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The regulatory framework for Hedge Funds in Guernsey**Consultation Paper**

The growing use of Guernsey structures as vehicles for hedge funds has highlighted a number of areas where the existing investment fund framework can create problems. By this consultation paper the Guernsey Financial Services Commission seeks input from interested parties to the issues highlighted and the solutions which the Commission is prepared to consider. Comments are welcomed, both on the specific issues raised by the Commission and on any other aspect of the topic under review. They should be sent to Peter Moffatt, Director of Investment Business, and should be received at the Commission no later than **31 December 2003**. Postal and e-mail addresses are set out at the end of this document.

Background to the discussion***Closed-ended funds******Legal Framework***

The Guernsey Financial Services Commission recently issued guidance on the disclosure regime for closed-end investment funds. That guidance re-emphasised the flexible nature of the Commission's approach. Guernsey domiciled closed-end funds are subject to Guernsey company law and the Control of Borrowing regime, and it is clear, from the closed-end hedge funds already established under those arrangements, that few structural problems arise.

Open-ended funds***Legal Framework***

In the open-ended sector, the position is more complex. Open-ended funds are subject to the Protection of Investors (Bailiwick of Guernsey) Law 1987, as amended, ("POI") and to rules and regulations made under that law. POI provides, *inter alia*, that all Guernsey open-ended funds must be authorised by the Commission - there is no provision for "unauthorised" funds - and that each fund must have a designated manager and a designated trustee or custodian.

Rules

The Commission has made three sets of open-end fund rules under the POI Law. These are the Class A Rules (originally issued in 1988 and radically revised in 2002), the Class B Rules (issued in 1990) and the Class Q Rules (issued in 1998).

The *Class A Rules* broadly replicate the UK collective investment scheme rules that were in force until the UK's most recent revisions. They are intended to regulate funds targeted at “retail” investors, and although they include categories of funds which may be of interest to hedge fund managers – including futures and options funds, geared futures and options funds and warrant funds - and make provision for efficient portfolio management and stocklending, the requirements on spread of investment, limitations on gearing and also on shorting of stock, have generally meant that few hedge fund styles could take advantage of them.

The *Class B Rules* can cover “retail” funds. They extend also to institutional and purely private investment vehicles. To that end, the Class B Rules require spread of risk, but are not otherwise prescriptive about how spread is to be achieved, what assets are permissible and what hedging and borrowing powers may be permitted. These are matters which are agreed with the Commission on a case by case basis. Just as the Commission emphasises its flexible approach in granting consent for closed-end funds, so the preamble to the Class B Rules notes the intention that the rules should be as flexible as possible consistent with meaningful investor protection. In particular, the Commission has the power to disapply any of the Class B Rules, where it is appropriate to do so.

The *Class Q Rules* cover funds targeted at qualifying professional investors. These are :-

- a government, local authority or public authority;
- a trustee of a trust which, at the time of investment, has net assets in excess of £2,000,000 (or currency equivalent);
- a body corporate or limited partnership, if it or any holding company or subsidiary has, at the time of investment, net assets in excess of £2,000,000 (or currency equivalent); or
- an individual who has, together with any spouse, at the time of investment, a minimum net worth, (which excludes that individual's main residence and household goods) of £500,000 (or currency equivalent).

The Class Q Rules again avoid prescriptive provisions on investment and borrowing powers. Although the requirement for a Guernsey-domiciled custodian is retained, the Class Q rules broadly limit the custodian's duty to controlling fund property and ensuring that sub-custodians are fit and proper.

Hedge Fund Questions

In terms of investment strategy, it appears that the Class B and Class Q regimes offer sufficient flexibility to accommodate most hedge fund styles. There are four main areas where current practice in operating hedge funds may not fit comfortably within the established legal and rules framework. These are :-

- the role of custodians and prime brokers;
- asset segregation;
- Net Asset Value and share price estimation; and
- client money segregation.

The role of custodians and prime brokers

In traditional fund structures, a depository, custodian or trustee has the related tasks of controlling fund property and ensuring that the manager runs the fund in accordance with local legislation and the fund's offering document. The role combines elements both of custody and trusteeship. Many hedge funds, by contrast, make use of a prime broker, which will typically hold some or all of the fund's assets, often as collateral for lending by the broker to the fund. Prime brokers are not fund custodians and do not generally undertake any of the trustee-style duties of ensuring regulatory and prospectus compliance.

In some cases, funds have dealt with the issue by treating the prime broker as a sub-custodian. This solution can, however, present its own difficulties; not every prime broker wishes to take on a formal sub-custody role or is prepared to meet all the formal reporting and inspection requirements some custodians impose on members of their sub-custody networks. The Commission also recognises that assets held by hedge funds may be very different from assets held by traditional funds. Structured products and complex derivatives, for example, do not necessarily lend themselves to traditional custody and delivery arrangements.

The requirement for an open-ended fund to have a designated custodian is a feature of the POI Law. The Commission has no authority to set that requirement aside. The Commission may, however, conclude that the custodian's duty to take control of fund property is not essential, or even appropriate, to the proper operation of a hedge fund. The corollary would be that fitness, propriety and solvency of the prime broker would take on additional importance. The custodian would remain responsible for oversight of the manager's operation of the fund.

- 1 *Is there support for the view that the custodian need not retain control of fund property?*
- 2 *If custodians do not need to control property, what information flows need they have in order to fulfil their role of overseeing the manager?*
- 3 *How else can the oversight role be provided?*

Asset segregation

The holding of assets by prime brokers rather than fund custodians raises the related issue of how assets are to be held. Fund custodians hold assets in trust for their clients under arrangements designed to ensure that, if the custodian were to fail, fund assets could not be attached by the custodian's creditors.

Where prime brokers hold a fund's assets, the arrangements may be different. For those hedge funds which habitually make use of gearing, the prime broker will typically be a creditor of the fund, and will be holding the fund's assets as security against its lending. Some prime brokers automatically arrange segregation of client assets in a similar manner to custodians, others may do so only for those assets which are surplus to collateral requirements, and others again provide no segregation at all. Full or partial segregation will tend to limit a broker's capacity to generate revenue from client assets, while incurring additional administrative costs in managing the segregation process. Those brokers who do not segregate may therefore be able to offer services at lower cost than those who do, notwithstanding that funds thereby carry greater counterparty risk.

- 4 *Should the Commission be prepared to authorise funds where the prime broker will not offer asset segregation?*
- 5 *In all cases, or only to funds offered to certain classes of investor?*
- 6 *What risk disclosures would be needed in fund offering documents?*
- 7 *Should the Commission require a minimum credit rating for prime brokers?*
- 8 *Should such a minimum rating be dependent on whether or not brokers segregate client assets from their own positions?*

Net Asset Value and share price estimation

The expectation with traditional funds, especially in the retail sector, is that Net Asset Value (NAV) and share price will be calculated frequently and will be determined within a period of a few hours. Investor's subscription money is only available to the fund manager in exchange for a known quantity of shares, and regulations normally require redemptions of shares to be paid away within a short period. For hedge funds, the norm appears to be that funds will be valued monthly or less frequently. In some cases, hedge funds do not establish NAV immediately and may take days – or even longer – finally to determine NAV and consequently share price. In the case of funds of hedge funds, the speed with which NAV can be calculated is effectively controlled by the time taken by the slowest of the hedge funds in which the fund of funds is invested.

Against this background, some hedge funds have adopted the practice of issuing an estimated NAV soon after the valuation point, with adjustment once the NAV is finally known. These funds process subscriptions and redemptions on the basis of estimated prices with redeeming investors deferring some proportion of their redemption proceeds until NAV is finally known; for subscribing investors the fund will typically adjust the number of shares issued once NAV is determined.

The justification for using NAV and share price estimation is that hedge fund managers, and especially those operating funds of hedge funds, need to be able to use subscription money to make new investments before NAV and share price have been finally determined. Risks are, however, apparent. A fund may overestimate its NAV and consequently overpay redeeming investors and overcharge subscribers. In that case, it would be important to establish whether the operator or the fund itself was liable for the cost of correcting such errors. And delay in calculating NAV may mask more fundamental deficiencies in a fund's administration.

- 9 *Should the Commission permit the use of estimated NAV and share price calculation for hedge fund transactions?*
- 10 *If estimation is to be used should the Commission set a maximum percentage which could be claimed from subscribers/paid to redeeming investors?*
- 11 *Should such a maximum percentage be applied uniformly to all hedge funds wishing to apply estimation, or could it vary according to the investment style in use?*
- 12 *Who should be liable for the cost of correcting errors in estimation?*
- 13 *What risk warnings should be given to investors?*

Client Money segregation

Guernsey investment business rules require that client money, including fund subscriptions and redemptions, must be held in a client money account until it may be properly paid to the fund or client in question. Hitherto, the underlying assumption has been that money is not properly payable to a fund until the fund's obligations to the client have been met, i.e. that the fund has allocated shares to the client in return for the subscription. One consequence of estimating NAV and share price is that the fund cannot completely meet its obligations to the client since it is not able to allocate shares, either in full or at all, in return for the subscription.

It is open to funds or their operators to borrow the equivalent of the committed subscription monies, and to be reimbursed once NAV had been confirmed. This would remove risk from subscribers, but would increase costs, either for managers or the fund (i.e. for other investors). One alternative would be for the Commission to redefine the client money rules in a way which would not preclude delivery of subscription money in advance of NAV calculation. Another might be for the Commission to grant either specific or general waivers from the client money rules.

- 14 *Should the Commission insist that client money remain segregated until NAV calculation is complete?*
- 15 *If not, should the Commission redefine the client money rules? Or*
- 16 *Should the Commission grant general or specific waivers?*
- 17 *If waivers were to be granted, what safeguards should apply?*
- 18 *What risk warnings should be given to investors?*

Comments on these and any other issues which correspondents wish to raise should be sent, to arrive by 31 December 2003, to :-

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Guernsey Financial Services Commission
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