



Hedge Funds

Flexible approach to authorisation policy

The Investment Business Division has reviewed responses to the hedge fund consultation launched on 18 November and formally closed on 31 December (but held open in practice until mid-January). Having considered all the responses, the Division intends to develop detailed guidance in accordance with the general policy framework set out below. It expects to issue that detailed guidance within the next two months.

1. General Approach to fund authorisation

The Commission starts from the premise that institutional and expert investors require fewer regulatory protections than retail investors. This view has been applied for many years to the authorisation process for Class B and Class Q (Qualifying Professional Investor) funds: the level of scrutiny given by Division staff to applications varies depending on the target investor base; and the rules themselves give the Commission the right to grant waivers to individual funds or to a group of funds, providing the granting of such waivers would not increase regulatory risk. It has always been, and remains, the case that the Class B rules framework can accommodate a wide spectrum of investor markets, from purely retail to exclusively institutional. As the name implies, the Class Q (Qualifying Professional Investor) Rules are generally aimed at a more restricted market.

There are, however, significant overlaps. The Class B rules can, and already do, accommodate expert investor funds, just as the definition of Qualifying Professional Investor in the Class Q rules can accommodate most types of institution. Although the policy approach which follows makes some distinction between institutional and expert funds on the one hand, and funds targeted at retail and less sophisticated investors on the other, this does not imply any automatic assumption by the Division that applications for expert investor funds must only be submitted under the Class Q Rules, or that institutional vehicles must fall within the Class B regime. The Division intends to retain its traditional flexibility of approach.

The policy framework is being published now in order to give users and potential users of the Bailiwick greater clarity over the kinds of rule waiver which can be made available to hedge fund applicants. Some aspects of the proposed regime – for example, the meaning of “acceptable jurisdiction” and “substantial net worth” in the context of prime brokers – will be the subject of the more detailed guidance referred to in the opening paragraph of this document. Potential applicants who wish to make use of the waivers need not, however, wait for the more detailed guidance to be issued before approaching the Commission. As of the date of this document, the fund authorisation team is ready to deal with applications for rule waivers falling within the framework set out below.

2. Custodians, prime brokers and asset segregation

The Protection of Investors Law requires each authorised Guernsey open-ended fund to have a manager and custodian designated by the Commission. The Class B and Class Q rules require that the manager and custodian are Guernsey domiciled and appropriately licensed under the POI Law. Both sets of rules include express provisions giving the Commission power of waiver.

- (a) **For institutional and expert investor hedge funds**, the Division will be prepared to waive the requirement for a locally licensed custodian and will be prepared to designate as custodian a prime broker, regulated in an acceptable jurisdiction and having substantial net worth. The Division would not require such a prime broker to take on formal duties of oversight over the fund manager.

In addition, the Division would not require a prime broker to offer physical segregation of fund assets from its own assets, even where fund assets held by the broker exceed credit extended by the broker. The offering document of a fund availing itself of these rule waivers would have to make clear and prominent disclosure of the risks inherent in these arrangements.

- (b) **For hedge funds targeted at retail and less sophisticated investors**, the Division will normally require a traditional custodian to exercise essential oversight of the fund manager. It will, however, be prepared to waive the requirement that the custodian

take control of the fund's property, provided that the property is held by a prime broker regulated in an acceptable jurisdiction and having substantial net worth. The Division will normally expect such a custodian to be a licensed Guernsey institution but will be prepared to consider requests to designate custodians from other jurisdictions provided it can be satisfied that the custodian's role in overseeing the fund manager will be subject to monitoring by the custodian's regulatory authority.

For funds of this type, the prime broker would be expected to provide clear segregation from its own assets of all fund assets exceeding the amount required for collateral against credit extended by the prime broker. The segregation arrangements would have to ensure that surplus fund assets would be fully protected in the event of failure of the prime broker. The offering document would have to make full disclosure of custody and prime broker arrangements and of the risks entailed.

3. Net asset value and share price estimation

The Division recognises that some hedge funds, and funds of hedge funds in particular, may have difficulty in establishing net asset value promptly because of the time which may be needed to establish the value of certain portfolio assets including underlying funds. The problem is even more acute where underlying funds do not have valuation points which coincide with the fund of funds' own valuation point.

- (a) **For the broad spectrum of funds**, the Division will be prepared to permit arrangements which allow preliminary estimation of net asset value. On this basis, subscription monies could be taken into a fund before the final number of shares to be allocated had been determined, and interim redemption monies could be paid out of a fund, subject to a later final adjustment once NAV calculation had been completed. The Division would require these arrangements to be fully disclosed in fund documentation and the risks to investors clearly set out. It would be necessary to demonstrate to the Division that the process for estimating NAV was robust, and if interim redemption payments were contemplated, the interim proportion would have to be set at a level which minimised the risk of overpayment to redeeming investors.

- (b) **For those funds aimed at retail and less sophisticated investors** the Division would not accept arrangements under which the fund itself bore any risk of loss through overpayment on redemption. The Division would expect that the redemption proportion should be set so that any risk of overpayment was extremely remote; and if overpayment did occur, it would fall to the manager or the investment advisor responsible to reimburse the amount of that overpayment to the fund.

The Division recognises that estimation processes introduce an element of uncertainty into subscriptions and redemptions which investors may regard as unsatisfactory. The Division encourages arrangements under which the Board of Directors of a hedge fund or fund of hedge funds undertakes the responsibility of establishing “fair value” for the underlying assets held at any particular valuation point. Provided that the approach to calculating “fair value” is fully disclosed in the fund’s offering document, the “fair value” approach would remove the uncertainties inevitably associated with estimation and delayed finalisation of net asset values.

4. Client Money Rules

Both the rules for Designated Persons, and the rules generally applicable to Licensees make provision for segregation of client money. Because these two sets of rules are couched in different terms there is scope for confusion. Where funds elect to use NAV estimation procedures, and where the final number of shares to be allotted to an investor cannot therefore be determined for some time, the effect of the Licensee client money rules would prevent the release of subscription money for use by the fund itself. For the avoidance of doubt, and provided that the Division is satisfied as to the robustness of estimation procedures to be used, the Division will make available appropriate waivers from the operation of the Licensee Client Money Rules.

5. General Comments

The investment strategies of hedge funds and funds of hedge funds may not, in every case, lend themselves to the oversight of the traditional trustee/custodian. It is for that reason that the Division is prepared to contemplate the prime broker arrangements set out in section 2 of this policy statement. The Division does, however, wish to ensure that managers of

Guernsey domiciled hedge funds and funds of hedge funds will be subject to some process of scrutiny to ensure compliance with offering documents and applicable rules and regulations. The Division can see an enhanced role for Boards of Directors and/or investment advisors and asset allocators in ensuring that hedge funds and funds of hedge funds remain within the investment strategies and styles disclosed to investors.

6. Further information

The full text of the Class B and Class Q rules and other relevant investment legislation referred to in this document can be found on the Commission's web site at <http://www.gfsc.gg/investment/>.

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