GUERNSEY
FINANCIAL
SERVICES
COMMISSION

THE LICENSEES (CAPITAL ADEQUACY) RULES 2010

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Legislative Framework and Principles of Capital Adequacy

Legislative Framework

Schedule 4 to *the Law*, which sets out the minimum criteria for licensing, states

5. (1) The applicant or *licensee* conducts or, in the case of a person who is not yet carrying on business regulated by this Law, will conduct his business in a prudent manner.

(2) Without prejudice to subparagraph (1) and subject to subparagraph (4), an applicant or *licensee* shall not be regarded as conducting his business in a prudent manner unless -

(a) he maintains or, as the case may be, will maintain -

(i) a capital base, and

(ii) insurance cover,

of an amount which *the Commission* considers appropriate,

(b) he maintains or, as the case may be, will maintain adequate liquidity, having regard to -

(i) the relationship between his liquid assets and his actual and contingent liabilities,

(ii) the times at which those liabilities will or may fall due and his assets will mature,

(iii) the nature and scale of his operations,

(iv) the risks inherent in those operations and (where the person is a company) in the operations of any other company in the same group, so far as capable of affecting the company, and

(v) any other factors appearing to *the Commission* to be relevant

(4) For the purposes of -

(a) subparagraph (2)(a), an appropriate amount is -

(i) an amount commensurate with the nature and scale of his operations, and

(ii) an amount and nature sufficient to safeguard the interests of his clients and potential clients, having regard to -

(A) the nature and scale of his operations,

(B) the risks inherent in those operations and (where the person is a company) in the operations of any other company in the same group, so far as capable of affecting the company, and

(C) any other factors appearing to *the Commission* to be relevant,

(b) subparagraph (2)(b), in considering the liquid assets of an applicant or *licensee the Commission* may, to such extent as it thinks appropriate, take into account -

(i) the assets of the applicant or *licensee*, and

(ii) the facilities which are available to him and which are capable of providing liquidity within a reasonable period

<u>Principles of Capital Adequacy</u>

The *Capital Adequacy Rules* recognise that there will be some occasions where the Rules for *financial resources requirement* and *liquidity requirement* will not take into account the nature and complexity of the *licensee's* business. Such an occasion might be, for example, due to foreign exchange risk, risk of counterparty default, off-balance sheet assets or liabilities (including contingent liabilities) or principal positions which the *licensee* has taken. Accordingly the *Board* of the *licensee* should consider an appropriate level above that required by Rules 2 and 3 and evidence that consideration. In assessing the above, as a <u>minimum</u> the *Board* of the *licensee* should consider the calculations laid out in Rule 5. These calculations are intended to be a framework; *the Commission* anticipates that there may be more sector-specific calculations in future.

In addition, *the Commission* will consider *adjustments* or modifying Rules to allow amendments to the *financial resources requirement* and *liquidity requirement* calculation. However *the Commission* will not consider such amendments or *adjustments* where they would permit the *licensee* to not meet the solvency test as defined in section 527(1)(a) and 527(1)(b) of the Companies (Guernsey) Law, 2008.

Further, Rules 2.1 and 2.2 insist that the *licensee* complies with the *financial resources requirement*, and Rule 3.1 with the *liquidity requirement*, at all times. However Rule 1.1(c) empowers *the Commission* to exclude or modify the application of any provision of the *Capital Adequacy Rules*. *The Commission* would expect any request for an exclusion or modification to be timely. *The Commission* will not grant a modification or exclusion that has a retrospective effect.

THE LICENSEES (CAPITAL ADEQUACY) RULES 2010

The Guernsey Financial Services Commission ("*the Commission*"), in exercise of the powers conferred on it by sections 12, 15 and 16 of the Protection of Investors (Bailiwick of Guernsey) Law, 1987 as amended ("*the Law*") hereby makes the following rules:-

1. Introduction

1.1. Citation, commencement and application

(a) These rules may be cited as the Licensees (Capital Adequacy) Rules 2010 ("*the Capital Adequacy Rules*") and shall come into operation on 16 April 2010.

(b) *The Capital Adequacy Rules* apply to all *licensees* unless specifically agreed otherwise by *the Commission* in accordance with 1.1(c).

(c) *The Commission* may in its absolute discretion by notice in writing to a *licensee* exclude or modify the application of any provision of *the Capital Adequacy Rules* if *the Commission* is satisfied that any such derogation will not be prejudicial to the interests of investors.

1.2. Interpretation

Unless the context otherwise requires, in *the Capital Adequacy Rules* expressions defined in *the Law* have the same meanings as they have in *the Law*, and the following expressions have the meanings assigned to them by this Rule:

"accounting reference date" means the date to which a *licensee*'s accounts are prepared;

"adjustments" means:

(a) deductions for non-current assets (which includes any investment in a *subsidiary*), debtors arising from sales or other transactions to associates, any deficiencies where the liabilities of a subsidiary of a *licensee* exceed its assets, and any other assets specified in writing by *the Commission*; and

(b) additions for creditors arising from purchases or other transactions from associates and other liabilities specifically permitted in both cases in writing by *the Commission*;

"annual audited expenditure" means either:

(a) an estimate of budgeted expenditure for the first 12 months which is submitted to *the Commission* in the case of a *licensee* which has not yet commenced its *controlled investment business*; or

(b) the expenditure as stated in the reported results in the immediately preceding period's *audited financial statements*

and, in either case, excluding any remuneration to directors whether through salary, bonuses or other benefits; this should exclude fees and commissions payable which are directly attributable to fees and commissions receivable; and should also exclude depreciation and amortisation of non-current assets.

"associate" in relation to a *licensee* means:-

(a) an undertaking in the same *group* as that *licensee*;

(a) any body corporate at least one-fifth of the issued equity share capital of which is beneficially owned by that *licensee* or an *associate*;

(c) any other person whose business or domestic relationship with the *licensee* or its *associate*, or with the partners, *directors*, *managers* or *employees* of the *licensee*, or its *associate*, places the person in a position to exercise significant influence over the *licensee* which might reasonably be expected to give rise to a conflict of interest in dealings with third parties;

"audited financial statements" has the meaning given in 4.2.1 of the Licensees (Conduct of Business) Rules, 2009;

"Board" has the meaning given to it by section 133 of the Companies (Guernsey) Law, 2008;

"carry value" is the value of the item carried in the balance sheet, determined by reference to GAAP;

"Capital Adequacy Rules" means the Licensees (Capital Adequacy) Rules 2010;

"client" means any person with or for whom the *licensee* carries on, or intends to carry on, *controlled investment business*;

"the Commission" means the Guernsey Financial Services Commission;

"contingent liabilities" have the meaning given in *generally accepted accounting principles*;

"collective investment scheme" means any arrangement such as is identified and described in paragraph 1 of Schedule 1 to *the Law*;

"controlled investment business" has the meaning given in section 1(3) of *the Law*;

"counterparty" includes any entity with which the *licensee* transacts unless otherwise excluded for the purpose of calculating counterparty risk at Rule 5

"current assets" means assets falling to be realised within one year of the *accounting reference date*;

"current liabilities" mean liabilities due to be realised within one year from the *accounting reference date*;

"designated manager", in relation to an authorised or registered *collective investment scheme*, means the person designated as such by *the Commission* for the purposes of *the Law* (as designated in *the Commission*'s authorisation of the scheme under section 8 of *the Law*, or *the Commission*'s declaration of registration of the scheme under Section 8 of *the Law*);

"designated trustee" or "designated custodian", in relation to a *collective investment scheme*, means the person designated as such by *the Commission* for the purposes of *the Law* (as designated in *the Commission*'s authorisation of the scheme under section 8 of *the Law*, or *the Commission*'s declaration of registration of the scheme under Section 8 of *the Law*);

"expenditure-based requirement" means a figure equal to 25% of the *licensee*'s *annual audited expenditure*;

"financial resources requirement" has the meaning given in rule 2.2;

"generally accepted accounting principles" ("GAAP") refers to financial statements prepared in accordance with International Financial Reporting Standards, UK GAAP or US GAAP;

"the Law" means the Protection of Investors (Bailiwick of Guernsey) Law, 1987 as amended;

"licensee" means the holder of a licence to carry on *controlled investment business* issued under *the Law*;

"liquidity requirement" means the value of *current assets* minus *current liabilities* less any loans to group companies, which must be at least equal to 10 per cent of *annual audited expenditure*, or £10,000, whichever is the greater as per Rule 3.1;

"margin requirement" means the margin required by the exchange or clearing house over which the derivative is being traded;

"net assets" means *total assets* less *total liabilities* after *adjustments* of the *licensee* and calculations required by Rule 5;

"subsidiary" has the meaning given in schedule 5 to *the Law*

"total assets" means assets of any type, which shall include non-current assets, and *current assets* (including debtors);

"total liabilities" means liabilities of any type, which shall include creditors and provisions for liabilities and charges;

"total revenue" means revenue of any type, which shall include commissions, investment management fees, advisory fees, interest and dividends.

2. Financial Resources Rules

2.1. Compliance

A *licensee* shall comply at all times with the appropriate *financial resources requirement*.

2.2. Financial Resources Requirement

A *licensee* must, at all times, maintain financial resources of not less than the appropriate *financial resources requirement* as follows:

2.2.1. for the *designated trustee* or *designated custodian* of an open-ended *collective investment scheme*, *net assets* of £4,000,000;

2.2.2. for the *designated manager* of a *collective investment scheme*, *net assets* of £100,000, or *net assets* equal to the *expenditure-based requirement* as shown by the latest annual financial statements submitted to *the Commission*, whichever is the greater;

and, for *licensees* for which Rule 2.2.1 or 2.2.2 applies, minimum *professional indemnity insurance* cover of £300,000, (or three times *total revenue,* whichever is greater), the excess of which must not exceed 20% of the total insured.

2.2.3. in the case of a *licensee* not falling within 2.2.1 or 2.2.2 but which is licensed under The Banking Supervision (Bailiwick of Guernsey) Law 1994; authorised or registered under The Insurance Managers and Insurance Intermediaries (Bailiwick of Guernsey) Law, 2002 or The Insurance Business (Bailiwick of Guernsey) Law, 2002; or licensed under The Regulation of Fiduciaries, Administration Businesses and Company Directors, etc (Bailiwick of Guernsey) Law, 2000; and *the Commission* has confirmed in writing that specific law takes precedence: as required by the Directors of Banking, Insurance and Fiduciary and Intelligence Services respectively;

2.2.4 in the case of a *licensee* not falling within 2.2.1 to 2.2.3 and with no physical presence (staff and premises) in the Bailiwick -

the higher of

£10,000; or

net assets and professional indemnity insurance cover which in the opinion of its directors is sufficient to meet its commitments and to withstand the risks to which its business is subject.

2.2.5 in all other cases, *net assets* of £25,000 or *net assets* equal to the *expenditure based requirement,* whichever is the greater and minimum professional indemnity insurance cover of £250,000, (or three times *total revenue,* whichever is greater), the excess of which must not exceed 20% of the total insured.

3. Liquidity Resources Rules

3.1 Liquidity Requirement

3.1.1 The *licensee* shall maintain, at all times, a *liquidity requirement* of £10,000 or 10 per cent of *annual audited expenditure*, whichever is the greater.

3.1.2 Where Rule 2.2.3 applies to the *licensee*, Rule 3.1.1 does not apply

4. Financial Notification

4.1. Immediate Notification

A *licensee* shall notify the Commission forthwith where the *licensee* has reason to believe that -

4.1.1 it is in breach of its *financial resources requirement* or *liquidity requirement*, or anticipates being in breach of its *financial resources requirement* within a period of one month; such notice shall specify the steps which the *licensee* is taking or has taken to remedy the breach and shall be confirmed in writing;

4.1.2 the *licensee*’s auditor intends to qualify the accounts;

4.1.3 the liabilities of a *subsidiary* of the *licensee* exceed the *subsidiary's* assets;

4.1.4 the liabilities of the parent company of the *licensee* exceeds the parent company’s assets.

5. Framework for Calculation of Financial Resources Requirement

Net Assets

Net assets after adjustments	**x**
Less:	
Contingent liabilities that require disclosure or provision under GAAP	x
Position risk (see page 12)	x
Counterparty risk (see page 14)	x
Net assets after adjustments, contingent liabilities, and risks	**x**

Position Risk

Sovereign Debt	5% of carry value	x
Daily-dealing Money Market Open-ended Collective Investment Schemes	5% of carry value	x
Other Marketable Debt	10% of carry value	x
Listed/Publicly Traded Equities	25% of carry value	x
Open-ended and Closed-ended Collective Investment Schemes (excluding daily-dealing money market open-ended collective investment schemes)	25% of carry value	x
Other derivative products as referred to in Schedule 1 to the Law	The greater of 25% of carry value OR 4 times initial *margin requirement* (see below)	x
Illiquid current assets (defined as being more than 90 days)		x
POSITION RISK		**x**

Guidance Note

The *margin requirement* may only be used as a measure for calculating the position risk of derivative products if it is considered, by the *Board* of the *licensee*, to appropriately reflect the risk.

Counterparty Risk

Exposure to any one counterparty is at least 25% of financial resources requirement	15% of excess over 25%	x
Exposure to any one counterparty is at least 50% of financial resources requirement	40% of excess over 25%	x
Counterparty risk		**x**

Guidance Note

For the purposes of calculating counterparty risk, the Commission recognises that not all unsettled bargains should be included. Accordingly the provisions above only apply to bargains which have been unsettled after 15 days (unless the bargain is subject to a legally enforceable guarantee).

Any money held at bank with term of less than 90 days should also be excluded from the counterparty risk.

6. Transitional Provisions

6.1 Ongoing Assessment of Capital Adequacy

6.11. Rules 4.1.1 and 4.2.2 of the Licensees (Conduct of Business) Rules 2009 require the *licensee* to prepare an ongoing assessment of capital adequacy. All *licensees* have until 30 June 2010 to meet the capital adequacy requirements as set out in these *Capital Adequacy Rules*. Until that time, a *licensee* may be considered to not have breached the *Capital Adequacy Rules* if it has met the requirements of the Licensees (Financial Resources, Notification, Conduct of Business and Compliance) Rules, 1998 or the Collective Investment Schemes (Designated Persons) Rules 1988, whichever was applicable. After 30 June 2010, the *Capital Adequacy Rules* will apply.

6.1.1 **Assessment of Capital Adequacy for the purposes of the audited financial statements**

6.1.2 The *Capital Adequacy Rules* will apply to all *audited financial statements* which have periods ending on or after 30 June 2010.