently by a US Senate report into Apple's use of offshore tax structures, including those in Ireland. However, as others have pointed out, if the law permits such structures then lawmakers should change the law and US tax rates, not attack companies which see tax only as a cost to be reduced. After all, profit always moves in the direction of least taxation.

We also need to consider the growing number of High Net Worth Individuals (HNWIs), because they too have been boosted by globalisation. During the Cold War years the world's rich were mostly in a handful of countries, primarily the US and Western Europe, plus a handful of dictators from South America to Africa. Post-Cold War, the rise of new wealth across dozens of developing nations has altered global wealth distribution, and led to a blossoming of dollar millionaires (see table 4).

Wealth Range (US$m)	*Number of Adults Globally*
$100m +	29,000
$10-100m	987,300
$5-10m	1,959,600
$1-5m	26,724,200

Table 4: Number of HNWIs globally in 2011, data Credit Suisse.

According to Forbes, the number of billionaires globally is now 1,426, controlling a total wealth of $5.4 trillion between them. Of these, 442 billionaires were from the US, followed by Asia-Pacific (386), Europe (366), the rest of the Americas (129) and the Middle East & Africa (103)[10]. It is fair to estimate that a significant level of this wealth is structured through offshore trusts and corporate structures, and we can expect more HNWIs in the future.

[8] 1986 is chosen as the sample year as this was the year of the Big Bang in the City of London.
[9] www.bloomberg.com/news/2013-03-08/offshore-cash-hoard-expands-by-183-billion-at-companies.html.
[10] Forbes, Billionaires List, 25 March 2013.

Impact on Offshore Law Firms

A huge increase in capital flows and a widening in the breadth of sources of family, investment and corporate capital are certainly welcome developments. We later will examine in more detail the opportunities and challenges of managing a global offshore law firm, but suffice it to say that keeping pace with globalisation already has led to a number of developments for offshore firms. Among them:

- The need to build capability in Asia, especially in Hong Kong[11], and for a smaller group Shanghai. Hong Kong often acts as gateway for outward flows of capital from mainland China and also acts as an important pathway for repatriation. Chinese corporates have also formed offshore vehicles based in centres such as BVI through which to carry out IPOs in Hong Kong or the US.
- The need to develop offices in a wider range of offshore centres to serve developing markets such as India, Africa and the Middle East. This has led to offshore firms opening offices in Mauritius and the Seychelles. Meanwhile, outflows from Russia have led to opening of offices in Cyprus[12], while South American in- and outbound investment has seen Montevideo in Uruguay grow as an 'onshore' centre.
- The inevitable growth in litigation based in offshore courts due to the higher number of funds and corporates based there, often in what are multi-billion dollar disputes between investors and fund managers.
- The need to provide legal expertise under multiple framing laws, e.g. BVI as well as Cayman, in offices across time zones for clients that are now global in outlook. The global nature of the client base has also demanded a far wider cultural understanding of developing markets by offshore lawyers who perhaps had previously worked mainly with Anglophone clients.

Overall, what we are witnessing is a progressive spreading out of offshore firms that parallels the growth of the global law firms in the UK and US, though mostly staying offshore. For now the only jurisdictions that all of the top seven offshore firms[13] are in, include: BVI, Cayman Islands, Hong Kong and London (see Appendix B). These four financial centres are now seen as an absolute minimum for a successful global offshore firm. In turn this places pressure on smaller offshore firms to compete by also expanding, though the cost may be prohibitive. Also, an offshore firm that is not in the BVI already would now face a host of very strong law firms already there, or recently arrived.

It is worth noting that though globalisation is generating and moving capital into every region of the world, the most international offshore law firms do not focus their attention equally on every offshore centre. For example, the Isle of Man, one of the oldest and most established offshore centres in the world only has a single top seven firm with an office there, Appleby. Even Guernsey only has three of the top seven present. This could suggest that 'new money' from Asia and the developing world is focusing on the Caribbean despite continual marketing attempts from the Crown Dependencies in markets such as China.

[11] All of the seven largest offshore law firms, Appleby, Conyers Dill & Pearman, Harney Westwood, Ogier, Maples and Calder, Mourant Ozannes and Walkers, now have offices in Hong Kong. Two, Appleby and Ogier also have offices in Shanghai. Jomati research. See Appendix B

[12] Though following the recent 'bail-in' debacle in Cyprus, Russian flows may well dwindle.

[13] See 9.

Chapter Two: The Regulatory Challenge

Changing Tunes

Something has changed in Washington DC, Brussels and London that heralds new regulation that will impact offshore centres in ways that go far beyond the OECD efforts in earlier decades to stamp out money laundering[14] (see table 5).

That change has been the financial crisis of 2008. Governments with large deficits and low growth are utilising unpopular austerity measures to balance their budgets. They have identified tax avoidance as both a deflective political strategy and means of gaining more taxes. Aggressive tax avoidance is thus the 'cause célèbre' of Western governments. Profit-shifting by global companies, such as Google and Apple, also has been publicly pilloried and has seen growing pressure to reduce the use of offshore structures (see more below and Chapter Three). Tax avoidance and transparency, not just tax evasion, are now 'moral issues', lawmakers say.

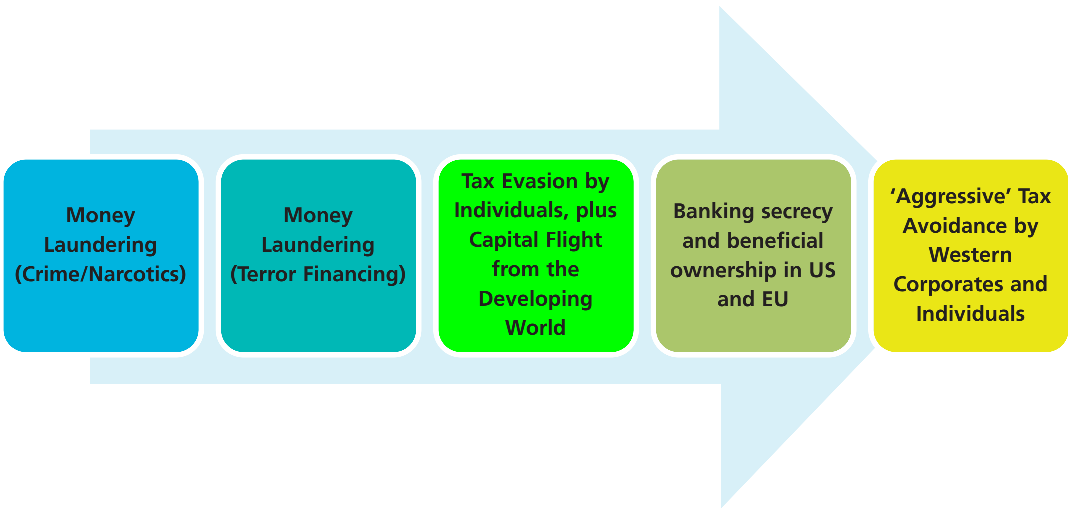

Table 5: The evolution of OECD regulatory focus on onshore to offshore capital flows.

The offshore sector could argue that double taxation on global companies' earnings would impact profits and that in turn would hurt many millions of people's equity investments, such as pensions. The insurance industry would not function without the ability to form captives in Bermuda that escape extra taxation. The hedge and private equity sector, which places billions of dollars of much needed investment into growing companies, would also be stymied. Moreover, the mainstays of the onshore financial world, i.e. major banks such as Barclays and Citi, all offer offshore bank accounts. The onshore world therefore makes great use of the offshore world, but this does not stop politicians' finger-pointing.

The G8 meeting this June will focus heavily on how to reform the global tax 'map'. And as noted earlier, David Cameron has written to offshore centres ahead of the G8 meeting warning that he wants to 'tear down the walls of corporate secrecy'. The EU has recently stated it plans to rush out a law compelling all major public and private companies to

[14] The idea that money laundering is essentially an offshore problem is a myth. The UN estimates that criminal enterprise accounts for 3.6% of global GDP, and 2.7% of GDP is then laundered through the banking system, or today around $1.9 trillion per year, more than the GDP of Russia. However, much of this money must enter the onshore banking sector first, as the allegations last year over Mexican drug money in local HSBC accounts shows. It also goes to show that OECD efforts to stamp out money laundering globally have largely failed. Ironically, these hundreds of billions of dollars are then blindly invested through centres such as London and New York inadvertently helping to pay money launderers interest on their savings.

reveal corporate profits and taxes on a country-by-country basis[15]. While EU bureaucrats have drawn up a wish list[16] of other tax law changes, including permanent establishment rules, which at least in theory could prevent profit-shifting abroad. France's President Hollande has called for 'the eradication' of tax havens, which is ironic for a leader who wished to raise the top rate of tax to 75% and is a watershed moment for the leader of a major Western nation.

Fuelling the debate is a cache of data on offshore accounts that was leaked to the press[17] and Western Governments in April. It included over two million documents detailing tax avoidance and evasion through 130,000 offshore accounts[18]. Illicit activity illuminated by the data allegedly includes British, Canadian, US, Russian and Central Asian citizens, among them senior politicians and ruling family members.

Meanwhile, in the US, Republican former Presidential candidate, John McCain, has called Apple's tax structures 'egregious' and 'outrageous' following a Senate investigation into the company's offshore cash holdings of over $100bn. And in May in the UK, Google's CEO Eric Schmidt faced a verbal battering by the media and politicians over paying just £6m ($9.3m) in corporation tax on UK sales of £3.2bn ($4.9bn) in 2011, or a rate of 1.9%, primarily by booking its UK earnings in Ireland. Google stressed it was doing nothing illegal, and despite the apparent absurdity of the situation, they were right. Only a change in the laws governing transfer pricing, along with joined-up international co-operation, will change this.

But the 'moral outrage' is having an impact in some quarters. The CBI, the UK's 'union' for business, recently[19] stated in a more conciliatory tone: 'Businesses should consider how to explain their taxes to the public. This could include explaining their tax management, together with the amount and type of taxes paid.' How far 'naming and shaming' efforts will impact Fortune 500 CEOs is still unknown. But publicly listed companies may seek to minimise the use of offshore vehicles to reduce their exposure to negative publicity.

Into the Light

Long-discussed efforts to enforce transparency on offshore centres and low tax, secret banking centres are finally taking shape. Below we outline a number of key developments:

- Introduction of FACTA[20] - The US Foreign Account Tax Compliance Act forces foreign financial assets that exceed certain thresholds to be reported to the IRS and demands foreign 'financial institutions' to report information on US citizens where accounts or ownership interests are held. This will include hedge funds and private equity funds.
- FACTA-led intergovernmental agreements, or IGAs – To make FACTA effective the US needs offshore governments to allow the investigation and exchange of client information. After all, a sovereign State could simply refuse to co-operate, though this may have severe repercussions later in terms of access to US financial markets and dollar clearing facilities. The UK has already agreed to a reciprocal IGA with the US. At time of going to press the position of key offshore IGAs were (see table 6):

[15] www.ft.com/cms/s/0/3ab900ac-c3c1-11e2-8c30-00144feab7de.html.
[16] www.bbc.co.uk/news/business-22626930.
[17] http://www.icij.org/offshore.
[18] http://en.wikipedia.org/wiki/Offshore_leaks.
[19] The Confederation of British Industry (CBI), 7 May 2013, 'Seven tax principles for UK business'.
[20] www.irs.gov/Businesses/Corporations/Foreign-Account-Tax-Compliance-Act-(FATCA). These complex rules, first laid out in 2010, have evolved in recent years and we are not going to examine them in detail.

Jurisdiction	*IGA Position*
BVI	Under 'consideration'
Cayman Islands	Has now agreed Model 1 IGA[21]
Bermuda	Under 'consideration'
Jersey	Final negotiations underway
Guernsey	Final negotiations underway
Isle of Man	Final negotiations underway
Cyprus	Discussions 'on-going'

Table 6: How far FACTA IGAs with US have progressed. Data: PwC, as of May 2013.

- Failure of FACTA and IGAs in Asia – The US has so far failed to engage China[22] or Hong Kong in setting up an information exchange. Though, Singapore will agree an IGA this year, but with carve outs. This leaves a huge hole in the American FACTA strategy for global compliance.
- The G5 European tax agreement extended – In May this year the UK, France, Germany, Italy and Spain, or G5, extended IGAs of their own to offshore centres including Cayman, Bermuda, BVI and Gibraltar. Earlier the Isle of Man, Jersey and Guernsey had also agreed information exchanges with the UK HMRC. However, the full details of the IGAs are still not clear, such as if beneficiaries of trusts would be included in the transparency agreements.
- Western Support to Prevent Developing World Capital Flight – Prime Minister, David Cameron, in April this year announced that the UK is setting up a new unit, jointly run between HMRC tax authorities and the Department for International Development, to improve the capacity of developing countries to collect tax domestically, including a fair share from multinational companies.
- The Convention on Mutual Administrative Assistance in Tax Matters – A plan for multilateral tax information exchange globally, including the offshore sector, supported by the OECD and Council of Europe. Prime Minister David Cameron has strongly supported this as part of his agenda for the G8 meeting this June.
- This May UK HMRC stated it will target offshore trusts connected to British residents, threatening 200% fines of tax outstanding on beneficial owners of trusts. They will also face criminal prosecution, in part to make an example of them.
- Swiss, Luxembourg and Austrian Banks Face End to Secrecy – Pressure on the main three secret banking centres in Europe is growing rapidly, with the UK and Germany pushing for full pan-EU transparency, rather than the limited bilateral agreements with single nations some centres have agreed. This is in part driven by an estimated loss of $1.3 trillion a year in tax evasion from the EU[23], with the three mainland secrecy centres regarded as key receivers of outflows. Recent developments include:
    - Closure of Switzerland's oldest private bank, Wegelin, in January 2013 after a US prosecution in relation to tax evasion.
    - Switzerland signs a FACTA IGA with US in February 2013.
    - Swiss law firm Niederer Kraft & Frey saw two partners step down, in relation to allegations of supporting tax evasion at Bank Frey, brought by the US[24].

[21] A Model 1 IGA means the financial centre must deliver information to another FACTA 'partner' country, which will then pass information on to the US. In the case of many offshore centres this will be the UK.

[22] China technically has some of harshest anti-tax evasion laws in the world and until 2011 'tax fraud' was punishable by death, though in reality aggressive avoidance and evasion of tax is commonplace. One potential reason for not wanting to offer information on US citizens is that this inevitably opens the door to discussions on Chinese citizens and their assets abroad. Given that many of China's new rich are either in the Communist Party or related to members of it, any such future information exchange could be embarrassing. There is also the issue of China not being seen to supplicate to the US's demands.

[23] www.bbc.co.uk/news/business-22621254. Many believe Switzerland is now too integrated economically with the EU to refuse its demands for the end to secrecy. As one Swiss law maker puts it: 'We can pretend we are alone up in the mountains, like Heidi, but that is not practical.'

[24] www.thelawyer.com/practice-areas/litigation-/-dispute-resolution/swiss-partner-duo-quit-after-being-caught-up-in-us-tax-evasion-allegations/3004491.article.

- Luxembourg announces it will reduce secrecy for individual depositors, April 2013.
- In April 2013, EU leaders proposed a multi-lateral agreement that could extend to automatic sharing of bank account information on capital gains, dividends and royalties. This would include Austria, Luxembourg and Ireland. Non-EU nation, Switzerland, would be under tremendous pressure to conform.
- In May 2013, Switzerland agreed in principle to permit breaches of its bank secrecy laws to allow Swiss banks to settle disputes with US tax evasion investigators.

This list will grow, with many new developments to come. Given the direction of travel we can expect this trend to widen and amplify until economic growth in the West reaches pre-Crisis levels[25]. And perhaps even after growth returns the pressure will remain.

Impact on Offshore Law Firms

The immediate reaction may be to assume that the changes above are very bad for the offshore legal sector. However, this is far from certain. If the US, UK and EU in general were targeting just one location then this would be an issue for law firms there, as the uneven application of pressure would scare off capital to other unaffected offshore jurisdictions. But, the aim has been to force compliance universally, even if China is not participating[26]. Though transparency will no doubt scare some clients, the low, or no, tax status of offshore centres will not change. The expertise of the lawyers, accountants and company formation experts in such locations will not evaporate either and clients with trusts, or complex fund structures will still have no better place to locate their capital. The commercial courts in Cayman, BVI or the Channel Islands will remain highly important forums for dispute resolution for offshore entities. Meanwhile, for large listed corporates that must be transparent in any case, FACTA or any similar data-sharing agreement may mean the extra attention is uncomfortable, especially if they feel their brand is exposed to reputational damage. But such large clients will not stop using offshore centres entirely, nor will they stop seeking legal advice on offshore matters.

The change in regulatory climate may actually generate a new stream of work for offshore law firms as corporates seek to guarantee compliance and ensure there is no risk to public reputations, an asset of growing value[27]. Companies' risk teams will want to know what is 'acceptable' avoidance and what is 'aggressive' avoidance. This is a complex new field and offers offshore firms the opportunity to pioneer best practice and to be 'thought leaders'.

For some individuals, certain family funds and the less mature hedge fund investors from developing markets that actively seek opaque and complex structures, there will be a dilemma. They placed their capital in well-known offshore centres because they trusted the local legal system and the law firms and accountants there. As with any financial centre, trust is a core factor in attracting business. Clients moving capital to less reputable offshore centres that have not participated in the developments above may not be wise. In which case it is debateable how much capital will flow out of the leading offshore centres because of FACTA and EU pressure.

[25] Waiting for the EU to see healthy economic conditions could be a very long wait. The US, though performing much better, is still in a structural straight jacket with growing demands on its welfare system that it cannot readily avoid. As taxation and transparency become more popular issues and pressure groups grow in confidence the demand for change will likely only increase in strength and sophistication.

[26] The US and EU have also apparently given far less attention to Delaware and Dutch tax avoidance structures. Though perhaps these will be targeted after the main offshore centres?

[27] A recent AON survey found that risk to corporate reputation was now the fourth highest area of concern for corporate clients.

The onshore secret banking centres also are far from panicking, yet. As one banking analyst[28] recently said: 'UBS and Credit Suisse have roughly SFr1.6tn and SFr800bn of assets under management [respectively]. Even if they suffer outflows of SFr10bn to SFr20bn, it will not hurt them.' Though, analysts cannot truly know what will happen because banking secrecy prevents observers from knowing who is banking in these locations. No one can know how many Swiss or Austrian account holders will move capital or invoke 'flee clauses' before secrecy ends. The outflows to other low tax centres could be far greater than expected.

In sum, though there is a degree of uncertainty about the economic impact of these changes, the long term trend is clear. Transparency and information sharing will triumph. Clients that are risk averse, i.e. would rather remain in trusted centres, will have no choice but to conform. Some clients will migrate their capital to less reputable centres, but as transparency spreads, losing such clients may not be a loss to major offshore firms. Offshore lawyers will want to be 'on the right side of history' and present themselves as part of the solution.

Taking the right approach will drive the most publicly accountable clients, such as FTSE or NASDAQ listed companies and exchange traded funds, to the most progressive offshore law firms. The most profitable and complex work, as well as the most long-lasting relationships, will continue to come from the institutional and major corporate client base. It therefore is going to be a new world, but by no means a less profitable one for offshore law firms, if they respond correctly.

[28] Teresa Nielsen, an analyst at Bank Vontobel, www.ft.com/cms/s/0/1c8cfdb6-9d3a-11e2-a8db-00144feabdc0.html.

Chapter Three: Onshore and Offshore Competition

When Worlds Collide

For many years the onshore and offshore legal markets were distinctly separate. Offshore lawyers may have been educated in the UK, perhaps even trained in City law firms, but they differentiated themselves by gaining admission to an offshore Bar, such as Cayman, and then generally remained in that jurisdiction for the rest of their career. City or US law firms that needed offshore advice for their clients referred matters abroad to these local experts, even if much of the law underpinning Overseas Territories' commercial matters was fundamentally English Common Law.

Onshore low tax centres, such as Switzerland and Austria, also were generally left alone by the large UK and US global firms. Luxembourg has been the main exception, with a number of firms setting up offices with local lawyers from the early 2000s, including Allen & Overy, Clifford Chance, Linklaters and more recently Baker & McKenzie, SJ Berwin and Speechly Bircham. In Luxembourg's case 'onshore' firms were attracted by fund formation and capital markets work, then later by the increasing number of corporates moving their European headquarters to reduce taxation.

Despite the huge expansion among global law firms, mergers with offshore law firms to create integrated on and offshore networks have not yet materialised, though it is understood some law firms have considered this in the past. Nor have global firms sought to open offices offshore, at least until now (see below). This relatively stable picture is now showing signs of change. Though we don't foresee rapid disruption of the offshore market the barrier between on and offshore worlds is eroding. Significant developments include:

- UK private client and tax experts, Withers, has an office in BVI, which it opened in 2009 and has now grown to employ several BVI lawyers. It has since developed BVI law desks in its foreign offices, such as Hong Kong, to service Chinese outflows[29].
- US litigation specialists Kobre & Kim, which also has a London office, has opened an office in BVI with two English partners, both of whom are barristers. It now also has an office in the Cayman Islands. Although limited to disputes work, such moves openly challenge the consensus position that 'offshore is for offshore law firms'.
- Offshore law firms developing their practices in Ireland, an important low tax location. For example Cayman-based Maples & Calder, which opened in Ireland in 2006, now has around 20 partners in Dublin offering Irish law advice[30].
- The growing number of onshore UK law firms opening offices in Ireland is another indication of change. Onshore firms with growing Dublin bases include: DAC Beachcroft, Eversheds and Kennedys. The aim has not been primarily to compete with the offshore firms that have bases there. But, as onshore firms seek to build market share direct competition with offshore firms on tax-related matters will grow.
- Litigation taking place in offshore commercial courts has provided a significant flow of work for many English barristers, especially since the financial crisis of 2008. Given that the top UK law firms are now focussed on increasing their revenues from complex international litigation and arbitration, the potential to handle more disputes work related to offshore litigation must be compelling.

Another factor to consider is that with FACTA and European efforts to remove offshore opacity, 'tax havens' would have few other advantages other than low or no taxes on domestically structured entities. The degree of difference

[29] It had been in merger talks with UK rival Speechly Bircham, which if talks had not been called off this May, would have created a far larger private client, funds and tax firm with great international reach. The likelihood is that both firms will continue to expand internationally, perhaps including other offshore and low tax centres.

[30] Maples & Calder states on its website's main page that it offers advice in 'the laws of the Cayman Islands, Ireland and the British Virgin Islands,' which underlines Dublin's importance. Walkers and Ogier also have offices in Dublin.

between, for example Luxembourg and Cayman, would drop considerably. In such a ‘flat world’, it is far easier to imagine global law firms, already used to serving clients in low tax jurisdictions, stretching their brand and expertise across offshore boundaries. After all, the client base of the leading US and UK firms is largely now the same as the top offshore firms, bringing practice capabilities together would make strategic sense. What will happen, however, remains to be seen.

Impact on Offshore Law Firms

Are we seeing the beginning of the end of the distinction between onshore and offshore law firms? The simple answer is: no. The encroachments seen above are not huge, nor do they automatically mean an ‘end game’ of consolidation between onshore and offshore law firms.

Though an international law firm with specialist tax and private wealth practices may seek to build capability in the law of offshore centres such as BVI, as Withers has done, there would be few offshore law firms that would want to merge with a City or US firm. This is because the offshore firm would likely lose their referrals from most other law firms around the world. Few global firms would be able to provide a sufficient work flow to compensate for the loss of referrals. Offshore law firms also have very different remuneration structures for partners to City law firms. While their fiduciary businesses, which have helped provide annuity payments to a number of firms, would not sit easily within the business models of most global law firms.

As noted, what we will probably see instead is onshore firms slowly encroaching into areas such as offshore litigation where they may employ or become partners with English barristers with expertise in tax structures. In the very long term that may lead to ‘mission creep’. In the long term a small number of onshore firms may develop wider offshore practices, though such a move would then risk losing relationships with the leading offshore law firms. One could also argue that global law firms have more pressing strategic priorities, such as grappling with how to build capacity in the developing world, and how to create truly transatlantic law firms with major capability in London and New York. Finally, law firms do what their clients want them to do, and as yet, major clients are not demanding Wall Street firms and the Magic Circle open in offshore centres.

Chapter Four: The Big Picture, Macro-Trends

China and the Offshore World

One of the most important trends over the last decade in terms of global capital flows has been China's rising wealth. Outflows from China have been huge, mirroring the exponential pace of economic development. One conservative estimate found that between August 2011 and September 2012 about $225 billion exited China[31]. Others estimate the figure to be far larger, with Renminbi 'hot money' moving through unregulated channels to avoid capital controls[32], initially into Hong Kong and Macau, and then in some cases into offshore centres. Hong Kong is also a key centre for repatriation of these funds[33], often via 'foreign investor' intermediaries.

Of course, a large part of Chinese capital outflows are for legitimate reasons, for example in relation to BVI companies that carry out IPOs in the US or Hong Kong. Chinese flows and offshore holdings also relate to foreign earnings, or foreign-denominated capital, that due to Chinese capital controls is complex to repatriate. Many wealthy Chinese are also behaving in the same way as other wealthy people by creating family trusts and offshore vehicles to control their corporate or property assets outside of their country of residence.

But will these huge flows continue? The short answer is: yes, even if there are challenges. The Asian superpower[34] faces market cooling and structural problems. For example, its population is aging rapidly and this will lead to pressure on the State to provide greater social support. In turn this may force Beijing to raise taxes and stamp out aggressive tax avoidance and evasion, just as the US and EU are now doing. China's economic growth will however remain high, certainly higher than Europe, and an exporter nation of over 1.2 billion people will continue to generate huge cash surpluses. Many more wealthy Chinese will also be created as privately owned corporates proliferate. A recent survey[35] by Bain claimed that nearly 60% of wealthy Chinese want to emigrate, many aiming for the US. This would naturally drive further outflows, some of which would be structured offshore.

A final point is that economists believe that Beijing will drop the Renminbi's dollar peg and restrictions on capital movement in the mid to long term. This may increase Chinese capital flows offshore as a result of wider equity trading and currency exchange activity.

Decreasing Funds?

Hedge funds and private equity funds, both major client bases for offshore law firms, have suffered since the financial crisis. Weak returns, flat growth in the West, pressure on fees and an increasing regulatory burden, including FACTA's drive for offshore transparency, will increasingly impact the sector. Some experts believe we will see far larger funds form that can leverage their size[36] to counter this pressure. That may lead to greater consolidation. Consolidation could lead to a smaller client base in this sector and that could impact offshore law firms. For now the figures suggest the number of hedge funds is increasing after a post-2008 dip. While a number of 'funds of funds' have closed down individually managed funds rose by the end of 2012 to 7,867, higher than the previous peak in 2007[37]. That said, it seems that many hundreds of funds are being closed each year still, with the numbers less visible due to many new ventures starting up to keep the totals high.

31 hwww.forbes.com/sites/gordonchang/2012/10/28/the-great-chinese-stampede-hot-money-leaving-the-country.
32 Though capital controls in China are regarded as very weak and easy to circumvent.
33 The huge rises in Hong Kong property prices over the last decade are a result of this process. This return of capital is often regarded as 'round tripping'.
34 We recently examined China in more detail: Jomati Report, May 2013, 'Global Balance: Law, BRICs and the Developing World'.
35 http://qz.com/82284/three-out-of-five-of-chinese-multi-millionaires-want-to-emigrate-out-of-china.
36 www.deloitte.com/assets/DcomCaymanIslands/Local%20Assets/Documents/2013_Hedge_Fund_Outlook.pdf
37 www.finalternatives.com/node/22347.

Research[38] also suggests that in terms of hedge fund total assets under management, a new record has been set at $2.375 trillion, up $122 billion in Q1 2013. Hedge funds have also experienced capital inflows now in 14 of the last 15 quarters. This is not an industry in terminal decline, though it is certainly a sector undergoing significant change.

Private equity also faces challenges. Buyouts represented less than 3% of global M&A in Q1 2013, compared to around 28% across the full year in 2007. Buyouts will return in the medium to long term in the West, but the focus in the short term may be on growing opportunities in the developing world. And, as with hedge funds, despite FACTA and growing pressure on transparency, there seems to be as yet little appetite to structure funds away from the main offshore centres, perhaps because managers both trust and need the fiduciary and legal expertise based in the main offshore centres as well as the low or no tax structures.

Banking and Insurance

As noted earlier, almost all major onshore banks, whether retail or investment banks, provide clients, private or corporate, with offshore accounts. One might have thought that banks that had received huge taxpayer bail-outs such as Lloyds TSB or Citi would have come under pressure not to support offshore tax avoidance. If any such pressure existed it has certainly missed its chance to take effect in the US where most bailed out entities have paid back their loans. In the UK, at the RBS annual shareholders meeting this May a question was asked about the bank's use of offshore centres. Even so, most attention remains on other issues: bonuses for excessive risk-taking; the LIBOR scandal; miss-selling of payment protection insurance; and the need to lend to small businesses.

In Chapter Two we considered how secret banking centres such as Switzerland and Austria are facing pressure to share personal account information with tax authorities. As noted, this has already hurt some of the smaller private banks. However, the large universal banks will have a sufficiently large and diverse client base to survive any loss of personal accounts due to transparency concerns. That said, certain offshore banking markets, such as Cyprus, may never recover from its recent Government intervention and demand for depositor 'bail-in'.

The insurance sector also appears to be robust. Bermuda remains the global centre for insurance captives, though experts there note that both Cayman and BVI are increasingly trying to threaten its dominant position. Bermuda also recently has sought to win Canadian captives away from Barbados, Canada's traditional choice of location, by signing a tax information exchange agreement[39]. It has also adopted the guidelines of Europe's Solvency II Directive that relates to insolvency risk in the insurance sector, though Bermuda has insisted on some 'carve outs'. It is hoped they have gone far enough to conform to European expectations. Overall, demand for offshore services from the insurance sector remains very high. Today there are over 5,000 captives worldwide, up from only 1,000 in 1980.

[38] www.hedgefundresearch.com/pdf/pr_20130419.pdf.
[39] www.bermudacaptivemagazine.com/Issues.asp.

Corporates Offshore

As with the large banks, the vast majority of listed companies in the US and UK make use of some form of offshore structure, account or special purpose vehicle. A recent study of the FTSE 100 found that 98 of the top hundred public companies saw the offshore jurisdictions as vital parts of their business, (see Appendix A).

The most used location among FTSE-listed PLCs was Delaware in the US, followed by the Netherlands and then Ireland; all clearly 'onshore' centres. The three leading offshore centres for UK corporates were: Jersey, Cayman and BVI, respectively. In total, just the FTSE 100 alone made use of 8,311 structures across 41 nominally offshore/onshore low or no tax jurisdictions. For example, Jersey has the equivalent of six locally structured entities for every member of the FTSE 100. Perhaps unsurprisingly, it was the UK's banks and oil companies, which often have a large global footprint, that made the most use of offshore structures. Though interestingly it was WPP, the listed advertising agency, that had the most ambitious offshore network, involving 618 entities among low tax jurisdictions. US data is not currently available, but recent investigations of Apple and Google perhaps give an indicator of how deeply American corporations think about their tax costs and how far they will go to reduce liabilities on a global basis.

As mentioned earlier, there may be greater efforts made by large corporations to explain to the public their tax planning, as well as reining back some of their most aggressive tax avoidance schemes. Ultimately, US, UK and European companies, as with all other corporates, will seek to reduce costs and boost shareholder value, but they also care about their image. No company wants to be seen by their customers as socially irresponsible. If negative publicity regarding offshore structures and tax avoidance continues to mount we may see eventually companies seeking to reduce their offshore activities and reducing the number of offshore entities they use.

More positively for the offshore sector, major corporates will only become more global in nature, both in terms of where their revenues are derived and the spread of businesses they operate abroad. Such complex networks of revenue flows and assets will inevitably demand the advice of offshore law firms, even if the number of offshore tax structures does not necessarily increase rapidly in the current climate.

Chapter Five: Strategic Challenges

Differentiation

A global client base is both a huge opportunity and a huge challenge. It provides many new clients in Asia that want offshore services in the Caribbean or in Europe. But, this demands in turn that offshore law firms open offices where the clients are, and also where they want to do business. For example, this has led to all seven of the major offshore law firms opening offices not just in Hong Kong to tap outflows, but also in BVI, as this is a key destination for Chinese capital. The problem now is that all seven of these rival firms offer the global client base what appears, at least on face value, the same capabilities. What differentiation in capability there once was has now been blurred.

Law firms therefore must find new ways of developing a compelling offering. One way would be to strengthen smaller offices to match their offering with that of rival offshore firms in the same locations, thereby giving clients a more even capability across a network. Of course, this in turn sets off similar responses from rivals (see table 7).

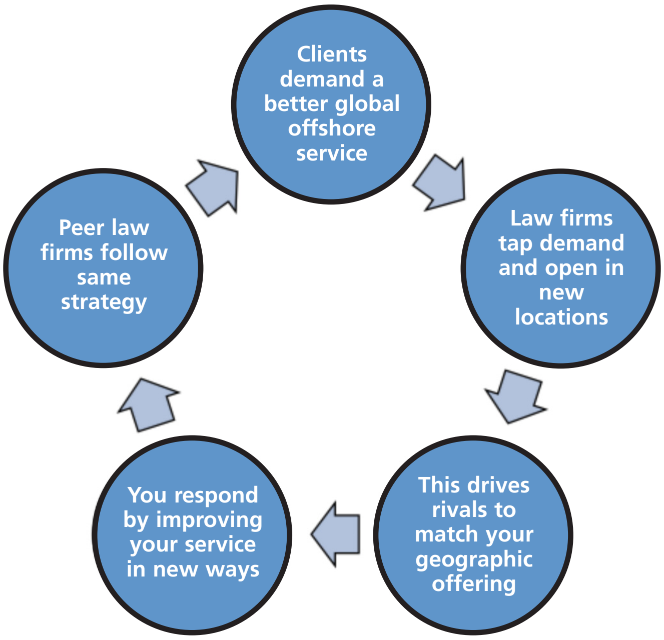

Table 7: The perpetual differentiation cycle for offshore law firms.

Can this process ever end? Can an offshore law firm deliver a ‘knock out’ strategic advance that puts them out of reach of their rivals? The simple answer is: no. Every action creates a reaction, and peers will at least try to match your strategy where it is business critical for them to do so. The challenge then becomes not just geographical differentiation, or even legal capability, but includes other areas that set you apart, such as service levels and production methods.

New Means of Production

Since 2008 pressure from clients, especially in the banking and insurance sectors, has driven major onshore law firms to offer a range of production innovations, such as: fixed fees, including aggregate annual fees for a menu of work; Mexican Wave arrangements[40]; use of LPO and BPO providers; and creation of integrated process units. At the same time firms are investing in predictive 'Know-How' systems that can reduce the costs of standardised matters, limiting work done by associates that more junior lawyers or paralegals could carry out, and improving project management and delivering cost certainty. This has covered not only due diligence in transactional work, or discovery in major litigation, but has spread to all aspects of legal work, no matter how complex some partners still believe their 'product' to be. The reality is that only the most bespoke 'opinion' or 'creative solution' types of legal work contain no elements that can be commoditised and produced more efficiently. The pragmatic truth is probably no more than 10% of any firm's work falls into the 'one off' category.

Change has already begun and will increasingly impact offshore matters. Most offshore firms have already developed 'process functions' employing less expensive labour that look after aspects of fiduciary services, even if they are not seen as such. Also, part of the client base is the same group of clients demanding change in London and New York. We may see eventually:

- Offshoring of offshore legal process work – firms in certain jurisdictions where associate salaries are relatively high may find they can move work to less expensive parts of their offshore network, or create new service centres offshore, or onshore, specially to manage such commoditised matters.
- Mexican Wave offshore – though the top seven offshore law firms dominate the market there are a number of far smaller firms where there could be opportunities to tap their lower cost base, perhaps via joint venture arrangements that support their hiring in of staff to handle the work.
- Fiduciary services BPOs – it seems slightly illogical to have large fiduciary staff numbers employed expensively offshore when much of this work could be reduced in production costs by use of better IT and dedicated BPO service companies, whether in Europe or Asia. Fears over compromising sensitive client data may be an issue, but onshore law firms have successfully managed to use BPO services.

Closing Offices and Office Investment

As we have examined, the top offshore firms have expanded globally, especially over the last ten years. However, and as has already occurred in some locations, offshore firms have found the need to close those offices again. This may be for a number of reasons:

- Lack of the right talent to lead and manage the office or to develop business there.
- Changes in local economic conditions that reduce business flow.
- Change in regulatory positions from the local Bar or financial regulator.
- Increasing costs of operation relative to revenues gained locally.

[40] i.e. where a law firm in a costly location sub-contracts some of its client work to another law firm in a less expensive location, often via a long term agreement. This is usually driven by client pressure on fees.

Some offices may also prove to be redundant as marketing centres as clients in that country are more than willing to travel to and/or deal directly with one of the current offices. This means that offshore law firms may move more toward the strategy of their corporate and banking clients in opening offices speculatively, but then closing them again if they do not provide a good return. Traditionally closing law firm offices has been frowned upon, but it is increasingly being seen as a sensible response among the most international onshore law firms, with closures in South America, Eastern and Central Europe, as well as in Germany.

The closure of offices is perhaps easier for offshore law firms than their onshore cousins because although they may have offices in multiple jurisdictions few intend to offer local legal expertise in every office. Instead, some offices in Asia are offering primarily Cayman and BVI expertise, rather than Hong Kong advice, and acting as business development centres. This means that foreign offices do not necessarily have to be staffed by large teams of local lawyers and the workforce is therefore more easily relocated to other offices in the network without loss of talent.

Market Share

If offshore law firms reach a point where they can no longer significantly increase their global market share under their current strategy and the majority of their clients are not increasing their legal spend, then how can market share be increased? This may be a particular issue if sustained growth, or the rate of growth of quality work for offshore firms, grows more slowly or even starts to decline. One answer may be: merger. Potential strategies could include:

- Merger with a smaller firm in order to develop or break into a new market where clients are showing an increasing interest, as happened in 2007 with the legacy Mourant du Feu & Jeune (now Mourant Ozannes) when it merged with Cayman firm Quin & Hampson.
- Merger with a smaller regional offshore firm in the same part of the world as your main base. This would add manpower, clients and further develop local market share.
- A merger with another major offshore law firm, perhaps bringing together firms with historical strengths in different regions, such as a firm with the bulk of its manpower in the Caribbean and a firm with its traditional base in the Channel Islands. This might trigger a process of consolidation where the number of leading offshore firms reduces to just four or five. The fewer top firms would have huge resources, economies of scale, strength across multiple framing laws and jurisdictions, and far greater revenues to fund business development on a global scale (see more below).

For many years it was considered unlikely that major offshore firms with historical rivalries in the same region, such as in the Channel Islands, would ever merge together. Yet looking back, it now seems perfectly logical that the 2010 merger between Jersey's Mourant du Feu & Jeune and Guernsey's Ozannes to form Mourant Ozannes took place. Before this merger the two firms invested heavily in competing against each other, including opening offices in each other's 'home bases'. However in a global marketplace for legal services it perhaps made more sense to pool resources and then invest in growing the combined practice into Asia and the Caribbean, rather than sustaining a regional battle. As we move further through the process of globalisation in the years ahead, the logic to combine major firms across regions may also make sense from a strategic and economic point of view.

The logic behind such a strategy is supported by the growing number of equally global corporates and HNWIs. These 'global citizens' see no conflict in having business interests and corporate structures in what may appear at first examination to be competing jurisdictions. They make the best use of all legal structures that are available in any jurisdiction they deem suitable. Clients may be aware that offshore law firms in different geographies are in competition with each other, or that certain offshore centres are competing against each other for capital flows, but the clients certainly do not care that much. There is no regional loyalty for capital in such a borderless world. Clients want simply the best possible outcome to protect and structure their investments.

Conclusion

As we have explored, the offshore legal sector is reaching a new stage of development. While the sector is by no means in decline, in fact its partners may see far greater profits in the years ahead, there is a sense that a Golden Age of unchallenged growth for offshore firms may be ending.

The regulatory pressure on 'aggressive' tax avoidance and the growing calls for transparency that have built up over many years has reached a watershed moment where lawmakers' concerns are turning into substantive action. FACTA is a case in point. It is also unlikely that the steps taken this year in relation to tax avoidance, transparency and banking secrecy will be rolled back; rather the process will keep moving forward. Public pressure to close tax 'loopholes' and stop profit shifting by large corporates will also increase and businesses, at least in the West, will see ever-greater demands to explain offshore structures to the countries they operate within and limit their use. Though, this trend may in turn lead to new forms of work for offshore law firms.

The boundary between offshore and onshore firms is also looking less distinct than in the past, and as noted, at least two major US and UK law firms now have offices in the Caribbean. Meanwhile, locations such as Dublin are seeing a steady influx of lawyers from offshore and also the UK, creating a further blurring of the boundary for clients. However, for now we expect such developments to remain small. We also do not expect to see mergers between the major offshore firms and US and UK law firms.

On a strategic level, the leading global offshore firms have now opened offices in many of the 'obvious' offshore locations through which capital flows. Their peers have largely followed similar strategies. To differentiate themselves and continue to meet client demands firms will need to keep developing their strategies. This may range from building better capability in smaller offices to match that of rivals with larger teams, to examining merger options with other major offshore law firms to build truly global capability and to pool greater resources to meet the challenges the market now faces.

Finally, there is the reality that though the top end of the offshore legal sector is a specialised one, where high value advice for sophisticated clients is the norm, post-Crisis onshore pressures on fees and demands to produce commoditised matters in new ways, will slowly migrate to the offshore sector and could lead to changes in how firms produce their work.

How management teams go about overcoming the challenges created by the evolving market will result in a new balance of power among the leading offshore law firms. In some cases firms may fail to adapt and move so far behind their rivals that clients notice and eventually send work elsewhere.

To conclude, we hope this short report has given partners some food for thought on these issues as they grapple with the strategic, business model and management challenges created by an offshore legal market facing one of its greatest ever turning points.

Appendices:

Appendix A: FTSE 100 in Offshore/Onshore Low Tax Jurisdictions

Low/No Tax Jurisdiction (Onshore and offshore)	*Total Related, Subsidiary or Joint Venture Entities of FTSE 100 Companies in each jurisdiction*
Delaware (US)	2,556
Netherlands	1,282
Ireland	736
Jersey	608
Hong Kong	525
Luxembourg	359
Singapore	330
Cayman Islands	323
Switzerland	221
British Virgin Islands	203
Guernsey	203
Bermuda	163
Mauritius	148
Isle Of Man	145
Panama	70
Cyprus	63
Bahamas	52
Gibraltar	40
Costa Rica	33
Barbados	32
Malta	30
Bahrain	25
Lebanon	24
Netherlands Antilles	22
Latvia	17
Liberia	13
Macao, China	12
St. Lucia	12
Cook Islands	11
Seychelles	7
Liechtenstein	7
Monaco	7
Aruba	6
Jordan	6
St. Kitts And Nevis	6
Samoa	4
Anguilla	3
Andorra	3
U.S. Virgin Islands	2
Antigua And Barbuda	1
Maldives	1
In British Overseas Territories or Crown Dependencies	1,685
Grand Total	**8,311**

Data: The Guardian/ActionAid, 12 May 2013. (Grey = Top 10).

Appendix B: Offices[41] of Seven Major Offshore Law Firms (June 2013)

	Appleby	Conyers Dill & Pearman	Harney Westwood	Ogier	Maples and Calder[42]	Mourant Ozannes	Walkers	Total
Bahrain				✓				**1**
Bermuda	✓	✓						**2**
British Virgin Islands	✓	✓	✓	✓	✓	✓	✓	**7**
Cayman Islands	✓	✓	✓	✓	✓	✓	✓	**7**
Cyprus			✓					**1**
Dubai		✓			✓		✓	**3**
Dublin				✓	✓		✓	**3**
Guernsey	✓			✓		✓		**3**
Hong Kong	✓	✓	✓	✓	✓	✓	✓	**7**
Isle of Man	✓							**1**
Jersey	✓			✓		✓	✓	**4**
London	✓	✓	✓	✓	✓	✓	✓	**7**
Luxembourg				✓				**1**
Mauritius	✓	✓						**2**
Montevideo			✓					**1**
Moscow		✓[43]						**1**
Seychelles	✓							**1**
Shanghai	✓			✓				**2**
Singapore		✓			✓		✓	**3**
Tokyo				✓				**1**
Zurich	✓							**1**
Total	**12**	**9**	**6**	**11**	**7**	**6**	**8**	**59**

[41] I.e. fully functioning, locally registered offices, not just locations of representatives.
[42] These counts exclude offices owned by Maples Fund Services or Maples Fiduciary.
[43] Office to close in June, with staff moving to London, http://www.conyersdill.com/locations/view/moscow.

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