Hedge fund managers head for Guernsey

Administrators thrive as funds soar

Expertise and flexibility pay dividends
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Published by: Hedgemedia Limited, 72 New Bond Street, London W1S 1RR
Tel: +44 (0)20 7692 7398 Web-Site: www.hedgeweek.com

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For Guernsey’s fund industry, 2005 was the most successful year yet, underlining the island’s pre-eminent position as the jurisdiction of choice for a growing number of fund promoters.

And there’s every reason for this unparalleled success to continue, as industry professionals work to develop and reform the island’s legislative and regulatory framework in order to encourage further innovation.

Guernsey now has more than £100bn worth of fund assets under administration - with growth of 36% in 2005. Traditional funds are doing well, but growth in funds of hedge funds, hedge funds, private equity and property funds has been particularly impressive. The figures reflect both the prevailing favourable market conditions and the fact that Guernsey has now become a recognised global fund services provider.

From its administrative heritage stretching back four decades, Guernsey has in recent years begun to attract fund managers, enhancing its reputation for fund work and significantly adding to the pool of expertise on the island. There is also a highly developed infrastructure, including comprehensive specialist legal and accounting services, to support the industry.

Guernsey developed its own professional funds, Qualifying Investor Funds, early last year and has now introduced further flexibility by changing the definition of a qualifying investor, to further enhance its competitive position in the international marketplace.

The optimism about future growth and success is well reflected by the participants in this special report. One of the drivers for this enthusiasm is the root-and-branch review of the industry’s legal and regulatory structure that has been conducted this year.

Guernsey’s Department of Commerce and Employment and the Guernsey Financial Services Commission jointly commissioned a working party to reappraise the investment sector legislation and regulation, under the leadership of a respected Guernsey advocate, Peter Harwood.

Its terms of reference called on the working party “to consider the investment industry in the Bailiwick of Guernsey and the conditions required for its continued prosperity”. The review evaluated the legal and regulatory framework, assessing how aspects of public policy relate to the industry, and the working party is expected to make recommendations for change in its report, which is due to be made public very soon.

It is also anticipated that the report will propose fundamental changes to the system of regulation, particularly within the investment funds sector, considerably reducing the number and scope of investment funds that are required to be regulated. Furthermore, it is expected that the working party will recommend that the focus of regulation should be on the licensed Guernsey administrator.

The working party is also likely to recommend other changes to facilitate the administration of non-Guernsey domiciled investment funds by Guernsey licensed administrators as a means of ensuring that Guernsey maintains a vibrant fund administration sector.

All of this is very good news for Guernsey’s thriving fund industry. The outcome of the review is sure to increase flexibility, boost confidence, and promote further growth in this highly dynamic area of the island’s financial services business.

Peter Niven, Chief Executive, GuernseyFinance
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Comparing apples to apples

By José Santamaria

The traditional lines of offshore jurisdictions, custody and fund administration continue to blur. Today’s world is no longer just about the administration of long-only equity, fixed income, money market, hedge funds and funds of hedge funds. The sector has expanded to include private equity, venture capital, securitisation, property and insurance structures. With all these offerings combined in a single jurisdiction, Guernsey is more than just a funds centre.

One must appreciate that each of these product segments requires distinct administrative service competencies and skill sets. In principle, they share some commonalities around the general concepts of unit-holder recordkeeping, financial accounting, the formalisation of periodic market valuations, calculation of net asset values and reconciliation to a formal record of cash and investment assets, although some structures will not require the formal appointment of a custodian.

Ironically, this is where the lines blur and the general market measurement practice of assets under administration starts to dilute its significance. A fund administration or custodian survey boasting so many billions in assets under administration that results in a certain ranking is fairly meaningless unless put in a proper context.

Comparing the custody and fund administration requirements of a USD 2bn master/feeder hedge fund, fund of hedge funds or traditional long-only fund with thousands of unit-holders is quite distinct from a USD 2bn property, venture capital or private equity structure.

Unfortunately, many offshore industry surveys do not make this distinction, which leads to a lack of transparency and results in apples being compared with oranges as far as assets under administration are concerned. Hopefully, more industry surveys will evolve to create a clear reporting mechanism that incorporates fund categories, which will then acknowledge size of assets where credit is due.

The range of fund categories results in a varied choice of service providers, whether they be global custodians, niche boutique independents or the administration arms of trust companies and legal firms. Here again, Guernsey boasts a robust choice of service providers, each able to deliver its select product offering and cater to its client segment.

When comparing service providers there are some important questions to ask. Is custody and fund administration a core business line of the organisation, and is there a long-term commitment to remain in the industry? Are the providers global players with multi-jurisdictional operational hubs, or niche boutique players with select or single jurisdiction presence?

What technology systems are used – home-grown Excel net asset value spreadsheets and Access unit-holder registry databases, or industry-recognised third-party vendor system platforms? Are operations scalable from both staffing and technology viewpoints? Does the service provider have the balance sheet and sufficient contingency insurance to cover unforeseen administrative errors and associated financial losses? These are all questions that should be posed to any custodian or fund administrator, regardless of jurisdiction domicile.

Of primary importance is the ability to offer a truly integrated, scalable and client-centric trustee, banking, custody and fund administration service, against the backdrop of a proactive and industry-progressive regulatory regime. This dynamic combination is a powerful force that is attracting more and more fund sponsors, investment managers and institutional clients to domicile their structures in Guernsey.
Coming off a record-breaking year for the funds sector, financial services professionals in Guernsey believe the island can go on to scale new heights in the coming years, backed by a consensus between industry, regulator and government on a strategy to enhance its global competitiveness while maintaining the high standards upon which its reputation rests.

The QIF funds regime has already done much to announce to the world that Guernsey is not only open for business but is willing to innovate to meet the needs of the industry and its clients. Now, industry members say, the island is ready to take a step further with a wholesale reform of its regulatory structure, while at the same time adjusting its tax system to ensure it does not lose out to Jersey, the Isle of Man, and rivals further afield.

“Guernsey’s got a very good message to tell,” says KPMG partner Neale Jehan. “The QIF regime is now in place, promoters have taken it up, and a good number of funds have already gone through that route. On top of that, the funds industry – not just in Guernsey but everywhere – is growing hugely.

“We’re very well positioned in terms of our infrastructure. We have our own stock exchange which is growing fast, and we offer a very convenient location at least for European managers, a few of which have already moved their business to Guernsey. And with the Harwood report setting out a blueprint for the future of the industry, the message now is that it’s only going to get better.”

Still, Jehan cautions that so far the island has travelled only some of the road toward global competitiveness. “Flexibility is key,” he says. “Guernsey needs to market itself as a location where you can domicile your business, run your funds, and everything’s here. But if you have specialist service providers you want to use in other jurisdictions, I don’t think there should be any restriction, as long as there’s proper oversight.

“We’ve got to recognise that the industry is growing hugely, and that on a small island there are always going to be potential...
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As interest in hedge funds has grown in the United Kingdom and Europe in recent years, a large number of promoters have chosen to locate their funds in Guernsey. This is because the Guernsey Financial Services Commission (GFSC) has adopted policies and regulations that encourage the use of the island as a domicile through two policy changes. By contrast, excessive regulation in other jurisdictions has resulted in hedge fund management companies looking to relocate their managers to Guernsey.

The first policy change introduced relatively recently in Guernsey is to the legal and regulatory framework and is designed to improve the regulatory environment for hedge funds. The other principal change is that there is now a streamlined authorisation process allowing promoters to establish Qualifying Investor Funds within three working days. These changes are outlined below.

The GFSC published a framework policy document on February 23, 2004 entitled Hedge Funds: Flexible Approach to Authorisation Policy.

In particular, the GFSC:

- is prepared to waive the requirement for a fund to have a locally licensed custodian and will permit the appointment of a prime broker as long as the latter is regulated in an acceptable jurisdiction and has substantial net worth;
- does not require a prime broker to offer physical segregation of fund assets from its own assets, even where fund assets held by the broker exceed credit extended by the broker; and
- will be prepared, provided that the process is robust, to permit arrangements that allow a preliminary estimation of net asset value for the purpose of allowing subscription monies to be taken into the fund before the final share allocation has been determined, and will also make available appropriate waivers from the operation of the client money rules provided it is satisfied as to the robustness of the estimation procedures to be used.

Recognising that many hedge funds are established for professional and experienced investors, the GFSC re-published a guidance document in April 2006 redefining its streamlined authorisation process for QIFs (first introduced in February 2005), which reduces the authorisation timescale from between four and six weeks to less than three working days once all fund documentation is finalised. Approval is given by the GFSC on the basis of the Guernsey administrator’s self-certification of the promoter and the fund.

QIFs can be established as open-ended or closed-ended funds and as single- or multi-class unit trusts, investment companies, protected cell companies or limited partnerships. They are open to ‘qualified investors’, defined as professional investors, which includes investors individually investing at least $100,000 (or currency equivalent) following changes introduced recently, experienced investors and knowledgeable employees.

The administrator has an ongoing responsibility to monitor compliance with the matters it has self-certified and to ensure its rationale for the self-certification is clearly documented. The GFSC will consider derogations in relation to the rules relating to the relevant classification of investment funds subject to it having sufficient notice before the QIF application.

The GFSC’s change in policy has gone a long way to promote the advantages of Guernsey as a domicile for hedge funds. Consequently, a number of large hedge fund managers are now using the island to domicile hedge funds, and a significant number are also relocating their offices and trading platforms to Guernsey.
capacity constraints, so we need to develop a regime that ensures capacity never becomes a problem. Flexibility to outsource would be a definite advantage."

Capacity constraints are a long-standing topic of debate in Guernsey and its competitor jurisdictions, many of which are relatively small island territories with limited populations and even more limited space for living and working. But today there appears to be a calmer appreciation of what this means for Guernsey.

"In a small jurisdiction where we have limited resources, there will always be concerns about capacity," says GuernseyFinance chief executive Peter Niven. "That’s one of the areas the Harwood report will have looked at in terms of options for the future, perhaps providing the opportunity for outsourcing to other jurisdictions where they have greater resources, as long as there are controls back at base in Guernsey to ensure that the whole thing is kept together.

“We are looking to provide jobs for locals and people coming onto the island that provide more added value and are higher on the salary scale, which in turn helps the tax take. But at the same time we must keep those checks and balances in place regarding where the other parts of the business are outsourced.”

As chairman of the education sub-committee of the Guernsey Investment Funds Association, Butterfield Fund Services (Guernsey) managing director Patrick Firth believes that maximising the potential of the island’s human resources is an important step. “There are resource issues in all jurisdictions,” he says, “but we’re keen to ensure there is effective training here. It can make a big contribution.”

Although the island’s parliament has yet to take a final decision, Guernsey is set to follow territories including Gibraltar, the Isle of Man and Jersey in cutting the basic rate of corporate taxation to zero, with banks paying a special rate of probably 10 per cent.

This far-reaching tax reform, which is due to take effect in 2008, is mainly the result of an international campaign against special tax regimes that allowed offshore companies to pay lower rates than domestic firms incorporated in the same jurisdiction.

Abolition of this type of ‘ring-fencing’ was expected by bodies such as the European Union and the Organisation for Economic Co-operation and Development to lead to the abolition of offshore company regimes; instead most of the jurisdictions affected responded by reducing the standard tax rate on all companies to zero, with a special 10 per cent rate levied on certain financial institutions and other businesses such as utilities.

But voluntarily renouncing a large slice of a territory’s corporate tax receipts leaves a gap that has to be filled. While other jurisdictions have announced plans to raise their take from personal taxation or from indirect taxes on goods and services, Guernsey seems poised to wait until the new regime is in place and the size of the shortfall is apparent before deciding on measures to bring the budget back into balance.

This attitude has prompted some alarmist and well-publicised comments - admittedly from the Tax Justice Network, an organisation not noted for its sympathy toward offshore jurisdictions – to the effect that a few years of the new tax structure will leave Guernsey bankrupt.

Niven is indignant about the reports. “It’s quite grotesque to say we’ll be bankrupt within a few years, and completely wrong,” he says. “In changing our corporate tax structure, there will inevitably be a gap in our finances in 2008, but what everybody’s trying to do is to solve that problem now, when in fact its scale can’t be fully appreciated until it hits.

"Jersey has decided to introduce a goods
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Guernsey’s fund industry began the year with more than £100bn in assets under management and administration. This follows impressive growth of £26.4bn, or 35.9 per cent, in 2005. This record level has been assisted by positive market conditions and increased flexibility in the regulation and licensing of funds, which have encouraged strong growth in the number of hedge funds, private equity and property funds requiring administrative, custodial and management services within the island.

Guernsey-domiciled open-ended funds grew by £14.5bn (43.1 per cent) during the year to reach a new record total of £48.2bn. Closed-end funds also showed signs of resurgence, with an increase of £8.2bn (36.0 per cent) during the year to reach £31.1bn, also a new record. Non-Guernsey schemes, for which some aspect of management or administration is carried out in the Bailiwick, increased by £3.6bn (21.5 per cent) during the year to a record £20.7bn.

These figures represent unprecedented growth in the industry and a testament to Guernsey’s success as a global fund services provider. The island’s ability to perform in a highly competitive market and stay ahead of the demands of the industry is set to be reflected in a steady rate of growth in the current and future years.

By the end of the year, 36 Qualifying Investor Funds (QIF) had been approved in Guernsey since the launch of the scheme on February 7, 2005. Coupled with other enhancements to the legal and regulatory environment, QIFs have put Guernsey at the forefront of the international investment funds industry as its professional infrastructure and pragmatic new regime have together encouraged significant new business.

A significant amendment to the QIF regime recently took place, defining ‘Qualified Investors’ as individual persons who make a subscription of USD100,000 or more in the fund, thus enabling them to benefit from the fast-track, self-certified QIF regime.

Guernsey has long been a choice location for leading fund promoters, managers, administrators and custodians whose professionalism interconnects with an in-depth infrastructure of fund service providers, including lawyers and accountants. Over the years this expertise has made it an attractive domicile for a range of alternative products including hedge funds, funds of funds, property funds, emerging market funds, traditional funds and private equity.

Guernsey’s commitment to remaining in the forefront of the industry means there are regular opportunities for the Guernsey Financial Services Commission to meet with agencies such as Guernsey Finance and the Guernsey International Business Association to discuss where improvements can be made. Once a regime has been put in place, it continues to evolve organically with the industry in constant communication with the regulator. The Commission recently updated the QIF regime with the aim of maintaining its competitiveness in the international marketplace and its ability to attract international fund managers. The Guernsey International Business Association continues to push for further flexibility to develop new innovative products in order to ensure that the island retains its allure as a leading funds domicile.

However, the island is also ambitious to develop its position as a centre for the servicing of sophisticated funds wherever they may be domiciled. There are many factors that contribute to a fund manager’s decision on where to domicile a fund and which service providers to use.

Guernsey’s flexible approach means that where a manager has decided to domicile a fund elsewhere, providers work closely with that jurisdiction to ensure all aspects of corporate governance are monitored. This helps Guernsey service international investment managers who by the nature of their client base offer products domiciled in multiple jurisdictions.
and services tax to fill the gap. Guernsey appreciates that there will be a problem and can roughly calculate its scale, but a lot can happen between now and 2008. For example, last year we saw an unexpected increase in the island’s personal tax take, which if extrapolated would mean that the so-called black hole would be smaller than under present calculations.

“There will also be an increase in business. We are seeking to move people to higher added value business, which means higher salaries and hence more personal income tax. With all that going on in the background, quite sensibly the authorities have decided to use some of the resources that we’ve built up in the contingency fund to tide us over for the first two or three years. Once we see the scale of the problem, we’ll decide whether to bring in a sales tax or how else to solve the problem. We’re just giving ourselves time.”

Ernst & Young partner Peter Franks notes that the reform will have little direct impact on funds, which currently pay a tax exemption fee of just £600, However, he says: “Talking of moving tax rates down to 10 per cent for banks and zero per cent for other companies is obviously an encouraging sign, and should attract further businesses to the island.”

Says Jehan: “The government has taken time to consider various options, and we hope that not only whatever regime comes out of that is competitive, but that our black hole will be relatively smaller than those in other jurisdictions. Maybe we can tag on some growth that will avoid the need for additional taxes, like a general sales tax.

“There has been some uncertainty about what Guernsey will choose, and Jersey and the Isle of Man have come up with their proposals a lot earlier. But I think what we will have in place will have been well thought out and will give us a good basis for being competitive against those jurisdictions.”

Robin Fuller, managing director of HSBC Securities Services (Guernsey), argues that another aspect of the planned reform – a cap on the maximum tax liability - will help. He says: “We hope ‘tax capping’ will go some way toward attracting intellectual capital to the island in the form of the teams brought over to run local managers such as FRM.”

Niven says the industry and authorities were keen to get the tax reforms finalised before embarking on a sustained effort to lure further hedge fund managers to Guernsey. He says: “The package will go to parliament in late May or June, and once that has been agreed, the time will be right to use it as a springboard marketing ourselves to fund managers and start the process of attracting them over to the island.”

Apart from Financial Risk Management, local financial services professional Peter de Putron has launched De Putron Fund Management, Dexion Asset Management has also set up an operation on the island to take advantage of the attractive tax regime, and Niven says another management operation, BBFA, has just been set up.

Says Franks: “We are already seeing a lot more interest from fund managers in domiciling in Guernsey. In particular, people are concerned about the UK tax authorities’ focus on whether businesses are being run out of the UK or in an offshore location, and are trying to have more substance in the offshore location.”

Attracting hedge fund managers is just one of the areas in which Guernsey and Jersey find themselves in competition, but members of the industry take pains to point out that the rivalry is far from cut-throat. Says Niven: “Yes, we are in competition with Jersey, but we shouldn’t get too worked up about it. They may be looking at the same opportunities, but there is plenty of business out there for both of us.”

Jehan argues that while the Channel...
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The custodian of a fund of hedge funds plays an important role in protecting its assets and carrying out oversight of the manager and administrator on behalf of the shareholders. But custodians often carry out a further vital function by providing credit to the manager for hedging purposes, gearing of investments and to manage settlement timing, to enable them to stay in the market while waiting to receive the proceeds of an investment that is being liquidated.

The custody market in Guernsey is keen and competitive. Along with MeesPierson (C.I.) (part of the MeesPierson Reads group in Guernsey, and ultimately owned by the Fortis Group), there are six major players in the market, including institutions such as Royal Bank of Canada, Northern Trust, which last year acquired the Barings fund services business, and HSBC.

MeesPierson (C.I.) distinguishes itself from its competitors in two ways. First, as a specialist custodian, rather than as an institution offering a package of services to funds including administration, the firm is probably more attractive as a partner to independent administrators, who can be confident that MeesPierson is not pitching for their own business.

The danger for independent administrators in choosing a custodian that is part of a large institution with a comprehensive range of services is that once the client has entered a business relationship with such an institution, before long they are being lured by the benefits of a one-stop shop.

The second characteristic that marks out MeesPierson is credit policies that are somewhat more flexible than those of many of its competitors. Other custodians can be unwilling to provide the same level of credit with hedge fund assets as collateral.

As a result, funds could potentially run into problems in obtaining credit for hedging and gearing purposes and potentially for the management of settlement timing. Each custodian has its own particular niche, and MeesPierson appears especially attractive to funds of hedge funds with a larger requirement for credit than other funds.

The main issue facing custodians of funds of hedge funds is that in contrast to custody of fixed-income and equity funds (which also represents a small proportion of MeesPierson’s business) is that it is very labour-intensive. Exchanging faxes is required to carry out subscription to underlying hedge funds, and data is entered manually. There’s very little opportunity for automation, so the requirement for people to administer is high.

Finding the right people is not always easy or inexpensive. Guernsey’s workforce is limited in size, and the number of skilled people looking for work is extremely small. As a result, demand for staff has pushed wage inflation higher than normal over the past couple of years, although measures to make it easier for the financial industry to recruit outside the island have helped to ease the pressure.

The importance of the custodian in overseeing a fund of hedge funds should not be underestimated. They check that valuations are carried out correctly, monitor that investments are appropriate and do not exceed predetermined limits, oversee that risks are properly spread, and perform regular due diligence checks on the administrator and manager.

The past year has been a particularly good one for Guernsey funds of hedge funds, which is one of MeesPierson’s core businesses. It also acts as custodian for some non-Guernsey schemes, as the regulations allow, some of which are now converting into Guernsey funds. With steady growth in the number of funds seeking custody services, the outlook for the next year seems as positive as the past 12 months.
Islands are relatively similar jurisdictions, Guernsey moved toward the alternative sector much earlier while Jersey remained a retail funds centre. “Only very recently, with the Expert Funds regime, has Jersey tried to move into this market – with some success,” he says. “In the alternatives sector, they’ve done very well in property funds, and hedge funds are doing reasonably well, although unlike in Guernsey the private equity industry is very small.”

Says Franks: “It’s very hard to differentiate yourselves, and these days it has to be on quality of service rather than the legal framework. We’re all quick at catching up with each other when something new is introduced in another jurisdiction, so we have to differentiate ourselves on having the right people to do the job.”

Firth argues that the two centres are as much complementary as competitive. “You have the Channel Islands Stock Exchange which serves both islands, accountancy practices that cover both Jersey and Guernsey, and a number of the administrators have Jersey operations as well.”

What both islands are trying to do is convince hedge fund promoters and managers that there are alternatives to domiciling funds in the Cayman Islands, home to probably as many as half of all the world’s hedge funds and certainly the dominant jurisdiction for offshore vehicles.

Says Jehan: “Traditionally the hedge fund route has been Cayman domicile and Dublin administration, but Guernsey has started to get in on that act by servicing Cayman or BVI vehicles. It’s still a relatively small piece of the market, and going forward I think we’d still want to focus on domiciling funds locally.

“The hedge fund industry is becoming more institutionalised, with much bigger investors who have very different demands from the kind of investors who were in the industry to start with. Big US pension funds will not want to invest in something they can’t do proper due diligence on.

“Corporate governance is one particular area where we have something to offer. Guernsey funds don’t have any strict requirements under the regulations to follow any particular corporate governance code, but listed hedge funds tend to put in place a regime incorporating some aspects of the UK Combined Code, such as an audit committee and independent directors, but without the requirement to follow the strict UK rules to the letter.”

Jehan believes that greater marketing efforts can help Guernsey can increase its share of the funds market. “Lawyers in London choose Cayman because it’s easier and they’ve done it hundreds of times. But if the investors turn round and say they don’t want Cayman, where do you go? Guernsey needs to develop its presence and shout a bit louder in order to be heard. I don’t think it’s ever going to be a Cayman, but it could be a lot bigger than it is now.”

GuernseyFinance is doing its best to achieve this through regular promotional trips abroad and events such as its annual funds conference in London. Says Niven: “What we’re trying to do, especially through the funds conference in September, is widen our net and put the idea into promoters’ minds that Guernsey provides them with opportunities.

“A lot of this business comes from the personal relationships that the our fund industry has with promoters, particularly in London. We’re only a stone’s throw away - you can virtually do all your business in a day, visit the regulator, see accountants, lawyers and administrators, and once the fund is set up, hold a board meeting with local Guernsey non-executives. Once people try us, they’ll like the way we do business, and decide to do more.”
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A question of governance

By Benjamin Wrench

Over the past few years the hedge fund industry has matured and London’s investment managers have become more comfortable with alternatives to the traditional Caribbean hedge fund.

This maturity has grown out of internal and external pressures. The pool of potential investors in hedge funds has increased, and the attention of regulators has become more focused. In recent times, the more traditional investment management houses have also recognised that they and their investors need exposure to hedge funds as an asset class.

With this maturity comes added responsibility and, with reputations to lose, investment managers have looked closer to home when choosing the domicile for an offshore fund.

The logistical difficulties of operating a Caribbean structure across the Atlantic mean it is very often difficult for such a fund to demonstrate to HM Revenue and Customs that, although the fund is incorporated offshore with a majority of offshore directors, its management and control are exercised in or from any particular jurisdiction other than the investment manager’s.

The more jurisdictions in which the fund could argue to have based its central management and control, the weaker the argument becomes for each one of those jurisdictions. Such funds also risk being deemed to be domiciled in the jurisdiction of the administrator if it has provided the fund with directors and facilities for repeated board meetings.

At a time of demanding corporate governance requirements, it is becoming increasingly important for directors to attend some board meetings in person. Domiciling an offshore fund in a more accessible jurisdiction allows the investment manager to attend meetings more frequently, visit the administrator in that jurisdiction at the same time, and thus demonstrate that the fund is domiciled in a particular place. Many of Guernsey’s administration firms are part of global operations that can outsource to other centres of particular expertise where necessary.

The Channel Islands Stock Exchange (CISX), which is based in Guernsey, is developing a serious reputation for listing both closed and open-ended funds. Since the FSA has approved the CISX as a designated investment exchange, FSA-authorised firms have been permitted to treat CISX transactions in much the same way as if they were trading on the UK’s recognised investment exchanges.

Consequently, an investment by a UK firm in a CISX-listed security incurs a significantly lower position risk requirement, which further reduces transaction costs. Trading costs are also minimised because there is no stamp duty in Guernsey, and Crest and Euroclear are available for electronic settlements. Finally, compliance costs are reduced for issuers because the CISX is not obliged to implement the EU Transparency Obligations Directive.

The CISX is also able to take a more pragmatic approach regarding the independence of directors of listed companies than either the London Stock Exchange or the Irish Stock Exchange.

The critical mass of service providers has allowed the Guernsey Financial Services Commission to lighten its oversight of Qualified Investor Funds that restrict their marketing to professional, experienced and knowledgeable investors. A minimum initial subscription per investor of USD 100,000 will also result in a fund being eligible for this fast-track approval procedure. With the help of their administrator, investment managers that already domicile offshore funds in Guernsey can establish hedge funds much more quickly than in the past.
A year after the introduction of the Qualifying Investor Fund regime opened new vistas for Guernsey's hedge fund business, administrators across the island are enjoying a broad-based boom that encompasses other types of alternative investment as well as hedge funds, and even includes its residual retail funds sector.

Fund assets grew at an unprecedented rate of more than 35 per cent in 2005 to pass the £100bn mark, partly down to the introduction of the QIF regime, but also to strong demand for two other Guernsey specialities, private equity and property funds. Peter Niven, chief executive of the industry promotional body GuernseyFinance, believes that business can only increase further as the regime is adjusted in response to feedback from the industry.

The QIF regime offers a fast-track procedure that enables funds to receive authorisation from the Guernsey Financial Services Commission within three working days of its application being received, an change that brings the island into line with leading hedge fund jurisdictions in the Caribbean such as the Cayman Islands and British Virgin Islands.

Just as importantly, the new regime has ushered in a new approach to authorisation and regulation that transfers the burden of due diligence and ongoing monitoring of funds onto their administrator. Restricted currently to professional and experienced investors, this structure is set to be extended to other types of funds in the wake of the Harwood report, a root-and-branch review of Guernsey's fund regulation that is due to be published imminently (see separate article).

Says Carl Rosumek, deputy director of investment business at the GFSC: “The Guernsey Qualifying Investor Fund regime was introduced as a means of streamlining the approval process for both open and closed-ended investment funds aimed at professional, experienced and knowledgeable investors. The regime applies to funds of all types; it was not specifically designed for hedge funds.

*Under the regime the commission
undertakes to grant the required fund approval within three working days, provided that an appropriately licensed Guernsey applicant has certified to the commission that the fund will be restricted to professional, experienced and knowledgeable investors, that the applicant has conducted due diligence on the promoter and associated parties and has found them to be fit and proper, and that the applicant is satisfied as to the fund’s economic rationale and the disclosure of any risks associated with the investment vehicle.”

Says Niven: “The QIF regime is just over a year old, and we recently tweaked it to include a provision that investors placing USD 100,000 into a fund will be treated as qualifying investors, which other jurisdictions already have done. We felt we wanted to see how the regime bedded down before we started to extend it, but we’ve now started doing that.”

Niven sees the changing regulatory structure and a planned reform of Guernsey’s tax system as elements of a package that will not only boost the island’s competitiveness as a centre for the domiciliation and servicing of alternative investment funds but could also lead to hedge fund managers choosing the island as a base for their operations.

He says: “The past 12 months has been a good year for funds, and the number of funds that have gone through the QIF regime has started to build up. But once we get these further building blocks in place, we will have a springboard from which to boost property, private equity and hedge funds. It’s early days yet because people are still getting familiar with the concept, but once we start to implement the Harwood conclusions we’ll see business really start to escalate.”

The changes include moves to ease the island’s rules on the role of custodians, a bugbear for hedge funds in many jurisdictions. Says Benjamin Wrench, an associate lawyer with Ozannes Corporate: “Guernsey has become much more attractive for hedge funds as a result of the GFSC relaxing its previous requirement for open-ended funds to appoint Guernsey regulated custodians, provided that a reputable prime broker has been appointed.

“’The GFSC no longer requires those prime brokers to take on formal duties of oversight over the fund, and waives the obligation to have segregation requirements for the prime brokers holding the fund’s assets and for subscription and redemption monies. A growing number of prime brokers have taken advantage of this, including Goldman Sachs and JP Morgan.’

Robin Fuller, managing director of HSBC Securities Services – which provides administration and custody services to more than USD 20 billion of assets in Guernsey – believes that the island’s success is down to a combination of factors, including its acknowledged professionalism and expertise in providing services to fund promoters from around the world.

He says: “Coupled with other enhancements to our legal and regulatory environment, QIFs have put Guernsey at the forefront of the international investment funds industry. Guernsey has always had a positive reputation, and such unprecedented growth is a tribute to the high standards of streamlined regulation and service provision throughout the island.”

According to Patrick Firth, managing director of Butterfield Fund Services (Guernsey), the strength of the QIF regime is that it is internationally competitive while maintaining the level of regulation Guernsey has always prided itself on. “There are some..."
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Advances in communications and in the requirements of financial services mean innovation and leading-edge skills are vital. Investment by Cable & Wireless in world-class telecommunications continues to support the local businesses and ensure that Guernsey remains a world-renowned centre for financial services.
“What the QIF regime does is give certainty to authorisation by the regulator within three working days as long as the service provider has signed off on the due diligence. The industry is happy that it provides another weapon in the armoury, and the regulator's announcement that a minimum investment of USD 100,000 is an indication of a qualifying investor has also been well received.”

Says Fuller: “Service providers can now offer an additional service to international fund managers who frequently operate to very challenging timetables. The new regime allows the licensing of funds within a three working day period, and Guernsey service providers are able to support the process of integrating what can be highly complex structures in a relatively short period of time.”

He insists that the self-certification of funds by service providers does not actually involve a shift in responsibility. “Administrators have always worked in partnership with the GFSC in ensuring high standards of regulation and corporate governance are met. The new regime only highlights the work licensed service providers are doing on behalf of the fund as part of normal compliance procedures.”

Adds Firth: “To the extent that administrators already discharge their duties in terms of the due diligence, there should be no impact on them. It falls into the broad spectrum of work we were doing already. It formalises it and brings it into a slightly different format, but the actual work required is pretty similar to what we were doing before.”

Industry observers note that Guernsey’s fund administration industry, like that elsewhere, has seen consolidation in recent years, most notably with the acquisition last year of Baring Financial Services Group, which includes Guernsey International Fund Managers, by Northern Trust. But the sector is also seeing new start-ups.

Says Fuller: “The growth rate of the fund industry as a whole will continue to drive corporate activity, including consolidations and start-ups. As the levels of fund administration continue to increase, we would expect to see further global players enter the market as threshold levels become more appealing, and more specialist funds look to Guernsey as their chosen domicile.”

KPMG partner Neale Jehan notes that Guernsey’s broad mix of administrators, ranging from big international service providers that are part of global banking groups to niche providers specialising in different areas of the alternative investment market, vary in their ability to outsource work to other jurisdictions.

He says: “The international service providers clearly have capacity in other jurisdictions and may choose to outsource retail-type administration to a centre of excellence elsewhere, but if you move down the scale there are mid-tier administrators that tend to be locally-owned businesses, and may not have the ability to outsource within their own group. These firms might want the flexibility to outsource to specialist providers elsewhere.

“Right at the bottom there are a large number of new entrants. The growth in the industry has brought many new start-up administration entities that are offshoots of existing financial services businesses that previously did not specialise in administration, and that are generating a lot more capacity, at the smaller, more niche level. Whatever regime comes into place needs to cater to all the businesses, whether they’re international or very local.”

Jehan notes that since many companies in the market are part of international groups, there is no guarantee that consolidation will follow the logic of administration business. “Consolidation is likely to be driven at a higher level than fund administration,” he
says. “There may be consolidation among some of the local businesses, but I don’t think that will happen for a few years yet.”

Says Franks: “The global players are becoming a lot more international in the way they run their businesses. We’ll find there’s more pressure on groups to do the vanilla stuff in lower-cost jurisdictions, while the value added business in which a Guernsey administrator can add value will continue to be performed here, But this is obviously subject to the regulatory framework in place and to how much you can do in less costly locations.”

Conversely, Guernsey administrators are continuing to win business from funds domiciled in other jurisdictions. Says Fuller: “This helps Guernsey service international investment managers, who by the nature of their client base have to offer products domiciled in a number of jurisdictions.”

Butterfield Fund Services is probably the largest provider of administration services to non-Guernsey schemes as measured by assets. Says Firth: “We can provide additional benefits for managers based in the UK or Europe, not only from the time zone point of view, but also increasingly as regards corporate governance. It’s increasingly beneficial to be able get over to Guernsey quickly and to hold board meetings here.

Says Niven: “Cayman does extremely well in terms of funds, a lot of which come out of the US, and I’m not sure we’re trying to compete with that kind of volume. You can set up a fund in Cayman and not a great deal happens there, but investors more and more are looking at corporate governance, at how these funds are run.

“They want some solidity, they want the ability to identify who’s running what and where they’re doing it. In Guernsey we’ve built up a lot of expertise and have put together all the various component parts of the funds industry, including a very good cadre of non-executive directors. We’ve established an excellent track record over many years.”

That track record includes the establishment of the Channel Islands Stock Exchange, which opened in Guernsey in 1998 and whose first listings, out of a total that recently passed 1,000, were hedge funds launched by Man Group. Today the exchange, which enjoys official recognition from the UK and other jurisdictions, is used by many managers to list their funds.

It also includes protected cell companies, a Guernsey innovation more than a decade ago. Says Wrench: “Illustrative of Guernsey’s leading edge as a funds domicile, the protected cell company was pioneered on the island and subsequently has been adopted by most offshore financial centres. It is particularly suited to funds of hedge funds because it provides a statutory basis for ring-fencing assets and liabilities within each cell.”

Last year Guernsey’s protected cell company ordinance was amended to extend its application, previously limited to insurance companies and investment funds, to any company that is administered by a firm regulated by the GFSC. Says Franks: “The PCC legislation has been used by funds here for a long time, because it works quite nicely with umbrella funds.

“Over the years the PCC has proved an effective model. A legal case that was coming up was going to test whether that cellular structure worked in a court of law, but because there was an out-of court settlement, we never got to see that proof. The challenge for PCCs has always been whether the ring-fencing provisions would stand up in a court of law, but since every country has one now, it’s more accepted than it might have been 20 years ago.

“We’ve had PCCs so long now that when people think of protected cell companies, they think of Guernsey. Jersey is currently playing catch-up by introducing PCC legislation, so it will be interesting to see the dynamics of that on the Guernsey marketplace. It has been one of the drivers of competition between Guernsey and Jersey in the past.”

In general, though, Guernsey administrators are sanguine about their competitive prospects. Says Fuller: “Guernsey is an established fund domicile with an internationally recognised but pragmatic regulatory environment.

“We would like to build on a vision of Guernsey as a domicile of choice rather than simply somewhere to establish a funds administration. Its geopolitical position, standards of corporate governance and skills-based economy should make it a jurisdiction of choice for European fund managers and managers of funds with a European investor base.”
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In a dynamic environment stemming from changes in international accounting standards, hedge fund administrators, investors and managers all need to understand that the accounting challenges hedge funds can pose should not be underestimated.

This is especially true for a jurisdiction such as Guernsey, which allows funds to use any recognised form of Generally Accepted Accounting Principles, at a time when UK accounting standards are evolving toward the international (IFRS) principles, which themselves have changed, and when hedge funds are also facing new accounting requirements in the United States.

The main issue affecting funds is a change in the way the fair value of investments should be determined. Under the UK and IFRS accounting principles, the fair value of a listed investment is its bid price, and for non-listed investments there is a requirement to use some kind of accepted valuation techniques.

Before this new approach, the accounting rules simply required administrators to determine the market value of an investment. For listed instruments this allowed a mid-price to be used, while the administrator of a fund of hedge funds could take prices from the administrator of the underlying fund.

This has major implications in particular for administrators of funds of funds, which in valuing underlying investments must now consider the structure of the fund in question, whether it is open- or closed-ended, how instruments within the fund should be priced, and what is a realistic expectation of the price that could be obtained on exiting the underlying fund.

Another issue involves hedge funds that use derivatives. Managers of such funds that use synthetic positions involving perhaps four or five options would price the position as a whole, since that is the way their strategy works. However, the accounting rules now require a bid value to be placed on each option separately, which could lead to volatility in the fund’s financial statements.

This may also result in a discontinuity between the regular periodic valuations provided by the manager and the fund’s annual accounts, because the regular valuations – daily, weekly or monthly – are liable to be carried out under a different set of principles from those that govern the annual financial statements.

For investors, this may mean that monthly valuations use mid-prices or whatever technique is set out in the fund’s prospectus, while the year-end accounts use the new accounting standards, resulting effectively in a different NAV per share.

Eventually it may become best practice for administrators to use the same accounting basis for monthly valuations and annual financial statements, but there’s no move towards this visible at present, and in the meantime it remains acceptable to reconcile the divergence between the two in the annual financial statements.

There’s also the issue of whether it is practicable for a fund of funds administrator to do anything apart from accepting the estimated price from the administrator of an underlying fund at month-end in order to calculate their own NAV for the purposes of dealing.

Meanwhile, in the US, auditors of some funds are now required by the SEC as part of their audit to obtain independent price quotes from third parties for all investments where a quoted price is available. While this goes against the traditional audit method of testing on a sample basis, it is designed to capture a situation where a manager is pricing investments with no reference to the market.

This may be relevant to simple hedge funds, but for the more complex sectors this could have a huge impact as no two people are likely to price a complex strategy in the same way. Fortunately there’s no sign at present of this approach being applied by regulators on this side of the Atlantic.
The Guernsey Financial Services Commission has unveiled changes to the Qualifying Investor Funds regime, which was introduced on February 7 last year. Henceforth, any individual investing at least $100,000 or its equivalent in a fund will qualify as a professional investor, alongside experienced investors and knowledgeable employees, the other categories to which investment in QIFs is restricted.

A minimum investment criterion was considered for the QIF regime during initial discussions in August 2004, according to Carl Rosumek, deputy director of investment business at the GFSC, but at that time an industry working party comprising representatives of the fund sector and the regulator decided not to adopt it.

However, in a review earlier this year, various participants requested that the position was reconsidered, and the working party agreed to its inclusion. “It is too soon to say whether the additional criterion will broaden the appeal of QIF funds,” Rosumek says. “It is perhaps a test that is simpler for fund operators to assess, whereas the other qualifying criteria involve a certain element of judgement.”

Between February 7, 2006 and April 7 this year the GFSC approved 43 Qualifying Investor Funds, comprising 14 authorised open-ended collective investment schemes, 20 closed-ended investment funds and nine non-Guernsey domiciled open-ended schemes for which the commission’s approval is required.

While hedge funds and funds of hedge funds constitute the largest single category of funds approved under the regime with 14, it has also attracted considerable interest from administrators of venture capital/private equity and property funds looking to take advantage of the fast-track application process.

During the 14-month period the commission approved a total (including the QIF applications) of 53 open-ended collective investment schemes, 90 closed-ended investment funds and 53 non-Guernsey schemes. Approval also was given for the creation of 231 new classes of open-ended umbrella or multi-class funds.

Rosumek notes that while the QIF regime requires licensed service providers to conduct due diligence and certify to the regulator that the promoter and associated parties are “fit and proper”, the commission expects licensees to have conducted due diligence on promoter clients before commencing to act for them in any fund application.

“The major difference is that under the QIF regime the licensee specifically has to certify to the commission that it has performed the relevant due diligence and has considered all of the issues set out in the guidance document,” Rosumek says. “The monitoring of licensees’ procedures and controls relating to the taking on of new business forms part of the commission’s routine oversight of regulated firms.”

The GFSC has made a point of re-emphasising the due diligence obligations incumbent on licensed service providers. Says Rosumek: “Commission staff assess licensees’ application due diligence as part of their post-facto monitoring of licensees, and at the conclusion of each specific fund review, feedback is provided to the licensee.

“Having experience of the regime going back over a year, the commission considered it appropriate to re-emphasise the due diligence obligations which licensees undertake to ensure that standards do not fall and that the jurisdiction is not exposed unnecessarily. The concept of licensees, service providers and fund promoters being fit and proper will remain paramount, defined as a requirement for integrity (or honesty), competence and solvency.”

The working party that drew up the QIF regime is also responsible for examining potential future changes. The commission currently has no plans for further amendments, but it is ready to raise any requests from licensed service providers or other industry participants for consideration.
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It should come as no surprise that Guernsey is so much in demand as a domicile for a broad range of alternative investment funds, including private equity, property and hedge funds, as well as a residual core of traditional long-only retail funds. Over the years, one of the most important characteristics demonstrated by the island’s funds industry is its flexibility.

That was first demonstrated more than a decade ago when the implementation of the European Union’s Ucits legislation made the Channel Islands less attractive, at least to the European market, as domiciles for retail fund vehicles.

Although this did not end Guernsey’s role as a domicile for long-only funds, one that could yet receive a fresh impetus from changes in the international regulatory environment, it did require the island’s funds industry to examine new directions and opportunities, initially leading to the introduction of traditional long-only specialist funds as B schemes, and more recently demonstrated by a reappraisal that coincided serendipitously with the rise to prominence of the alternative investment industry.

The range of funds serviced in Guernsey, domiciled both on the island and in other jurisdictions, is matched by the breadth of its skill base. This is now paying dividends, as is demonstrated by last year’s increase of more than one third in the total volume of assets under administration in Guernsey. While the establishment of the Qualifying Investor Fund regime undoubtedly boosted hedge fund inflows, the overall total also benefited from vigorous growth in the island’s well-established property and private equity business – and from continued expansion in the servicing of non-Guernsey funds.

What the QIF regime has successfully done is to counter any misconception that Guernsey is purely a centre for funds of hedge funds, important though this business is to the island. Last year’s changes to fund regulations have also reinforced the jurisdiction’s reputation as a good place to do business by underlining its capacity for innovation and self-renewal.

The QIF regime is part of a long Guernsey tradition of trail-blazing in the international financial services sector that included the invention of the Protected Cell Company concept more than a decade ago. The PCC, which among other advantages allows a single corporate structure to contain multiple units or cells that are not legally affected by each other’s insolvency or liquidation, has since been copied by jurisdictions around the world.

The PCC offers cost benefits for a variety of purposes in the financial industry. Until a recent change in the law its use was restricted to the funds sector, where it offers a structure well suited to the umbrella fund concept, as well as to the insurance sector, where it is commonly used for captive insurers and reinsurers set up for smaller companies. The uses PCCs can be put to have now been broadened, and Guernsey will shortly also have an Incorporated Cell Company vehicle.

As with every leading international financial services jurisdiction, Guernsey is constantly examining ways to add the greatest possible value within the constraints of a small island. The high level of expertise and flexibility of the industry’s workforce has proved vital by enabling limited resources to be deployed to best advantage.

The growing number of experts both in the private equity field and in the hedge fund sector is set to benefit the island as the alternative asset management business evolves in the future, since many of these skills are easily transferable into different types of administration.

Guernsey’s flexibility pays dividends

By Patrick Firth

Patrick Firth is managing director of Butterfield Fund Services (Guernsey)
Guernsey is on the brink of what many industry professionals believe may be a revolution in the way funds are authorised and regulated, following the publication – expected imminently – of a report from a working party led by leading Guernsey advocate Peter Harwood. Although full details of the report have not yet been released, it is understood to put flesh on concepts that members of the industry have been discussing for some time.

With members of the government and officials from the Guernsey Financial Services Commission having taken part in the deliberations of the working party Harwood led, their endorsement of the recommendations is seen as all but a formality, and some observers believe the measures could be enacted into law as early as this autumn.

Says KPMG partner Neale Jehan: “We hope that what will come out of the Harwood report will be a completely new regime that will leap Guernsey close to being the pre-eminent offshore jurisdiction. There is general support for the fact that we need to change the regime, so everyone’s waiting for the report to arrive and ready to debate it.”

Ernst & Young partner Peter Franks argues that the proposals contained in the report will contribute to “a phenomenal step change in the perception of Guernsey” over the next 12 months that will build upon the island’s image of being innovative and open to new ideas, underlined by the introduction of the QIF regime last February and other legislation over the past year.

Says Franks: “The Harwood report stems from a government-led initiative around 12 months ago to look at the whole regulatory and legal framework and identify the changes that would be required to encourage the future growth of Guernsey. That means that a lot of the existing legal framework will be pushed aside and replaced by new frameworks that will encourage business to flow here.”

At present the report is being digested by members of the industry and the political authorities. Says Guernsey Finance chief executive Peter Niven: “The report’s recommendations will go a long way toward changing the way we regulate funds in the Bailiwick, and will provide another layer of opportunity on which the industry can capitalise, on the strength of the momentum it has gathered over the course of the past 12 months.”

“The industry itself sees this as a great opportunity. Certainly by September, when we hold our annual funds conference in London, we’ll have started down the road to implementing the Harwood recommendations. That will be an ideal time to showcase the industry.”
It is understood that a key proposal is to create a distinction between regulated and registered funds. Regulated funds will consist of traditional Ucits-type funds as well as Guernsey’s existing class B schemes, which are frequently used for alternative investment funds. These funds will be required to have their administration carried out in Guernsey, and their promoters and managers will be subject to full due diligence by the GFSC when the funds are set up.

By contrast, registered funds domiciled in Guernsey can have their administration performed in other jurisdictions. This regime is similar to the Qualifying Investor Fund structure in that once the administrators have notified the regulator that they have satisfactorily carried out due diligence work, the fund will be free to do business.

Observers say the distinction between regulated and registered funds mirrors the current different treatment of closed-ended and open-ended funds, with the latter subject to a much higher degree of regulation. However, that distinction would disappear under the Harwood proposals by combining the Control of Borrowing Ordinance with the Protection of Investors Law into a unified funds law.

By contrast with other jurisdictions that have enacted separate pieces of legislation for each type of fund, such as retail funds, private equity and property, Harwood and his colleagues have taken the view that simplicity is the best approach, advocating a single law and providing regulatory exemptions to different types of fund through schedules to the legislation.

The proposed structure will be revolutionary, industry members believe, because it will “collapse totally” the involvement of the regulator in the authorisation process. Instead of waiting six weeks or even six months for regulatory approval, they say, fund promoters will be approved to start doing business as soon as their application has been submitted by the administrator to the GFSC.

This change is a vital one for Guernsey because it brings the island into line with rival jurisdictions such as the Cayman Islands that have benefited from a fund approval process that takes as little as a couple of days. The principle of an accelerated approval process was first introduced with the QIF regime last year, but the Harwood proposals would extend it to other types of fund with fewer restrictions on whom they can market to.

Similarly, the Harwood working party is thought to recommend that administrators should be able simply to notify the commission that they are taking on non-Guernsey funds, ending the requirement for them to seek permission to do so.

The report is also expected to propose bringing the rules into line with standard industry practice by allowing the safekeeping and oversight roles of a fund’s custodian to be split. This would enable custody to be performed anywhere in the world as long as a custodian in Guernsey was responsible for ensuring that the fund’s assets were in place.

The Harwood report is one of a number of initiatives that aim to improve the competitiveness of different area of Guernsey’s financial services industry. A working group for the fiduciary sector has already published proposals that are set to introduce the civil law concept of foundations into Guernsey law, in a symbolic counterpoint to Switzerland’s adoption last year of the common law concept of trusts.

Rapid action to implement the Harwood recommendations is expected, since representatives of the industry, the regulator and the government have already signed off on the proposals within the working group, and according to some estimated it could all be implemented into law by October. With good ideas copied swiftly in the offshore world, time is of the essence. Says Franks: “There’s no point in putting your cards on the table and waiting for someone to overtake you.”