Discussion Paper

Funds Growth Omnibus

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Guernsey Financial Services Commission

Contents

Discussion Paper

Responses to this Discussion Paper are sought by 2 September 2020.

We welcome and strongly encourage respondents to provide feedback or comment on any section and question. Feedback may be provided via the Consultation Hub section of the Commission's website (www.gfsc.gg).

Introduction

The Commission seeks to regulate and supervise financial services in the Bailiwick of Guernsey, with integrity, proportionality and professional excellence, and in so doing help to uphold the international reputation of the Bailiwick of Guernsey as a finance centre.

The purpose of this Discussion Paper is to seek feedback from all interested parties on potential changes to the regulatory framework under the Protection of Investors (Bailiwick of Guernsey) Law, 1987 (the "PoI Law").

Consistent with the Commission's objectives, the proposals in this Discussion Paper aim to ensure that the Guernsey funds framework remains fit for purpose including: broadening the options available for certain categories of fund formation; introducing efficiencies in the current framework and seeking to clarify current areas of uncertainty. These changes will ensure that investors and the reputation of the Bailiwick continue to be protected while also helping to create opportunities for further growth.

Responses to this Discussion Paper will be considered by the Commission with a view to making more detailed policy proposals in the form of a Consultation Paper to be issued later in the year.

This Discussion Paper is a working document and does not prejudge any final decision to be made by the Commission.

Private Investment Fund

The Manager Requirement

The Private Investment Fund Rules 2016 (the "PIF Rules") require that a Private Investment Fund ("PIF") has within its structure a licensee responsible for management[1]. When considering an application for the registration of a proposed PIF, the Commission relies on certain declarations made by the proposed licensed fund manager. The fund manager makes declarations in respect of:

- prospective investors' ability to sustain losses;
- the maximum number of investors; and
- the completeness and accuracy of the application.

There have been calls from some industry participants for the Commission to consider the necessity of the requirement to appoint a PoI Law-licensed manager to a PIF. The costs associated with the appointment of a locally licensed manager are viewed by some in industry as a disincentive for new PIF formations.

The philosophy behind the PIF is that the manager through its relationship with the promoter, will have a close relationship with the investors giving them the necessary knowledge and familiarity with them to be in a position to make the required declarations. The licensed status of the manager provides the Commission with comfort and assurance as to the reliability and accuracy of any declaration made and, ultimately, the Commission would have recourse to enforcement powers in the unlikely circumstances where a declaration is false, misleading or recklessly made. In this way, the Commission seeks to ensure the protection of investors by ensuring only those able to sustain any potential losses invest in a PIF.

If alternative approaches to PIF registration were to be introduced, with the requirement for a licensed manager removed, the question must be asked as to how the Commission could continue to ensure that only appropriate investors have access to a PIF. Three possible solutions have been identified: placing reliance on a declaration made by fund directors; placing reliance on a declaration made by an associated fiduciary licensee; or more strictly prescribing the nature of investors permitted to invest in a PIF by defining a qualifying private investor.

Option A Placing reliance on a declaration made by fund directors

If certain PoI Law provisions applicable to licensees and funds were to be extended to PIF directors then the Commission may be in a position to rely on declarations made by such directors as an alternative option to placing reliance on declarations made by the fund manager. The requirement for a local, PoI-licensed manager may fall away in such a scenario. The requirement that a PoI licensee administrator is appointed would remain. The administrator would be required to confirm that it has performed sufficient due diligence to be satisfied that the directors of the PIF are fit and proper. Such a change in the legal framework would require the making of Ordinance by the States.

[1] PIF Rule 2.05

Option B Placing reliance on a declaration made by an associated fiduciary licensee

In the case of certain PIF structures, investment may be limited to a group of investors who may have a client relationship with a local licensed fiduciary. In such circumstances the licensed fiduciary may have sufficient knowledge of the investors to be in a position to make the appropriate declaration to the Commission.

Option C Defining a "qualifying private investor"

An alternative to the current declaration may be the use of a more quantitative approach. Under such an approach, access to investment in the PIF would be limited to certain types of entity or investors would be required to meet certain qualifying criteria. There are examples of this approach within the current Guernsey funds framework such as the Class Q Authorised Scheme and the Qualifying Investor Fund process. Under such an approach the licensed administrator would confirm that there were effective procedures in place to ensure restriction of the scheme to qualifying private investors. This approach could be combined with the following additional elements:

- Restriction of marketing to 50 investors;
- A prescribed minimum investment amount;
- Investor disclosure in the form of a short form prospectus or minimum investor suitability disclosure.

Key considerations

In considering and developing alternative approaches to the PIF, the Commission must be mindful of a number of factors. First and foremost, there must be no weakening of the existing framework for the protection of investors. The PIF is unsuitable for retail, unsophisticated or vulnerable persons and the above options would continue to appropriately restrict investor access.

It is important than any changes do not create potential gaps in our jurisdiction's framework for countering financial crime and terrorist financing. All the options above would ensure that the PIF, like all Guernsey funds, would continue to be required to appoint a fund administrator acting as the nominated firm responsible for investor due diligence, with therefore no weakening of controls.

Another consideration is the need to ensure that the current funds framework continues to be fit for purpose. In considering changes it is important to avoid negative impacts on the current framework and funds created under it, or the introduction of additional levels of complexity. Simple, universally understood rules are both beneficial to industry participants and their clients, and lead to positive regulatory outcomes. It is therefore proposed that in implementing any of the potential changes described above that these would be described as an alternative route to qualification as a PIF and that the original existing PIF qualification would be retained. There is no intention to create an entirely new class of fund.

Question 1

Option A - are director declarations an appropriate and viable alternative option to declarations made by a PoI-licensed fund manager?

Question 2

Option B - is a declaration by an associated licensed fiduciary an appropriate and viable alternative option to declarations made by a PoI-licensed fund manager?

Question 3

Option C - is restriction of PIF investment to a defined category of "qualifying private investor" an appropriate and viable alternative option to declarations made by a PoI-licensed fund manager?

Question 4

Do you have a view on the appropriate criteria which would distinguish a "qualifying private investor"?

Question 5

Would introduction of additional investor protection requirements such as restriction of marketing, minimum individual investment or increased disclosure negatively impact the viability of a new proposed PIF approach?

Question 6

Of options A, B and C described above, if any, which would you most strongly support?

Question 7

Do you have any views on any further alternative approaches to the current PIF model?

Basis of declaration

The Commission's PIF guidance currently in issue is not prescriptive as to how the declaring party should satisfy itself as to the ability of investors to sustain loss. The guidance does, however, offer examples of how the declaration may be satisfied and also clearly cautions against any failures in the process leading to the signing of such declaration. It is proposed that,

where a declaration is relied upon as a part of the application process, an explicit requirement be placed on the declaring party to retain evidence of its assessment process in making the declaration and to make this available to the Commission upon request.

Question 8

Do you have any comments on the proposed introduction of an explicit requirement on the declaring party to retain evidence of its assessment process in making the declaration?

New promoters

The PIF regime provides a streamlined application process whereby application for fund registration and licensing of the fund manager is made via a single form. The fund administrator is required to confirm that it has performed sufficient due diligence to be satisfied that the promoter of the PIF is fit and proper but there is no requirement to complete and submit to the Commission a New Promoter's Introductory Checklist, as is required for other fund category application. It is not proposed to change the streamlined application process but the absence of the Introductory Checklist does not diminish the obligation on the declaring administrator to ensure that sufficient due diligence is conducted on the promoter. The Commission relies on the investor-related declarations made by the promoter, which are in turn supported by the promoter due diligence of the administrator. It is proposed that additional guidance be published, clarifying the Commission's expectations in respect of due diligence to be performed by the administrator.

Question 9

Do you have any comments on the proposed issuance of additional guidance to clarify the Commission's expectations in respect of due diligence to be performed by the administrator?

Additional classes, sub-funds and cells

Existing Commission guidance states that a new declaration, in respect of investors' ability to sustain loss, must be made to the Commission if new cells, sub-funds or share classes are added to an existing registered PIF. It is proposed, therefore, that the framework is amended to clarify the rules and process for this type of declaration and create a standardised declaration form for additional classes, sub-funds and cells.

Question 10

Do you have any comments on the proposed standardisation of the form and process for declaration at the point of formation of additional PIF classes, sub-funds and cells?

Exemption from Licensing for General Partners of Funds Structured as Limited Partnerships

Typically a Guernsey-based general partner ("GP") of a collective investment scheme authorised or registered under the PoI Law would hold an investment licence under this Law.

Certain fund structures may be formed where an entity separate to the GP (the "Management Company") may assume the primary management role for the fund. Such an entity may be appointed through the terms of the limited partnership agreement. The Commission understands that such a structure may be regarded as more efficient from the perspective of the fund sponsor because a single manager could act in respect of a number of funds within its stable. Duplication of governance, administration, licensing and compliance costs could be avoided. Representations have been made to the Commission that where such an appointment has been made the residual responsibilities of the fund GP should not be regarded as controlled investment business requiring a licence.

The Commission is of the view, however, that in all circumstances the GP to a fund, provided that it acts by way of business, is carrying on controlled investment business as defined under the PoI Law and would be prohibited from carrying on business without a licence.

The Commission is, nevertheless, supportive of proposals enabling innovative and efficient structures, provided that there is no diminution in investor protection. The Commission believes that investors would be protected, provided the Management Company is licensed under the PoI Law and shares common ownership with the fund GP.

The Commission is of the view, and is supported in this view by some leading players in industry, that the treatment of GPs in this type of fund structure could be clarified and regularised through the creation of a new category of exempt person under section 29 of the PoI Law. The States of Deliberation has the power to exempt persons from licensing by the making of Ordinance.

Question 11

Do you support the making of Ordinance to exempt the GP of a limited partnership authorised or registered fund where a Management Company has been appointed to exercise managerial function in relation to the a partnership and its underlying assets?

Question 12

Do you agree that such exemption should only be available where such Management Company is licensed under the PoI Law and shares common ownership with the fund GP? If not, what alternative restrictions on this possible exemption category do you believe would be appropriate?

Non-Guernsey Schemes

The Licensees (Conduct of Business and Notification) (Non- Guernsey Schemes) Rules 1994 (the "NGS Rules") require PoI licensees intending to carry out the restricted activities of management, administration or custody in connection with a Non-Guernsey Scheme ("NGS")[2] to give prior written notice to the Commission and receive approval before commencing these restricted activities. Approval must be sought in respect of each individual NGS. This requirement applies only to PoI licensees in respect of restricted activities for open-ended NGS which are not exempt by virtue of establishment in a Designated Country or Territory[3].

The observation can be made, and has been made by representatives of the Guernsey funds industry, that the current NGS Rules are both inconsistent and duplicative.

The role of the Commission in approving individual fund client take on is inconsistent with the jurisdiction's other supervisory regimes.

The NGS is subject to the regulatory regime in its domicile jurisdiction and the argument could be made that the NGS Rules introduce a second form of indirect quasi-fund regulation. The NGS Rules also impose certain conduct of business rules. These rules are however largely duplicative of provisions made under the Licensees (Conduct of Business) Rules 2016 (the CoB Rules") which all PoI Licensees are required to meet.

It is therefore proposed that the NGS Rules are amended to remove the requirement for prior Commission approval in respect of the commencement of restricted activities in respect of a NGS. The requirement to provide notification under the NGS Rules would be retained for open-ended funds. It is further proposed to amend the NGS Rules to remove any duplication with the CoB Rules.

Question 13

Do you agree that the Non Guernsey Scheme Rules should be amended to remove the requirement for prior Commission approval in respect of the commencement of restricted activities in respect of a NGS?

Guernsey Green Fund

The Guernsey Green Fund Rules 2018 (the "GGF Rules") establish a framework under which a fund registered or authorised under the PoI-Law may be designated as a Guernsey Green Fund ("GGF").

The objective of the GGF framework is to provide a platform upon which investments into various green initiatives can be made. The GGF designation enhances investor access to the

[2] A NGS is defined as a collective investment scheme which is neither incorporated nor established under the law of any part of the Bailiwick of Guernsey nor authorised under the PoI Law

[3] Designated Countries and Territories are Jersey, Isle of Man, the United Kingdom and the Republic of Ireland

green investment space by providing a trusted and transparent product that contributes to the internationally agreed objectives of mitigating environmental damage and climate change.

The GGF Rules provide that the Commission may designate a fund as a GGF provided that certain green criteria are met. Schedule 2 to the GGF Rules provides a list of the green criteria that are endorsed by the Commission. At present the Commission endorses only one standard, the Common Principles for Climate Mitigation Finance Tracking[4], but has indicated the intention to add to the list of green criteria standards in Schedule 2 where it considers it appropriate to do so.

In the period since the development of the GGF Rules, internationally a plethora of privately and publicly sponsored green investment standards have been published of varying quality and nature. In this crowded environment it is important that the Commission in adopting additional alternative green criteria ensures that only credible and internationally recognised standards are considered.

The European Union has published and agreed a general framework proposal for a Taxonomy for Sustainable Finance (the "Taxonomy")[5] and the European Commission is to finalise a fully developed Taxonomy, addressing the objectives of climate change mitigation and adaptation, before the end of 2020, for implementation before the end of 2021. The Taxonomy is a classification system for sustainable activities and is designed to sit under a regulatory reporting framework and to be used by EU financial market participants and financial products, such as Alternative Investment Funds.

The Taxonomy promises to be widely adopted through its use in EU regulation and therefore will represent a credible and well-understood international standard. The Commission proposes that, once finalised, the Taxonomy should be considered for adoption within Schedule 2. Adoption would therefore likely take place during 2021. It is considered that through careful and considered expansion of green criteria the GGF will continue to be a relevant, transparent and broadly recognised product providing investors with assurance that their investments make a positive environmental impact.

For the avoidance of doubt, application for GGF designation will continue to be at the discretion of fund sponsors and management and there is no proposal at this time to introduce mandatory green investment, reporting or disclosure requirements.

Question 14

Do you agree that the EU Sustainable Finance Taxonomy should be considered by the Commission for endorsement under the GGF Rules?

[4] Developed by the joint climate finance group of Multilateral Development Banks and the International Development Finance Club

[5] https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/200309-sustainable-finance-teg-final-report-taxonomy_en.pdf

Green Verifier

At present the verification or certification of Green Financial Products rely on voluntary codes of conduct or membership of industry bodies. Globally we do not understand there to be a regime backed by Financial Services Regulation. The International Organisation of Securities Commissions published a report in April 2020 that identified concerns by both regulators and market participants, amongst others, relating to greenwashing. Recent research by Guernsey Finance among Family Offices has also shown that "*Trust in green products is key to unlocking the demand for green and sustainable investment and providing the confidence to invest. The need for transparent verification or certification of green investment products has been highlighted*".

The Commission is seeking views on a proposal to introduce a new restricted activity to the POI Law of "Verification of *Green Transactions*". This activity would enable new multi-disciplinary licensees to operate with compliance and financial experts working alongside environmental scientists.

Licensees would, as now, have to meet the Minimum Criteria for Licensing, be fit and proper with the necessary integrity, skill and appropriate policies, procedures and controls. The Licensee would crucially have a *Chief Scientific Officer*; a Member/Fellow of a recognised Scientific Organisation. In order for the Commission to assess all aspects of scientific governance it would appoint appropriate Officers to advise it. In all other respects the Commission would approach licensing and regulating in the same way as for other licensees.

It is proposed that the scope of the green verification restricted activity would be broad including not only the verification of Guernsey Green Funds under Route 1 but also verification of instruments offered elsewhere, such as Bonds, Securities and other financial products. It is proposed that the provision of a declaration under Route 2 of the GGF Rules would not be within scope of the green verification restricted activity.

The new Licensees would create a "one-stop service" for verification of Green Transactions which should provide a more effective and efficient mechanism for the market. It is considered that the introduction of a verification regime, if undertaken carefully, will provide an important tool in the fostering of confidence in financial products intended to support the fight to address the significant issues of Climate Change. It would also see Guernsey develop further as a centre of *Green Finance*.

Question 15

Do you agree with the introduction of a new restricted activity of "verifying *Green Transactions*"?

Question 16

What financial products should, and should not be considered *Green Transactions*?