Guernsey confident whatever the outcome of EU legislation

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Barely recovered from the turbulence resulting from the credit crunch and the global economic downturn, the alternative fund industry is now on tenterhooks awaiting the outcome of negotiations between the European Parliament and European Union governments on the final form of the proposed Directive on Alternative Investment Fund Managers. Just over a year after the first draft of the legislation was unveiled to almost unanimous outrage from all parts of the industry, there is now a grudging acceptance that the directive will eventually become law and that some of its more egregious elements have been removed or toned down.

Still, for offshore financial centres specialising in alternative fund services from the South China Sea to the Caribbean, a critical uncertainty remains: how (or indeed whether) managers and funds outside the EU will be able to access European investors once the directive is in force. The best case would allow funds from non-EU jurisdictions to benefit from a European ‘passport’ offering the same distribution rights as those enjoyed by funds domiciled in Ireland or Luxembourg; the continued ability to distribute alternative funds through private placements would be acceptable; the worst case would leave external managers and funds effectively shut out of the European market.

A compromise on the definitive version of the directive was supposed to be reached before next month, although this now looks unlikely after negotiators from the European Parliament and EU member states failed to agree a compromise in June. It remains to be seen whether complications such as the political turmoil in Belgium, whose government takes over the rotating presidency of the EU Council on July 1, will result in fresh delays to what has already been an extremely long and tortuous legislative process. But in Guernsey at least, there is widespread confidence that the island’s alternative fund industry will continue to survive and thrive whatever the outcome of the EU’s deliberations.

As in other offshore fund centres, total fund assets domiciled and administered in Guernsey declined markedly in 2008 and the first half of 2009 under the impact of plunging hedge fund performance and massive investor withdrawals across the industry, but the sector has been back on the growth path now for around 12 months. Fund assets increased by 7.2 per cent in the first three months of 2010, the third successive quarter of growth, to a total of GBP197.4bn at the end of March, representing a year-on-year rise of 12.2 per cent.

“The Guernsey fund statistics are really quite good,” says Mike Bane, a partner with Ernst & Young. “There was net new investment during the quarter to the end of March, and it was pretty static in the last quarter of 2009. That is impressive compared with some other jurisdictions, and in fact I’m surprised business is holding up so well given the massive levels of uncertainty. The markets were looking generally healthier toward the end of last year than they do now.”

Peter Niven, chief executive of industry promotional body Guernsey Finance, says: “The past 18 months have been a pretty thin time, although good pieces of new business are coming through, and the industry is slowly but surely starting to take off again. Over the next 12 months or so, we’ll see assets increasing, but I suspect slowly. There is still a degree of caution in the marketplace.”

Niven acknowledges that one element feeding caution in the industry is the continuing uncertainty about the AIFM Directive, but he believes that the efforts made by his organisation, other members of the industry and the Guernsey government to discuss with European decision-makers the issues it raises – especially the steps already taken on the island to provide the level of oversight and regulation sought by the framers of the directive – will eventually bear fruit.

He has consistently maintained that as long as the EU sets out a coherent set of rules for

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third-country funds, Guernsey will be able to meet them. Niven says: “We have been talking very closely with people in the EU who are leading this, particularly the [European Parliament] rapporteur, who himself acknowledges that the Guernsey fund sector is very robust. We already adhere to world-standard regulation – indeed we believe our regulation is probably higher than the level called for in the directive.”

He is critical of the sometimes chaotic decision-making process – “It’s crazy that this has been allowed to fester and drift along, and that different parts of the EU want different things” – but believes that if the legislation sets out conditions for third-country fund access, Guernsey will be capable of adapting to them: “We will be able to fit in with whatever they ultimately come up with.”

Niven’s optimism is shared by Gavin Farrell, a partner in Guernsey with newly-merged law firm Mourant Ozannes. “The AIFM Directive is a big cloud for all the offshore centres, and indeed all non-EU jurisdictions, including the US, which has been protesting about European protectionism,” he says. “However, we are confident that whether we have private placement or passporting arrangements, we will be very well placed among the offshore ‘club’. We are one of the more robust offshore centres and have sufficient regulatory and disclosure framework and requirements to satisfy the EU, possibly unlike certain more exotic jurisdictions.”

Farrell has seen evidence of the uncertainty over the directive having a potentially difficult impact on Guernsey, noting that main advisers to fund promoters are suggesting to their clients that they ought to be aware of the potential impact of the directive. “Whereas before they might have said that the offshore route was best for a certain type of product, now they are suggesting that the clients might also consider an onshore European structure,” he says.

Ben Morgan, a partner with Carey Olsen, is confident that at the least promoters of Guernsey funds will continue to be able to access European investors in the same way as in the past. “We believe that the private placement arrangements that allow Guernsey funds to be marketed into European countries could remain in place, but an equivalence regime would an added bonus,” he says. “Guernsey would comfortably get equivalence because it’s actually better regulated than most EU countries. The island has done pretty well out of the existing private placement arrangements over the years, but if we can get equivalence for some of our funds that would be fantastic.”

Bane is more reluctant to pronounce on the outlook for the island until there is greater clarity about how its fund business will fare under the directive. “A scenario is certainly possible where you end up with an AIFM Directive that is particularly unhelpful for non-EU businesses, including the US,” he says. “That scenario would not be great for Guernsey – or Jersey.

“On the other hand, if there are mechanisms for dealing with the directive and the new UK coalition government understands the importance of the Channel Islands and the Isle of Man as places where alternative fund business can be done in an appropriate way, the next year could be very positive. We are hearing about promoters that are interested in redomiciling their funds from the wider offshore markets to somewhere closer to Europe. Alternative fund managers are talking to lawyers and our structuring experts about how to use the islands, structures and people available to meet their needs.”

Alan Brint, head of corporate and institutional business for the British Isles at RBC Wealth Management, points out that the Channel Islands have successfully dealt with previous issues raised by EU legislation. “We’ve met challenges in the past such as the EU Savings Tax Directive, and the overall growth in the industry has continued. The feeling of the service providers on the island is that there will be more challenges ahead, but they are ones that we can overcome.”

Paul Keltie, head of fund administration at HSBC Securities Services in Guernsey, notes that the European regulatory issues have not stemmed a small but steady flow of alternative fund managers that are setting up operations in the island. “A number of major private equity players have had permanent establishments in Guernsey for years,” he says. “Most recently, BlueCrest Capital Management has established a presence here as part of a move to relocate some of its operations outside the EU, alongside its offices in Switzerland and London.”

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These moves are not by chance but the result of a concerted campaign to encourage the industry to put down deeper roots in Guernsey. “We’re working to get the message out that we are a friendly place not only to put your business but also to live,” Niven says. “We’re just a short hop from the UK, you can get to Europe very easily, and the tax rates are obviously very benign, particularly for high earners thanks to the GBP100,000 tax cap.”

Guernsey Finance is discussing possible relocation with other firms. “There are others expressing an interest in the island – not everyone wants to go to Switzerland,” he says. “It has been helped by people like Guy Hands, Jon Moulton and even people outside the financial services sector, like Jenson Button coming here. People think there must be a reason these wealthy and high-profile people are coming to Guernsey and they must have done their homework. Once we make it onto their shortlist of places to look at, we can really show them what we have to offer.”

Niven does not expect Guernsey’s attractiveness to be damaged by its expected move away from its 0/10 tax structure, which exempted most companies from corporate income tax but which has come under fire for not complying with the ‘spirit’ of the EU’s Code of Conduct on Harmful Tax practices, which the island has to accommodate because of its relationship with the UK.

There is a certain amount of resentment that the EU has changed its mind about the 0/10 regime, which ended tax discrimination between domestic and offshore companies, but ultimately a change would have a silver lining by bringing the government much-needed extra tax revenues. Says Niven: “It’s very debilitating when you go through the process of changing your tax regime, it’s all nodded through, and then suddenly the EU doesn’t like it. Changing a tax regime doesn’t happen overnight – we have to take everything into account – but the change will probably come over next two or three years.

“If we go to a positive rate of tax, it will ease a situation that created a so-called black hole in our finances. The general reduction in business flows has meant a reduction in the tax take. The majority of our tax is now taken from the banks’ business, particularly deposit-taking, which has been pretty lacklustre over the past 18 months with interest rates at an all-time low. Fortunately we haven’t yet had to resort to further indirect taxes such as VAT. We’re still keeping our powder dry there, unlike Jersey which brought it in when they went to 0/10.”

Niven emphasises, however, that the fund sector will not be included in any return to taxation of corporate profits. “We are doing another root-and-branch review of the whole system, which will take time, but because we didn’t want uncertainty, the government announced that it would not affect the fund sector. It will be carved out and either be zero-rated or exempt. The industry can take comfort that this will not be a new concern to worry about when business flows start to pick up.”

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