FINANCE INDUSTRY AND POLICY WORKING PARTY

REVIEW OF INVESTMENT SECTOR LEGISLATION AND REGULATION

MARCH 2006

Report of Finance Industry and Policy Working Party to review Investment Sector Legislation and Regulation

Contents

1. Introduction

The Working Party was established by the Finance Industry Policy Advisory Group to follow a series of initiatives following on from a series of blue sky meetings held under the auspices of the Finance Industry Policy Advisory Group in 2004.

The following persons were nominated to the Working Party:-

i) Advocate Peter Harwood (Chairman);
ii) Peter Moffatt (representing the Guernsey Financial Services Commission);
iii) John Le Prevost (representing Guernsey International Fund Association);
iv) John Clacy (representing Guernsey Association of Chartered and Certified Accountants);
v) Nigel Carey (representing the Guernsey Bar); and
vi) Shaun Lacey (representing the Securities and Investment Institute).

The Working Party held its first meeting on 18 March 2005 and has held approximately 20 meetings subsequently.

In order to obtain a wider understanding of the full investment business sector, the Working Party invited a number of representatives from different types of organisations within the investment sector to attend interviews with the Working Party. A total of 12 people attended such interviews. A full list is attached as Appendix 1.

In addition, the Working Party was fortunate, through the offices of John Clacy of Deloittes, to be able to link in to representatives of Deloittes in London, Dublin, Luxembourg, Jersey and the Cayman Islands, in order to obtain a comparison of industry trends and regulatory practices within those jurisdictions.

The Working Party was also able to conduct an interview with Martin Dryden, as a representative of the Jersey Fund Association.

The local interviews illustrated the diversity of business activity undertaken within the Guernsey investment business community. Whilst the fund sector and related services still accounts for the majority of employment within the investment business section, Guernsey also hosts a significant number of non-fund specific investment activities. The Working Party recognises that it is important for the benefit of the Island to encourage the growth and contribution of these non-fund specific investment activities.

2. **Terms of Reference**

Purpose and Method: To consider the investment industry in the Bailiwick of Guernsey and the conditions required for its continued prosperity.

The review will include, but not be limited to, the legal and regulatory framework as well as aspects of public policy relating to the industry, and will, where appropriate, make recommendations for change.

Consideration will be given to the statutory objectives contained in the Protection of Investors Law and rules and regulations made under it, as well as the Commission's powers, duties and responsibilities. The review will also consider aspects of company law and other enactments which are relevant to the development of investment business. Business environment dependencies, such as telecommunications, will also be within the scope of the review.

3. **Glossary of Terms**

"Bailiwick"	Bailiwick of Guernsey
"Close-ended"	investment funds regulated under COBO where the investors do not have an entitlement to redeem shares
"COBO"	Control of Borrowing (Bailiwick of Guernsey) Ordinances 1959 to 1989
"Collective Investment Schemes"	Open-ended investment schemes regulated under the POI Law categorised as either a Class A Scheme, Class B Scheme or Class Q Scheme
"Funds and Investment Funds"	investment funds both open-ended and close-ended
"GFSC"	Guernsey Financial Services Commission
"Guernsey Licensees"	Guernsey entities licensed under the POI Law to undertake restricted activities. Those restricted activities may relate to the provision of management, administration or custodian services to Funds
"Non-Guernsey Schemes/Funds"	Investment funds whether open-ended or close-ended constituted in a jurisdiction other than that of Guernsey where some element of service is provided by Guernsey licensees
"Open-ended"	collective investment schemes where investors have an entitlement to redeem shares
"POI Law"	The Protection of Investors (Bailiwick of Guernsey) Law 1987 to 2003
"Qualifying Investors Fund"	means a Fund that is capable of being "fast tracked" for the purposes of GFSC approval under the POI Law or COBO by reason of such Investment Fund being only available to investors who are capable of satisfying the Qualifying Investor Criteria published by the GFSC.

4. Current Regulatory Structure

The investment business sector within the Bailiwick of Guernsey can be identified as comprising two sub-sectors:-

i) fund specific sector, eg investment funds and related fund specific services such as fund custodians, fund managers, fund administrators; and

ii) non-fund specific sector, eg traditional investment/stockbrokers, discretionary investment managers, execution only broking activity, boutique investment facilitators and wealth management.

As at 31st December 2005, out of a total of 486 licences issued by the GFSC to local service providers, approximately 323 licences fall into the category of the fund specific sector.

(A) Fund Specific Regulation

As at 31st December 2005, there were 233 open-ended funds comprising 1,103 separate portfolios, with a value of £48.2 billion, compared with 206 funds, comprising 557 portfolios, with a value of £14.8 billion, at the end of 2000. In the closed-end sector, there were 351 funds at 31st December 2005, with a value of £31.1 billion compared with 272, with a value of £11.7 billion, at the end of 2000. Within the open-end totals, there were 15 Class A funds comprising 127 portfolios at 31st December 2005, compared with 24 Class A funds comprising 127 portfolios at the end of 2000.

At 31st December 2005, there were 200 Class B schemes comprising 922 portfolios (31st December 2000: 178 schemes, 498 portfolios) and 18 Class Q schemes comprising 54 portfolios (31st December 2000: 4 schemes, 7 portfolios). Over the five years to 31st December 2005, therefore, open-ended portfolios have broadly doubled in number and tripled in value, while closed-end funds, although increasing in number by less than one third, have increased in value by some 2½ times.

At the time of the introduction of the Protection of Investors Law, retail investment funds represented the majority in number of all investment funds administered in Guernsey. As at 31st December 2005, the number of equivalent retail investment portfolios (as represented by Class A funds) represents less than 12 per cent of all Guernsey Collective Investment Schemes.

Control of Borrowing Ordinances 1959 to 1989

The investment fund sector has been a significant driver of growth in the financial services sector since the first Guernsey unit trusts were established in the mid 1960s. The first corporate vehicles to be used

for open-ended collective investment schemes were established during the 1970s following changes to the Guernsey Companies Legislation permitting redeemable preference shares to be issued.

The sole basis of regulation of open or closed-end investment funds prior to 1986 was The Control of Borrowing (Bailiwick of Guernsey) Law, 1946 and the Ordinances published thereunder.

The Control of Borrowing (Bailiwick of Guernsey) Ordinances ("COBO") provide that no person or company should, without the consent of the GFSC (acting as agent originally for the Advisory and Finance Committee of the States of Guernsey now the Policy Council), raise money in the Bailiwick by the issue, whether in the Bailiwick or elsewhere, of any shares in that body corporate. This restriction applies also to non-Guernsey corporate entities if a register of shareholders is kept in Guernsey.

A similar prohibition also extended to unit trusts and more recently to Limited Partnerships. COBO provides that a person shall not, without the consent of the GFSC (acting as agent), raise money for the purpose of a unit trust scheme, issue units under the scheme or issue any units under a unit trust scheme where the scheme is governed by any of the laws of the Bailiwick or the units are to be registered in the Bailiwick. A limited partnership may not be registered in Guernsey except with consent given under COBO nor may a limited partnership raise capital in the Bailiwick without consent.

The consent of the GFSC (acting as agent) is also required under COBO for the circulation within the Bailiwick of any prospectus for the offer for subscription or sale of any securities in a body corporate not incorporated under the laws of the Bailiwick if this offer is a public offer. There is no definition of what does or does not constitute a "public offer" for these purposes. In practice, it is difficult for the Guernsey authorities effectively to police this particular aspect, nor is there any effective sanction that can be imposed upon any person operating from outside the jurisdiction.

COBO does not specify the grounds upon which the GFSC (acting as agent) is expected to exercise its discretion. Implementation of COBO therefore places heavy reliance upon the determination and interpretation of policy applied by the GFSC (acting as agent). There is no appeal against any decision of the GFSC (acting as agent).

COBO was and still remains the sole basis upon which the GFSC (acting as agent on behalf of the Policy Council of the States of Guernsey) exercises regulation over close-ended Guernsey funds and non-Guernsey domiciled funds that do not fall within the definition of Collective Investment Schemes. The appropriateness of relying upon legislation derived from a law of 1946 that was not intended to be a regulatory law has been the subject of much debate and criticism.

Almost certainly, the absence of specified criteria for decisions and the absence of an appeal process, renders the application of COBO non-human rights compliant. As will be described elsewhere in this Report, the Working Party recognises that confusion can arise as to the distinction between an open-ended and a close-ended fund and questions the necessity or desirability for retaining a distinction between open and close-ended investment funds for regulatory purposes.

The Working Party also questions to what extent it is appropriate to regulate funds that do not fall within the definition of open-ended investment funds. In this regard, the Working Party notes that in the United Kingdom, HM Treasury has recently concluded that regulation of investment trust companies (broadly equivalent to non-close-ended investment funds) would not give rise to an improvement in regulation.

The Working Party also notes that there appears to be a considerable amount of confusion and misunderstanding concerning the extent of regulation under COBO and suggests that the Control of Borrowing regime is no longer appropriate for modern regulatory purposes.

Protection of Investors Law ("POI Law")

The Protection of Investors (Bailiwick of Guernsey) Law, 1987 was introduced for the purpose of regulating Collective Investment Schemes and activities relating to Collective Investment Schemes. The POI Law carved out of regulation under the Control of Borrowing Ordinances the regulation of Collective Investment Schemes by the introduction of a form of process for authorisation of Collective Investment Schemes (as "Controlled Investments") and a system of licensing of those providing services ("restricted activities") in support of such collective investment schemes. The POI Law regulates both the investment product and the service providers.

The POI Law was introduced primarily to satisfy requirements introduced in the United Kingdom by the Financial Services Act of 1986 to permit Guernsey Collective Investment Schemes aimed at the retail investment market to continue to be capable of being marketed to UK investors.

Under the terms of the POI Law:-

(i) no person shall carry on, or hold himself out as carrying on, any controlled investment business in or from within the Bailiwick, nor shall any Bailiwick body carry on, or hold itself out as carrying on, any controlled investment business in or from within a country or territory outside the Bailiwick, unless it is licensed under the POI Law; and

(ii) a licensed person may not engage by way of business in any restricted activity in connection with a Collective Investment Scheme unless that Scheme is authorised under the POI Law.

The POI Law sets out the criteria for licensing and the criteria for obtaining authorisation of a Collective Investment Scheme. The POI Law sets out procedures for appeal against decisions of the GFSC.

In considering whether to grant an application for a licence under the POI Law, the GFSC is required to have regard to the need to protect the public and the reputation of the Bailiwick as a financial centre and to that end, the POI Law states that the GFSC shall consider:-

"(a) the general nature and specific attributes of the controlled investment business to which the application relates;

(b) whether or not the applicant is a fit and proper person to carry on that business;

(c) the manner in which it is proposed to organise the carrying on of the controlled investment business to which the application relates, the number of persons who will be responsible for carrying on each aspect of that business and the relationship between those persons;

(d) what, if any, economic benefit the Bailiwick is likely to derive from the carrying on of that business; and

(e) any other factors which the GFSC thinks it appropriate to consider."

The Working Party would question whether it is still appropriate for a regulatory body such as the GFSC to be obliged to make a subjective assessment of "economic benefit" in its determination of a licence application.

In the case of an application for authorisation of a Collective Investment Scheme, the GFSC must be satisfied that:-

"i) the scheme must comply with all rules made under the POI Law applicable to the class of the authorised Collective Investment Scheme with which it is declared to be;

ii) the name of the scheme must not be undesirable or misleading;

iii) the purposes of the scheme must be reasonably capable of being successfully carried into effect;

iv) the scheme must entitle investors either:-

(a) to have their units redeemed or repurchased at a price related to the net value of the property to which the units relate; or

(b) to sell their units on a recognised investment exchange at a price not significantly different from that mentioned above;

v) the manager and the trustee or custodian of the assets of the scheme must each be a body corporate."

Simultaneously with the POI Law taking effect, the GFSC published in 1988 the Collective Investment Scheme Rules ("CIS Rules") that contained detailed rules to be followed in the construction and operation of a Collective Investment Scheme. The CIS Rules were agreed with HM Treasury and accepted by HM Treasury as satisfying the "equivalence" test required under the original Financial Services Act to enable Guernsey Collective Investment Schemes to be marketed to investors in the United Kingdom. Those original CIS Rules were extensively revised after protracted negotiations with HM Treasury and re-issued as the Collective Investment Schemes (Class A) Rules 2002.

At the same time as the introduction of the original CIS Rules, the GFSC identified a separate category of Collective Investment Scheme to be known as Class B Schemes to satisfy those managers who did not wish to utilise the equivalence of the CIS Rules for the purposes of marketing their funds to investors in the United Kingdom. The Class B Rules (introduced in 1990), although modelled on the CIS Rules, created a regime that offered greater flexibility and less prescription than the CIS Rules.

More recently, in 1998 the GFSC introduced a further set of rules known as the Class Q Rules which were intended to satisfy demand from some investment managers to offer an even more flexible set of rules for Collective Investment Schemes that were targeted solely at qualifying professional investors. For this purpose, "qualifying professional investors" were defined as meaning either 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 million; a body corporate or limited partnership, if it or any holding company or subsidiary of it has, at the time of investment, net assets in excess of £2 million; or, an individual who has, together with any spouse, at the time of investment, a minimum net worth (excluding that individual's main residence and household goods) of £500,000. The Working Party notes that the definition of "Qualifying Professional Investors" for the purposes of the Class Q Rules is not consistent with the definition used for the purposes of the "Qualifying Investors Fund" regime

The Working Party recognises three features of the POI Law that are potentially seen as inhibiting the establishment of Collective Investment Schemes:-

(i) the first is the requirement that as a condition of authorisation there must be a named "designated trustee or custodian" of the assets of the scheme. The designated trustee or custodian means a person designated as such by the GFSC for the purposes of the Law. This means that a Guernsey licensed entity must be named as designated trustee or custodian. The role of the designated trustee or custodian is not confined to that of safe custody of assets, but extends to a significant role in the oversight of the duties of the Manager;

(ii) the second is the requirement (derived from the definition of "open-ended investment company") that a Collective Investment Scheme must have as its purpose the investment of its funds "with the aim of spreading investment risk", without providing a definition of, or guidance on, what is intended by that statement; and

(iii) the third is the requirement originally derived from the CIS Rules and the Class B Rules that there must be a "Principal Manager". This requirement introduced as a matter of policy by the GFSC has meant that the promoter of the Collective Investment Scheme has had to establish its own "brass plate" licensed entity in Guernsey. This has cost implications and also creates a further layer of corporate complexity. In the case of the regime applying to Class Q Schemes, the GFSC has, as a matter of policy, relaxed this requirement by accepting that a Class Q Fund that is promoted by a group of which the designated manager is a member may operate with a non-Guernsey "Principal Manager".

It is acknowledged that for those funds (especially more traditional funds) seeking wider distribution in international markets a regulatory requirement for a local custodian and demonstrable spread of risk may be required, in order to achieve recognition. In other sectors, such as the alternative investment sector, the requirement for a traditional custodian, whether domiciled in Guernsey or elsewhere, may not be appropriate.

(B) Non-Fund Specific Investment Business Regulation

Investment Business that did not fall within the definition of a Collective Investment Scheme or a restricted activity relating to a Collective Investment Scheme did not fall into regulation until 1998 when the definition of "Controlled Investments" was extended to include "general securities and derivatives". The definition used in that extension has meant that, in practice, anyone undertaking any

investment activity in Guernsey (other than those relating to real estate management) is now regulated by the GFSC. The Non-Fund Specific Investment Business Sector now accounts for approximately 65% of all licences issued under the POI Law.

Under the POI Law, it is an offence for any person to carry on, or hold himself out as carrying on, any controlled investment business in or from within the Bailiwick of Guernsey, except under and in accordance with the terms of a licence granted under the POI Law. A person carries on controlled investment business if, by way of business, he engages in a restricted activity in connection with a controlled investment.

There is no statutory definition of what does or does not constitute "in or from within the Bailiwick". This gives rise to certain interpretational difficulties for investment managers, brokers or others who have no presence in the Bailiwick of Guernsey when dealing with Guernsey based customers.

The list of "restricted activities" defined in the POI Law applies to both fund specific and non-fund specific investment activities. Non-fund specific investment activities, and operation of investment exchanges, were added in the late 1990s, but the categories of restricted activity have not otherwise been amended or revised since the list was originally published in 1987 as a Schedule to the POI Law. In particular, the list now differs significantly from the equivalent list of regulated activities in other jurisdictions especially in relation to exemptions and other "carve outs" from regulation.

The restricted activities listed are:-

i) Promotion;
ii) Subscription;
iii) Registration;
iv) Dealing;
v) Management;
vi) Administration;
vii) Advising; and
viii) Custody.

The procurement of any of those restricted activities (even if those restricted activities are to be supplied outside the Bailiwick of Guernsey) also constitute a restricted activity for the purpose of the POI Law. This would apply, for example, in the context of the outsourcing of activities by contracting parties within the Bailiwick of Guernsey to other parties outside the Bailiwick. Outsourcing in this manner does not, however, cause the party providing the outsourced service to become subject to any requirement for a licence under the POI Law. The Working Party recognises that certain of the restricted

activities, in particular that of "promotion", would benefit from further clarification and revision.

Licensees are required to comply with certain further rules published by the GFSC under the POI Law, namely:-

i) the Collective Investment Schemes (Designated Persons) Rules, 1988 ("the DP Rules") (these Rules, however, only apply to those licensees who are either a Designated Manager or Designated Trustee or Custodian in relation to Collective Investment Schemes); and

ii) the Licensees (Financial Resources, Notification, Conduct of Business and Compliance) Rules, 1998 ("the FNCC Rules").

All licensees, whether or not they are also obliged to comply with the DP Rules, are required to comply with the FNCC Rules.

The FNCC Rules were introduced at the time when the POI Law was extended to non-fund activities. The Working Party questions whether there is any merit in retaining the DP Rules as a separate set of rules, given that the FNCC Rules themselves offer comprehensive rules for investment business, whether fund specific or non-fund specific.

One criticism levelled at the FNCC Rules is that, in the application of those Rules, no distinction is drawn between the different categories of clients/customers with whom a licensee may be dealing. The Working Party recognises the need for exempting certain categories of activities that presently fall within the definitions of "restricted activity" possibly by adopting new definitions and exemptions in line with those used in the Financial Services and Markets Act of the United Kingdom.

The Working Party also recognises that the promotion of investment services (rather than investment products) is not included in the list of "restricted activity". The Working Party is of the opinion that this omission should be corrected for the protection of the public in Guernsey.

(C) **Non-Guernsey Funds**

Under the POI Law, it is an offence for a Guernsey licensee to undertake any restricted activity in relation to a non-Guernsey collective investment scheme unless that non-Guernsey scheme has been notified to the GFSC and the appropriate fee paid. As at 31st December 2005, 194 non-Guernsey collective investment schemes had been so notified.

The system of notification, however, only applies where confirmation can be given that no other licensee carries on or intends to carry on any other restricted activity in connection with that same scheme. Where

two or more Guernsey licensees are intending to carry out restricted activities in connection with the same scheme, then that scheme must itself apply for authorisation under the POI Law. The Working Party considers that the justification for this distinction is questionable and that the implications of such distinction may act as a deterrent to Guernsey licensees offering their services in the administration of non-Guernsey schemes.

In the case of non-Guernsey closed-ended funds, there is no formal process for notification to the GFSC, nor is it certain that the GFSC is necessarily being made aware of all such non-Guernsey closed-ended funds which are administered by Guernsey licensees.

The Working Party would suggest that consideration be given to a modified system of notification and annual filing with the GFSC in respect of all non-Guernsey domiciled funds administered in Guernsey irrespective of whether they are open or close-ended.

5. External Competition

The Working Party has sought to obtain information relating to the manner under which investment business activities are regulated within other competing jurisdictions. In particular, the Working Party was anxious to establish the nature and manner of regulation applicable to investment funds, whether they be Collective Investment Schemes or closed-ended funds.

The major competitors to Guernsey as jurisdictions in which funds are domiciled or administered are:-

i) Jersey;
ii) Cayman Islands;
iii) Dublin;
iv) Luxembourg.

i) Jersey – Jersey is the most immediate competitor to Guernsey as a domicile for investment funds. The Guernsey Practitioners have noted that in recent years, Jersey has been very active through Jersey Finance in attempting to attract hedge fund managers and other boutique operators to create permanent establishments within the Island. In particular, Jersey, through the issuance of IIK housing licences, appears able to negotiate special tax deals with high net worth individual fund managers.

There is an external perception that the process of regulating funds in Jersey is lighter than the equivalent regulation in Guernsey. It is, however, difficult to quantify or establish the reality of this perception. Certainly, Jersey has a wider category of funds that appear to be exempt from regulation, whether it be under the Jersey equivalent of Control of Borrowing Ordinances or under their Collective Investment Fund legislation. In particular, it seems that a number of funds fall to be treated as "very private" funds and appear to be capable of being launched within a very short time span, requiring minimum regulatory intervention, whilst yet others appear to fall completely outside the ambit of regulation. Even within the ambit of regulated funds under Jersey's Collective Investment Fund regime, the introduction of the "expert fund" regime appears to have given Jersey a marketing advantage, given that the regime was introduced and marketed extensively before Guernsey introduced its own "qualifying investor fund" regime. There remain one or two differences of approach between the two alternative regimes, in particular, in the case of the Jersey expert fund, investor qualification can be satisfied by a minimum stated level of investment per investor. The Working Party understands, however, that the GFSC has indicated that it is now willing to adopt a similar criterion.

In order to compete with Jersey, the Working Party recognises that it would be an advantage for Guernsey to adopt an approach whereby

certain categories of investment funds would not require any form of regulatory consent.

ii) Cayman Islands – It is perhaps the Cayman Islands that are perceived to pose the greatest competitive threat to the Channel Islands and to Guernsey, in particular, as the domicile of choice for investment funds.

As a jurisdiction, the Cayman Islands have focused primarily upon the establishment of hedge funds within its jurisdiction and boast that there are over 10,000 Cayman Island domiciled hedge funds with new funds being established at the rate of 300 per month.

The Cayman Island Authorities are willing to offer the Cayman Islands as a jurisdiction for hedge funds with little apparent regulation beyond a formal filing process.

The evidence obtained from the Cayman Islands confirms that the process of fund establishment is controlled by the local law firms acting on instructions from lawyers in New York, London and the Far East. Unlike Guernsey, however, a comparatively small number of Cayman domiciled hedge funds are administered or managed locally in the Cayman Islands. Approximately 90 per cent of Cayman funds merely use the Cayman Islands as a jurisdiction of domicile with effective management and administration being undertaken elsewhere – typically in Dublin.

The approach adopted by the Cayman Island Authorities requires a robust attitude towards the reputational risk to the jurisdiction that may be caused by public failure of Cayman domiciled hedge funds. There have, in fact, already been a number of very well publicised failures of Cayman hedge funds, yet notwithstanding such failures, the Cayman Island Authorities appear to have effectively avoided accepting the responsibility for such failures and there is no evidence to suggest that the reputation of the Cayman Islands has suffered notably as a result of such failures. It is worth noting, however, that certain European jurisdictions (Switzerland being the most notable example) will not allow the promotion of Cayman Islands domiciled funds (even if they are administered in Guernsey) because of the perception of the reputation of the Cayman Islands.

The only significant requirement for any ongoing involvement in the Cayman Islands in respect of Cayman domiciled funds is the requirement for each Cayman domiciled fund to appoint a local Cayman auditor. In practice, this requirement appears not to have created any particular difficulties, given that the audit will, in practice, be undertaken in the jurisdiction in which the fund is administered with a local sign off by that firm's local Cayman associate.

Given comparatively little ongoing local involvement required with Cayman domiciled funds, the measure of economic benefit to the

Cayman Islands is no doubt considerably less per fund than would be considered politically acceptable in Guernsey. The annual costs of maintaining a domicile in the Cayman Islands are materially less than the equivalent costs would be in Guernsey.

It is also pointed out that the legal costs associated with the establishment of a hedge fund in the Cayman Islands are also significantly less than the equivalent legal costs associated with the establishment of a Guernsey fund.

It is assumed that the law firms who are establishing the Cayman Island funds will have undertaken due diligence with regard to the fund promoter/manager. Interviews conducted by the Working Party suggest that standards of due diligence vary significantly between individual firms and that many of the Cayman Island law practices appear to rely upon their instructing lawyers in New York, London or elsewhere to have satisfied appropriate due diligence enquiries.

The Working Party has received representations that it should encourage a move towards the adoption of a similar "volume based" approach to the attraction of fund registration within Guernsey. The Working Party has, however, considered that such a move would require a significant change of policy by the Guernsey authorities in relation to:-

(i) acceptance by the Island and the Island Authorities of a potentially greater reputational risk; and

(ii) acceptance that the economic contribution from each individual fund would be considerably less than at present.

Whether or not at this late stage, Guernsey could attract sufficient volume of fund registrations to compete with the Cayman Islands or other jurisdictions, to justify such change of policy, is a matter of conjecture. Before any decision is taken, the Working Party would recommend that a detailed economic assessment be undertaken.

The Working Party also recognises that a lessening of the regulatory regime in Guernsey could possibly impact adversely upon the ability to continue to market all categories of Guernsey investment funds in other jurisdictions.

iii) Dublin – Dublin has uniquely established itself as a thriving offshore financial centre from a zero base over the past 15 years.

In particular, Dublin has established itself as a successful centre for fund administration and custodian services in respect of non-Irish domiciled funds. Dublin is recognised as a specialist centre for hedge funds. It is estimated that one third of all hedge funds are administered

in Dublin. The administrators of non-Irish domiciled schemes are regulated but not the funds that they administer.

Dublin also offers the further advantage of being within the European Union. Irish domiciled funds qualifying as UCITS are capable of being marketed throughout Europe. This feature has attracted a number of global investment managers to use Dublin as an alternative jurisdiction to Luxembourg.

Dublin has also been able to take advantage of the membership of the EU, in order to promote pan-European investment products, including the recently established common contractual fund targeted at European multi-jurisdictional pension funds.

The ability of Dublin to administer non-Irish domiciled funds with no regulatory interference has been a strong contributor to the vast growth of Dublin and will be a contributor for future growth. Dublin is also clearly able to benefit from a significant pool of skilled labour.

The government of Ireland is trying to encourage investment managers themselves to relocate into Dublin. The certainty of a fixed tax rate of 12% is perceived to offer an advantage, although the personal tax rates which will apply to individual managers are less attractive.

There is little or no evidence to suggest that the regulatory process in Dublin for Irish domiciled funds offers any particular advantages to the equivalent system of regulation in Guernsey.

iv) Luxembourg – Unlike its principal competitors, Luxembourg's fund industry is based primarily upon Luxembourg domiciled investment entities, eg Luxembourg UCITS and Luxembourg SICAVS. Luxembourg has not developed as a significant centre for administration of non-Luxembourg domiciled funds. Luxembourg has also benefited significantly from its membership of the EU by operating as a centre for International Bond Issues listed on the Luxembourg Stock Exchange.

Luxembourg therefore relies primarily upon its membership status within the European Union as the basis for its fund industry. Its recent development of special vehicles for venture capital/private equity investment purposes within the EU potentially poses a threat to Guernsey which has historically provided a jurisdiction of choice for such vehicles.

There is little or no evidence to suggest that the regulatory process in Luxembourg offers any particular advantages to the equivalent system of regulation in Guernsey.

v) UK – There is evidence to suggest that the Financial Services Authority in the United Kingdom is aware of the growth of the hedge

fund sector and that it is considering how it ought to react, given that much of the investment expertise used by offshore hedge funds is based in the United Kingdom. Paradoxically at the same time the UK Revenue authorities appear to be targeting those same onshore advisers causing many to consider migrating to other jurisdictions that offer a more favourable fiscal regime. The attitude of the UK Revenue authorities offers a window of opportunity for Guernsey to attract such onshore advisers to relocate to the Island. Unfortunately, Jersey and other EU jurisdictions are competing strongly for the same business.

The introduction by the FSA of a new rule book following the implementation of the EU Prospectus Directive may offer alternative investment vehicles onshore that are capable of competing against traditional offshore structures.

The introduction of the real estate investment trust ("REIT"), may pose a threat to the offshore fund sector that has benefited materially over the past three years from the movement of UK real estate investments into offshore structures. How much of an impact that threat will have upon existing offshore fund structures is not yet known. It is possible that certain offshore investment funds may opt to re-domicile onshore to the United Kingdom for tax purposes, in order to qualify for REIT status. In those circumstances, it seems likely that some of the administration currently undertaken offshore may be taken onshore to the UK. This could have an impact upon the volume of administration activities undertaken in Guernsey.

vi) General Threats – As a result of the interviews that it has undertaken, the Working Party is also aware of the increasing trend towards the consolidation of offshore service providers. Associated with this consolidation process, there is evidence that certain global service providers are tending to create global centres of excellence for different types of offshore fund activity. The establishment of such centres of excellence is likely to influence the jurisdiction in which investment funds are domiciled. This may operate to the detriment of Guernsey if, for example, the global centre of excellence for hedge fund administration is centred in Dublin or the global centre of excellence for real estate fund administration is centred in Jersey. In contrast, however, if and to the extent that Guernsey is itself identified as a global centre of excellence for a particular type or style of fund administration, then this could lead to an increase in the number of both Guernsey and non-Guernsey domiciled funds administered in Guernsey.

The point has also been made that the creation of global centres of excellence outside Guernsey may attract a movement of staff out of Guernsey and the loss of specialist expertise that has built up in Guernsey over recent years.

If Guernsey is to offer itself as a centre of excellence for particular fund types, then the Working Party recognises that it is important that the regulatory framework must be such that it is perceived to be no more onerous than its competing jurisdictions and that there are no significant barriers to prevent non-Guernsey domiciled funds being administered in Guernsey.

6. Inhibitions on future growth within the Investment Business Sector

During the course of the interviews conducted by the Working Party, a number of common opinions emerged as to what might be perceived to be the principal restraints on the future growth of the Island's investment business sector.

Broadly, these fall into the following categories:-

(i) Constitutional;
(ii) Regulatory;
(iii) Fiscal; and
(iv) Housing/Labour resource.

(i) Constitutional – Guernsey's exclusion from membership of the EU undoubtedly operates as a deterrent to the attraction of certain types of investment business, especially fund specific business that is currently attracted to Dublin or Luxembourg. The single market in European investment business creates a significant barrier to competition from outside the EU. It cannot be denied, however, that other types of investment business are attracted to Guernsey by virtue of the fact that it is outside of the EU and therefore free of the increasing complexity of EU directives. The Working Party considers that, on balance, there are probably greater opportunities for the investment sector by remaining outside the EU, provided that the Island retains the ability to resist indirect pressures to implement EU directives.

(ii) Regulatory – In general terms, the non-fund specific sector of the investment business community had little complaint about the nature or style of regulation. Some of the interviewees suggested that the definition of "restricted activities" contained within the POI Law could benefit from a review and modification and that it made little sense to retain both the DP Rules and the FNCC Rules.

There is also a suggestion that the segregation of regulation into the traditional divisions of investment, insurance, banking and fiduciary is no longer appropriate, especially in the context of modern wealth management/discretionary investment management activities. It is also recognised that investment products increasingly straddle more than one of the traditional divisions. The necessity of obtaining a multiplicity of licences and having to satisfy the different criteria attaching to each licence is seen by some as being unnecessarily burdensome.

One common theme throughout the interviews was that it was necessary to recognise different categories of clients and to allow different rules and standards to apply to those different categories, eg those dealing solely with market counterparties as opposed to public or retail clients.

A number of those interviewed questioned the criteria adopted by the GFSC requiring potential licensees to demonstrate an appropriate track record before permitting them to operate with Guernsey domiciled funds. The GFSC have pointed out that this policy of selectivity has operated to protect the Island's reputation. Unfortunately, initial experience of the QIF regime suggests that service providers in Guernsey are reluctant to take upon themselves responsibility for the process of vetting and certifying the expertise of new investment bodies.

Within the fund specific sector, lack of clarity as to the differences between the different categories of open-ended schemes and the confusion between the POI Law regime and the COBO regime were given as examples that deter some of the London lawyers from recommending Guernsey as a jurisdiction of choice for fund registration. There was general criticism of the COBO regime where a perceived lack of clarity as to issues of policy adopted by the GFSC from time to time made it difficult to predict with any certainty, whether or not a closed-ended fund proposal would or would not be acceptable. There was also a general criticism that it was difficult to identify the policies from time to time adopted by the GFSC. The requirement under POI Law for a local licensed "Designated Custodian" of Collective Investment Schemes was seen as a further deterrent as was the need for a "Principal Manager" for Class A and Class B open-ended investment funds particularly when contrasted with the relaxation by the GFSC of its policy by permitting Class Q Funds to operate without a Guernsey domiciled "Principal Manager"..

The general lack of a prescriptive approach to the definition of "Qualifying Investor" for the purposes of the qualifying investor fund regime was quoted by some as a disadvantage, but by others as an advantage.

Notwithstanding the existence of several bilateral agreements negotiated by the GFSC with overseas regulators, the lack of regulatory gateways to enable Guernsey funds and investment services to be marketed into foreign countries, especially Europe, and other regulatory barriers to entry into the EU, were considered to operate as a significant inhibition to the growth of the fund sector. Many expressed disappointment that, in the context of the negotiations for the establishment of the bilateral treaties to implement the EU Savings Directive, the opportunity was not taken to push for recognition of Guernsey regulated investment products or services or for the negotiation of double tax treaties.

(iii) Fiscal – Concerns over the uncertainty surrounding the 2008 Zero/10/20 proposals were cited by many as a major inhibition and threat to the development of new investment business within the

Island. This concern was common, both to the fund specific sector and to the non-fund specific sector.

The fact that Guernsey still appears on fiscal black lists in many countries and the absence of double tax treaties with those countries is seen as a major inhibitor to the development of the investment business sector.

The inability to negotiate capping on the tax liability of individual high paid investment managers made Guernsey, in the eyes of many, less attractive than Jersey when targeting UK based investment advisers to relocate to Guernsey. The fact that Cayman Islands and the Isle of Man are able to zero rate investment management activities is also seen to place those jurisdictions at a further advantage over Guernsey.

(iv) Housing/Labour resource – The most common and consistent criticism which arose during the course of the interviews concerned the application of the Guernsey housing laws. In particular:-

(a) the inability to predict in advance whether or not a housing licence will be forthcoming;

(b) the rateable value limits attaching to housing licences; and

(c) the length of time for which housing licences are available.

All of these points were seen by the majority of the interviewees as creating perhaps the most serious inhibition upon the ability to attract new business and the necessary calibre of staff into Guernsey. The limited periods for which licences are available leads to a high turnover of trained staff. The cost of training short term staff borne by the Guernsey service providers benefits other jurisdictions. If Guernsey is to compete seriously as a centre of excellence for investment management activities and/or as a centre of excellence for administration of specialist funds, it is essential that Guernsey must be able to attract and retain the appropriate skills.

The non-fund specific sector expressed particular concerns that, whilst Guernsey may have a sufficient pool of labour to undertake routine fund administration, there is a lack of skills to undertake non-fund specific investment business activities.

The costs of hiring staff for fund administration services in Guernsey is considered to be high when compared with the cost and the ability to hire more highly qualified staff in other jurisdictions. The combination of lack of qualified staff and costs of employment is likely to influence a move towards a greater use of outsourcing of activities. This may, in turn, have a long term impact upon the range and variety of employment that can be offered within the fund specific sector in Guernsey.

One of the interviewees reported that, due to difficulties in obtaining a housing licence to bring in a key member of staff for a specific purpose, that person was relocated to the Isle of Man and, as a result, a team has been built up around that individual within the Isle of Man. This event has benefited the Isle of Man economy and has diverted business that would otherwise have been undertaken within Guernsey.

(v) Infrastructure – There is no evidence that the infrastructure facilities available within the Island are seen as a deterrent to growth. The only criticism made was that of the cost of such services when compared with equivalent services in other jurisdictions. Cost in relation to building work in the Island was also a source of complaint.

Transport links with the Island were discussed. Surprisingly, there was no evidence to suggest that the present transport links were a source of complaint or considered to be a deterrent to growth. Complaints concerning transport mostly focused on difficulties created by weather conditions.

7. Conclusions

The Island has benefited significantly from the Investment Business Sector. In particular, the fund specific sector has been responsible for creating and sustaining a significant volume of employment in the Island and contributing to the profile of the Island in the International Investment Community.

The Working Party believes that it is important to encourage and sustain the fund specific sector and, where possible, to encourage local ownership of licensed service providers within that sector. The Working Party has concerns that the fund specific sector is vulnerable to consolidation amongst its service providers. The Working Party is also concerned to note that there is a trend towards globalisation whereby larger multinational service providers will concentrate activities globally within centres of excellence possibly at the expense of the Guernsey financial services sector. In order to combat this trend, the Island needs to encourage local ownership of its service providers and to ensure that there are no barriers that preclude service providers in Guernsey administering or providing services to non-Guernsey funds. The Working Party recognises that Guernsey is perceived externally as a high cost base from which to operate administrative services and recognises that there will be increasing pressure to move administration to jurisdictions that offer a lower cost base.

In order to sustain existing fund administration business and hopefully to encourage further growth within the sector, the Working Party recognises that, from a regulatory perspective, there needs to be a careful balance between the amount of administration that is required to be undertaken onshore in Guernsey and the level of administration that is permitted to be outsourced to cheaper jurisdictions. The current outsourcing policy adopted by the GFSC that applies to both open and closed-end funds (although this fact needs to be more clearly understood within the industry) appears to give sufficient flexibility. The policy towards outsourcing of functions will, however, need to be kept under review if the fund specific sector is to maintain growth without seriously overheating the local economy. The alternative approach, moving towards the Cayman Islands model, by permitting greater elements of the administration of Guernsey domiciled funds to be undertaken outside the Island would have a significant impact upon:-

(i) the economic benefit to be retained within Guernsey
(ii) the continued sustainability of Guernsey as an administration centre
(iii) the reputation of the Island where Guernsey domiciled funds are administered by persons over whom the GFSC has no authority.

On balance, the majority of the Working Party prefers the retention of the present policy permitting Guernsey based administrators to outsource elements of administration whilst still retaining responsibility and accountability to the GFSC.

The Working Party recognises that the distinction drawn between open and closed-ended funds and the style of regulation applied to each has been a source of confusion and that the distinction is probably no longer justified (except for Class A Collective Investment Schemes where the regulatory regime needs to be substantially equivalent to that applicable in the UK). The Working Party also recognises that there is confusion as to what does or does not constitute an "Investment Fund" for the purposes of regulation. The Working Party considers that a definition is necessary, but recognises, however, that previous attempts to arrive at a comprehensive definition have not succeeded in finding a satisfactory solution.

The Working Party considers that the Control of Borrowing regime is no longer appropriate as a means of regulation and should be replaced with legislation dealing generally with minima criteria for disclosure of information in relation to the offering of securities by all Guernsey companies, not merely investment funds.

The Working Party is also persuaded that the regulation of the funds sector ought to concentrate less on regulation of individual investment funds as products but should focus more attention upon regulation of those licensees who are providing services to such investment funds.

The Working Party is also conscious of the fact that concentration of regulation upon approval of each investment fund as a "product" imposes considerable strain upon the resource within the GFSC. The inherent delay in that regulatory process also places Guernsey at a competitive disadvantage.

The Working Party is keen to encourage growth within both the fund specific and the non-fund specific sectors. In particular, the Working Party considers that it is important that the Island continues to endeavour to attract intellectual capital to move to the Island to establish ownership within the Island. The Working Party considers this policy to be of importance, given that the fund specific part of the industry is largely owned and controlled from outside the Island and is therefore vulnerable to decisions taken outside the Island not having regard to the interests of the Island. In order to attract such intellectual capital, the Working Party believes that the Island needs to address two principal issues:-

(i) Tax capping in order to attract high net worth investment personnel to move to, and establish business in, the Island; and
(ii) a fundamental reform of the current system of housing licences to assist in the recruitment of the necessary skills required to support the financial services industry.

Unless the Island is able to tackle those two issues, the Island's ability to compete with other jurisdictions to attract such intellectual capital will be seriously impaired.

In the interests of both the fund specific sector and non-fund specific sector, the Working Party recognises that it is important that the Island should strive

to attempt to remove barriers that preclude Guernsey investment businesses offering investment products or services into other jurisdictions. The negotiations of double tax treaties with and mutual recognition of other jurisdictions would be seen as a first step in this process.

8. Proposals

Based on the conclusions set out in the previous chapter, the Working Party considers that the existing regime for the regulation of investment funds should be radically changed by placing greater emphasis upon the regulation of the licensed service providers and less upon the investment fund itself as a product. The Working Party also recognises that restrictions on selling investment products or limiting the categories of persons to whom investment products may be sold is a matter for regulation within the jurisdiction in which the product is being offered and not a matter for the jurisdiction in which the investment product is domiciled.

In consequence, the following proposals should be implemented:-

(i) Control of Borrowing Ordinances should be repealed and should be replaced by a generic "Prospectus" law applicable to all Guernsey domiciled entities whether they be investment funds or trading or commercial companies setting out minimum criteria for disclosure for any Offering Document. There should be an obligation upon any such entity that is raising capital by the issue of securities whether or not directly to the public to file a copy of the Prospectus/Offering Document with the GFSC together with an appropriate fee accompanied by a certificate from a local lawyer confirming that the requirements of the law have been satisfied.

(ii) The funds provisions of the existing POI Law should be modified to become a Funds Law applying both to open and closed-ended investment funds. This will require a detailed definition of what does and does not constitute an "investment fund".

That Funds Law would identify two separate categories of investment funds namely Regulated and Registered Funds. Regulated funds would be restricted to categories equivalent to existing Class A, Class B and Class Q Funds and, possibly, a new regime offering equivalence to UCITS III. Equivalent Class B and Class Q Fund Rules would need to be introduced, in order to admit closed-ended funds as regulated funds (at the election of the promoter). The regulated categories of funds would be funds that are capable of being offered by the issuer directly to the public in Guernsey. The category of regulation would continue to offer the same benefits, eg Class A would allow recognition by the UK for the purposes of marketing directly into the UK. If, as suggested, an UCITS III equivalent category was introduced, funds regulated under that regime might potentially be able to be marketed into the EU. The style of regulation of all categories would be similar to that currently adopted under the POI Law. In the case of all Regulated Funds, the requirement that there be a "Principal Manager" should no longer apply. The Qualifying Investor Fund regime should still be available to fast track the approval process for Regulated Funds. The Regulated Fund category would be relevant to those promoters seeking international recognition for their investment funds.

All other investment funds would be categorised as Registered Funds whether they be open or closed-ended. Registered Funds may not be offered directly by the issuer to the public within Guernsey, but may be listed.

All Registered Funds would have to comply with the minimum Prospectus disclosure requirements.

All Registered Funds would have to appoint a local licensed administrator. Each Registered Fund through its appointed administrator would be required to make an initial filing with the GFSC and there must be an annual renewal of such filing. The administrator would be required to certify that it has undertaken due diligence on the promoter of the Registered Fund. The GFSC would need to establish clear guidelines to establish minimum criteria for the due diligence to be undertaken by the administrator.

There should be a standard rubric to be incorporated on any Prospectus, Information Memorandum, Offering Circular or similar document issued by a Registered Fund and also in the annual report and accounts of such Registered Funds to the effect that the Fund is a Registered Fund and is not therefore regulated by the GFSC. Evidence that such rubric has been incorporated would need to be submitted to the GFSC.

The current outsourcing policy adopted by the GFSC should continue to apply to all investment funds whether Regulated or Registered and should be kept under review, in order to permit growth in the fund specific sector without overheating the local economy.

In order to encourage Guernsey as an administration centre for non-Guernsey funds, the only obligation imposed upon a Guernsey licensed administrator or custodian when assuming a role in relation to a non-Guernsey fund should be that of formal notification to the GFSC. Such notification should require certain minimum information concerning that fund, together with a certificate from the Guernsey administrator that it has carried out an appropriate level of due diligence. Notification should then be renewed annually.

The current FNCC Rules and DP Rules should be amalgamated and made into one body of rules applicable to all licensees irrespective of whether they are providing services to a Regulated or Registered Fund or non-Guernsey Fund.

The "Oversight/Monitoring" functions presently required of the custodian of Guernsey Regulated Funds should be separated from that of its custody/safe keeping role. Only the former activity should need to be undertaken by a Guernsey licensed entity. Consideration should be given to dropping the requirement that such Guernsey licensed entities providing the Oversight/Monitoring Function must have a minimum capital of £4 million, at least in those cases where a change of approach would not undermine international acceptability.

The current list of restricted activities set out in the POI Law needs to be reviewed. In particular, consideration needs to be given to building in certain exemptions/carve outs in line with other jurisdictions especially by reference to the different categories of clients with whom the licensed entities may be dealing.

Finally, the Working Party recognises that there appears to be some element of duplication between the different divisions of the GFSC in relation to the licensing of activities that overlap the regulatory divisions. The Working Party considers that there should be a review of the process of licensing generally and there may be merit in separating out from the Protection of Investors Law the process of licensing of Guernsey service providers. Consideration should be given to creating a separate law dealing with licensing of all Guernsey financial services activities irrespective of whether they fall within the current definitions of banking, investment, insurance or fiduciary.

APPENDIX 1

LIST OF INTERVIEWEES

M Thistlethwayte	LCF Edmond de Rothschild
C Brock	Brewin Dolphin
J Davy	Collins Stewart
A Burgess	Collins Stewart
W Milroy	Dawnay Day Milroy
P Meader	Dawnay Day Milroy
N Harris	Kensington Wealth Management
T Menteshvili	Channel Islands Stock Exchange
P de Putron	de Putron Management
J Renouf	FRM
M Huntley	Northern Trust
H Camp	Kleinwort Benson