

Hedge funds in Guernsey: regulatory overview

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MARKET OVERVIEW

1. What is the structure of the hedge funds market? What have been the main trends over the last year?

Guernsey is a long-established jurisdiction for the establishment of hedge funds and funds of hedge funds, and such funds form a significant part of the island's fund industry. Established promoters of hedge funds in Guernsey include Dexion, BBBSA, Man, FRM, Fauchier, Pershing Square and Credit Suisse. The net asset value of hedge funds and funds of hedge funds currently stands at about GBP20.6 billion.

Alternative investments are at the core of Guernsey's funds industry, in particular private equity, venture capital and funds of hedge funds. Private equity and venture capital funds account for almost two-thirds of the closed-ended funds in Guernsey, by number and value, with a current net asset value of over GBP114.7 billion.

REGULATORY FRAMEWORK AND BODIES

2. What are the key statutes and regulations that govern hedge funds in your jurisdiction? Which regulatory bodies regulate hedge funds?

Regulatory framework

The position is virtually the same as that for open-ended retail funds.

Authorised funds. These funds are authorised and regulated, and subject to ongoing supervision, by the Guernsey Financial Services Commission (GFSC). The funds are classified as follows:

- **Class B.** These can be structured as retail products marketed to the public, or established as strictly private or institutional funds. The rules applicable to Class B funds are the Collective Investment Schemes (Class B) Rules 2013 (Class B Rules). These rules are less prescriptive than for Class A funds (which are "true" retail funds that are equivalent to Undertakings for Collective Investment in Transferable Securities in the EU), and allow Class B funds greater latitude in their investment and borrowing powers, provided that there is full disclosure in the fund documents.
- **Class Q.** These are not retail funds as they can only be beneficially owned by qualifying professional investors (essentially, government bodies or high net worth individuals or entities). The rules applicable to Class Q funds are the Collective Investment Schemes (Qualifying Professional Investor Funds) (Class Q) Rules 1998 (Class Q Rules).

Registered funds. These funds are registered with and regulated by the GFSC. The ongoing supervision is performed by the designated administrator (a local entity authorised by the GFSC, carrying out such supervision on its behalf, also referred to as the designated manager). Registered funds include:

- **RCIS funds.** Commonly referred to as "registered funds" (as they were the only type of registered fund until the introduction of private investment funds (see *below*), the rules applicable to

such registered open-ended funds are the Registered Collective Investment Scheme Rules 2018. The fund documents must contain the disclosures required by the Prospectus Rules 2018. These rules are not prescriptive concerning the features of the fund (for instance, in relation to investment powers) but require full disclosure of all material matters and ongoing notification of specific events. There are no restrictions on who can invest in an RCIS fund, but they are not typically used as retail funds.

- **Private investment funds.** In 2016 the GFSC introduced a new class of registered fund, the Private Investment Fund (PIF), governed by the Private Investment Fund Rules 2016 (PIF Rules). The PIF regime is intended for funds with a small number of investors where there exists a close relationship between the manager of the PIF and the investors. In recognition of this close relationship, the PIF rules do not require an offering document. The PIF must contain 50 or fewer investors and can add no more than 30 investors per year after the first year. The manager of the PIF is responsible for giving certain undertakings to the GFSC on the ability of investors to suffer losses. Other than this, the PIF rules are not prescriptive concerning the features of the fund (for instance, in relation to investment powers) but require ongoing notification of specific events. There are no restrictions on who can invest in an RCIS fund, but they are not typically used as retail funds.

Class A funds are not suitable for use as hedge funds, but the other types of fund are all suitable.

The GFSC can also grant certain derogations to hedge funds (which are not available to other types of fund), as follows:

- Institutional or expert investor hedge funds can be permitted to appoint a foreign prime broker rather than a local custodian or trustee, who is not required to offer physical segregation of fund assets from its own (so long as the fund prospectus makes clear the risks of such arrangement).
- Retail or less sophisticated investor hedge funds can be permitted to appoint a foreign prime broker to take control of the fund's property, but will normally be expected to appoint a local custodian or trustee to oversee the prime broker.
- Hedge funds can be permitted to accept subscription monies or effect redemptions on the basis of estimated valuations.
- Hedge funds can be permitted to apply client money in certain circumstances, in which other funds would be required to segregate such money in a client account.

Regulatory bodies

The GFSC regulates all funds in Guernsey and its powers are derived from the Protection of Investors (Bailiwick of Guernsey) Law 1987, as amended (POI Law). The GFSC issues the rules and regulations regulating funds under powers derived from the POI Law.

AIFM Directive

Guernsey is a "third-country" non-EU jurisdiction under the Directive 2011/61/EU on alternative investment fund managers (AIFM Directive) and has established a dual regime which provides a flexible regulatory framework which allows fund managers to



comply with the AIFM Directive without being required to do so when compliance is not absolutely necessary.

The first part of the dual regime ensures that Guernsey funds can be marketed in the EEA using national private placement regimes, with the GFSC acting as a local regulator that co-operates with the relevant EEA securities regulator. These are now thoroughly tried and tested routes to market which typically require only partial adherence to the provisions of the AIFM Directive which can result in lower running costs and consequently higher investor returns.

The second part of the dual regime allows managers and depositaries, in connection with the introduction of the pan-European passport, to opt in to a regime which is fully compliant with the AIFM Directive, if this is required.

The European Securities and Markets Authority (ESMA) has twice assessed Guernsey and concluded that no obstacles exist to the extension of a "third country" passport to Guernsey, giving the island an "unqualified and positive assessment". However, due primarily to the UK's vote to leave the EU, it is currently uncertain when the passport regime will be introduced for third countries and so there continues to be a strong trend towards establishing funds with a Guernsey based alternative investment fund manager so that the fund and the manager are free from the full requirements (and associated costs) of the AIFM Directive, but can make use of national private placement regimes if they wish to market the fund in specific EEA jurisdictions. As a result, Guernsey is particularly attractive for promoters based in the EU or for promoters in the US and Asia who may otherwise be discouraged by the complexities of raising capital in the EU.

3. How are hedge funds regulated (if at all) to ensure compliance with general international standards of good practice?

Risk

The applicable fund rules (other than the Private Investment Fund Rules 2016 (PIF Rules) which do not require a prospectus) require clear disclosure of all material risks to the fund and investors, in order to enable the investor to make an informed judgment as to whether or not to invest.

Valuation and pricing

The applicable fund rules do not prescribe a method of valuation or pricing. However, fund documentation rules (other than the PIF rules, which do not require a prospectus) require disclosure of the methods and bases to be used.

Systems and controls

All Guernsey funds must be administered by a local licensee, which must comply with the Licensees (Conduct of Business) Rules 2016 (COB Rules) and the Licensees (Capital Adequacy) Rules 2010 (Capital Adequacy Rules). These also apply to custodians and trustees in relation to the provision of custody services.

Insider dealing and market abuse

Insider trading is prohibited (*The Companies Securities (Insider Dealing) (Bailiwick of Guernsey) Law 1996*). The POI Law prohibits market abuse.

Transparency

There are no transparency requirements requiring reporting to investors or the disclosure of significant holdings, aside from periodic reporting requirements and the requirement under the Prospectus Rules (applicable to RCIS funds) to disclose in the prospectus significant beneficial ownership interests (meaning 15% or more of the voting rights) in the offeror, the administrator, custodian, trustee and general partner (as applicable) at the date of the prospectus.

Managers of open-ended funds must prepare the following periodic reports:

- **Class A fund: annual and half-yearly reports.** The annual reports must contain audited accounts and a report by the custodian or trustee. The annual reports must be published within four months of the year end, and half-yearly reports must be published within two months of the end of the half-year period.
- **Class B fund: annual reports.** The reports must contain audited accounts and a report by the custodian or trustee. The annual reports must be published within six months of the year end, and if interim reports are prepared, they must be on a basis consistent with the annual reports.
- **Open-ended RCIS funds and PIFs: no periodic reporting requirements.** However, the annual report that must be given to the Guernsey Financial Services Commission (GFSC) is usually also given to investors. Every Guernsey company is legally required to provide its accounts to shareholders at its annual general meeting.

Money laundering

Funds and their Guernsey service providers must comply with the various laws and regulations concerning the prevention of both money laundering and terrorist financing. The local designated manager of the fund must ensure compliance with these laws. The GFSC endorses the international standards of the Financial Action Task Force (FATF) in relation to combating money laundering and the financing of terrorism.

Short selling

There are no applicable regulations.

MARKETING

4. Who can market hedge funds?

Guernsey hedge funds

A Guernsey authorised or registered fund can be marketed in Guernsey:

- By a Guernsey entity which is licensed by the Guernsey Financial Services Commission (GFSC) under the Protection of Investors (Bailiwick of Guernsey) Law 1987, as amended (POI Law) (using a POI licence).
- By persons who are not Guernsey bodies or persons ordinarily resident in Guernsey (Non-Guernsey Persons) whose main place of business is in one of the countries or territories specifically designated by the GFSC as affording "adequate protection" to investors. In this case, the promotion must only be made:
 - to persons holding a licence under a designated list of Guernsey regulatory laws;
 - in the manner in which the person making the promotion would be permitted to market the relevant fund in their home country;
 - following written notice to the GFSC of the date from which the marketing will be carried on.
- On a reverse solicitation basis without the need for a POI licence or notification.

Foreign hedge funds

Non-Guernsey funds can be marketed in Guernsey (without the need for the fund to be authorised by or registered with the GFSC):

- By POI licensees and Non-Guernsey Persons, where the scheme is authorised under the law of a country or territory specifically designated by the GFSC as affording "adequate protection" to

investors and the marketing is conducted in a manner that would be permitted in that designated country or territory and (in the case of a Non-Guernsey Person) following notification to the GFSC and payment of a fee. This exemption covers certain categories of funds that are authorised in the UK, Jersey, the Isle of Man and the Republic of Ireland as well as EU alternative investment funds.

- By Non-Guernsey Persons whose main place of business is one of the countries or territories specifically designated by the GFSC as affording "adequate protection" to investors. In this case, the promotion must only be made:
 - to persons holding a licence under a designated list of Guernsey regulatory laws;
 - in the manner in which the person making the promotion would be permitted to market the relevant fund in their home country;
 - following written notice to the GFSC of the date from which the marketing will be carried on.
- On a reverse solicitation basis without the need for a POI licence or notification.

5. To whom can hedge funds be marketed?

Hedge funds

Open-ended retail funds. The following restrictions apply:

- Class A funds. There are no restrictions.
- Class B funds. There are no restrictions.
- Class Q funds. These non-retail funds can only be marketed to qualifying professional investors (see *Question 2, Regulatory framework*).
- Funds authorised using the fast-track QIF application process. These funds can only be marketed to qualified investors (applicable to Class B funds and Class Q funds only).
- Registered funds. There are no restrictions.

Closed-ended retail funds. The following restrictions apply:

- Authorised closed-ended funds. There are no restrictions.
- Funds authorised using the fast-track QIF application process. Qualified investors only.
- Registered funds. There are no restrictions.

Foreign hedge funds

Certain funds authorised in the UK, Jersey, the Isle of Man or the Republic of Ireland, as well as EU alternative investment funds, can be promoted in Guernsey without being authorised or registered in Guernsey (see *Question 4, Guernsey hedge funds*). Guernsey regulations permit these funds to be marketed in the same manner in which such funds can be marketed in the designated country or territory in which they are authorised.

INVESTMENT RESTRICTIONS

6. Are there any restrictions on local investors investing in a hedge fund?

See *Question 5*.

ASSETS PORTFOLIO

7. Who holds the portfolio of assets? What regulations are in place for its protection?

All open-ended funds authorised or registered in Guernsey must appoint a local designated custodian or trustee, who must be licensed by the Guernsey Financial Services Commission (GFSC). Irrespective of the type of fund, the custodian or trustee must be:

- Independent of the designated manager and investment manager.
- Where the fund is a company, independent of the company and its directors.
- Designated custodians/trustees must comply with the COB Rules and Capital Adequacy Rules.

Institutional or expert investor hedge funds can be permitted to appoint a foreign prime broker rather than a local custodian or trustee, who is not required to offer physical segregation of fund assets from its own, so long as the fund prospectus makes clear the risks of such arrangement. Retail or less sophisticated investor hedge funds can be permitted to appoint a foreign prime broker to take control of the fund's property, but will normally be expected to appoint a local custodian or trustee to oversee the prime broker.

Closed-ended funds are not required to appoint a designated custodian or trustee. However, the GFSC must be satisfied that the assets of the fund are adequately safeguarded. This can involve the appointment of a local custodian or trustee (or a foreign custodian or trustee), or it can involve some other form of safeguarding arrangement. The designated manager can provide safekeeping facilities.

REQUIREMENTS

8. What are the key disclosure or filing requirements (if any) that must be completed by the hedge fund?

The fund must file copies of the following with the Guernsey Financial Services Commission:

- All constitutional and offering documents.
- The principal agreements relating to the fund, for example, the:
 - administration agreement;
 - custodian agreement; and
 - investment management agreement.

Side letters which are personal to a particular investor do not need to be filed.

9. What are the key requirements that apply to managers or operators of hedge funds?

There are two key roles in a Guernsey fund.

Promoter

The term promoter is not specifically defined but is generally considered to be the party ultimately responsible for the fund's success. It is usually, but not always, the investment manager. The identity, standing and track record of the fund's promoter are of vital importance to the Guernsey Financial Services Commission (GFSC) when determining whether (or not) to authorise a fund. The GFSC's selection policy requires applicants to be able to demonstrate a

favourable track record in an established jurisdiction, involving a business which is both:

- Equivalent to the new proposal.
- Financially successful.

The following are also taken into consideration:

- Whether the promoter is authorised or licensed by another regulatory body.
- The promoter's ownership, financial resources and reputation.
- The experience of the principals behind the promoter.

In the case of qualifying investor funds and registered funds, the proposed designated manager of the fund carries out the assessment. However, it involves the same considerations and the same criteria as if the GFSC were conducting the review.

Designated manager/designated administrator

All funds authorised or registered in Guernsey must appoint a local designated manager (also referred to as the designated administrator) which must be licensed by the GFSC. Guernsey has a well-developed fund administration industry, and a local firm usually carries out the functions of the designated manager. However, these functions can be outsourced to a third party (whether local or foreign). In those cases, the local designated manager remains primarily responsible to the GFSC, and must comply with the GFSC's guidance on outsourcing when considering and monitoring those appointments.

Designated managers must comply with the:

- **Licensees (Conduct of Business) Rules 2016 (COB Rules).** These include provisions dealing with the following:
 - compliance arrangements, including monitoring and employee training;
 - record keeping;
 - categorising clients;
 - suitability of transactions for clients and disclosure of information to clients;
 - timely execution and best execution;
 - dealing with client assets;
 - the timing and content of contract notes relating to transactions;
 - conflicts of interest;
 - events to be notified to the GFSC.
- **Licensees (Capital Adequacy) Rules 2010 (CA Rules).** These specify the level of financial resources, liquidity and insurance that a licensee must maintain, as determined by reference to their business type, historical turnover and risk profile.

Foreign fund managers

It is common for a foreign manager to perform the investment management role, and a local designated manager to perform the administration role. The considerations set out above in respect of the promoter will be applied to the foreign manager.

LEGAL FUND VEHICLES AND STRUCTURES

10. What are the main legal vehicles used to set up a hedge fund and what are the key advantages and disadvantages of using these structures?

Legal vehicles

The vehicles most often used for hedge funds are corporate vehicles, although it is also possible to use limited partnerships:

- **Corporate vehicle.** Guernsey company law allows for a number of different forms of company (*The Companies (Guernsey) Law, 2008, as amended*). The most commonly used for hedge funds are the:
 - **protected cell company (PCC).** The PCC takes the form of one company that can form any number of cells, with the assets and liabilities of each cell segregated from the other cells. Shares issued by the PCC are attributed to a cell, so that a shareholder's rights relate only to that cell.
 - **incorporated cell company (ICC).** The same rules apply as for a PCC (see above), except each cell has its own legal personality.
- In this way, the cells can each have different investment objectives, invest in different asset classes, or be hedged against different currencies. The statutory basis for the segregation between cells provides comfort to investors that each cell is properly ring-fenced.
- **Limited partnership.** Funds established as Guernsey limited partnerships have the following features:
 - a specific general partner company is usually incorporated. It manages the affairs of the limited partnership and has unlimited liability in respect of those affairs. It must be licensed or receive an exemption from licence if incorporated or operating in Guernsey;
 - each of the investors is a limited partner, holding a partnership interest, with no liability beyond its investment commitment, provided it does not participate in the conduct or management of the partnership's business. The law provides certain "safe harbours" (investor actions that do not constitute management (*The Limited Partnerships (Guernsey) Law, 1995, as amended*)), including acting as a director or shareholder of a corporate general partner; being an employee of the limited partnership or of a general partner and consulting with and advising the general partner;
 - a partnership is typically treated as tax transparent in many jurisdictions (that is, tax is levied at the level of the individual investor rather than the partnership itself);
 - there are no restrictions on returning capital to limited partners, provided that the limited partnership is solvent. If the partnership becomes insolvent within six months of the payment, the return of capital can be clawed back within one year of the payment;
 - the limited partnership agreement remains a private document (but must be provided to the Guernsey Financial Services Commission (GFSC) as part of the authorisation/registration process);
 - limited partnerships can elect to have a separate legal personality and to be a body corporate. However, this does not affect its transparency for tax purposes.
- **Limited liability partnership (LLP).** LLPs were introduced in Guernsey in 2014. LLPs are rarely used as fund vehicles but may be used as part of the wider structure for funds that are

established as limited partnerships. LLPs have the following features:

- an LLP is an incorporated legal entity;
- members have limited liability for the liabilities of the LLP;
- an LLP is typically treated as tax transparent in many jurisdictions (that is, tax is levied at the level of the individual investor rather than the LLP itself).

The most important difference between the corporate and partnership structures (whether limited partnerships or LLPs) is the partnership's tax transparency. Whether this is an advantage or a disadvantage depends on the position of the prospective investors. With corporate funds it is usual for investors to subscribe for the full amount of their commitment at the outset, whereas with a limited partnership structure, the investors' commitments are often drawn down in stages as and when required.

Advantages. The advantages of each legal vehicle in relation to each proposed structure will depend on what the parties wish to achieve when establishing the fund. For example, a corporate vehicle has greater certainty as to its rules of governance as many rights of shareholders are enshrined in law or are considered to be standard practice. Limited partnerships are more flexible in terms of their governance and the rights of partners depend, to a greater extent, on the terms of the individual agreements. This may be an advantage or disadvantage depending on the view of the promoter and the investors.

Disadvantages. The disadvantages of each legal vehicle in relation to each proposed structure will depend on what the parties wish to achieve when establishing the fund.

TAX TREATMENT

11. What is the tax treatment for hedge funds?

Funds

Funds are eligible for tax exempt status (for Guernsey tax purposes), on payment of an annual fee of GB£1,200. Funds with exempt status are not regarded as being tax resident in Guernsey.

Resident investors

The fund must provide the Guernsey director of income tax with details of distributions made to investors resident in Guernsey, or who carry out business in Guernsey through a permanent establishment. In all other respects, the tax treatment is the same as for non-resident investors (see *below*).

Non-resident investors

The fund does not deduct income tax from any dividends, distributions or interest payable by the fund to investors. There are no death duties, capital inheritance, capital gains, gifts, sales or turnover taxes levied in Guernsey in connection with the acquisition, holding or disposal of interests in funds. No Guernsey stamp duty or stamp duty reserve tax is payable on the issue, transfer, conversion or redemption of interests in funds.

RESTRICTIONS

12. Can participants redeem their interest? Are there any restrictions on the right of participants to transfer their interests to third parties?

Redemption of interest

Participants of open-ended hedge funds can redeem their interests under the terms specified by that fund. No minimum frequency of

liquidity is specified by Guernsey regulations for a fund to be classified as open-ended. Interests in closed-ended funds are not redeemable at the option of the participant.

Transfer to third parties

It is common to include restrictions to prevent persons acquiring interests if that acquisition would bring the fund within the scope of US Employee Retirement Income Security Act 1974 (*Pub. L. 93-406, 88 Stat. 829*) (ERISA) legislation. This is generally undesirable as the ERISA legislation can impose strict fiduciary standards on the management of the fund assets.

The rules concerning restrictions on participants' rights to transfer their interests are the same as for retail funds. Restrictions on the transfer of interests would normally be imposed for both open-ended and closed-ended funds to ensure that interests are not transferred to any investor whose circumstances would cause the fund to breach any securities laws or to suffer any adverse tax consequences, or if the transfer would result in any investor holding less than the specified minimum holding for the fund. Units or shares in Class B funds must be freely transferrable. For all other types of fund, restrictions can be imposed. Interests in Class Q funds and QIFs cannot be transferred to persons who are not eligible to invest in such funds. The manager, the fund and its directors must take all reasonable steps to ensure that interests in Class Q funds are not owned by ineligible investors. The designated manager of a QIF must be satisfied that effective procedures are in place to ensure that interests in the QIF are not owned by ineligible investors.

PRIVATE PLACEMENT

13. Are private placements of hedge funds permitted under national private placement rules in your jurisdiction?

There are no private placement exemptions as such for the marketing of hedge funds in Guernsey (see *Question 5*).

14. What are the requirements for making a private placement of hedge funds?

Not applicable (see *Question 4*).

REFORM

15. What (if any) proposals are there for the reform of hedge fund regulation?

The Guernsey Financial Services Commission (GFSC) has conducted a consultation on a major revision of the regulatory laws, including the Protection of Investors (Bailiwick of Guernsey) Law 1987, as amended (POI Law). It is anticipated that the change will result in a rationalisation and consolidation of laws, rather than result in substantial changes in the nature of regulation applicable to funds.

The Class Q Rules are due to be revised, although wholesale changes are not expected.

The Limited Partnerships (Guernsey) Law 1995, as amended, is due to be revised and updated to enable further flexibility in the use of limited partnerships.

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Areas of practice. Corporate; commercial; investment funds; banking and finance; regulatory.

Recent transactions

- Advised Permira on the launch of Permira VI, Permira Credit Solutions III, Permira Credit Solutions Managed Account, Permira Growth Opportunities, Permira Sigma V and Permira VII funds.
- Advised Terra Firms on its proposed acquisition of Parmaco Oy (Parmaco) from Finnish private equity group MB funds.

Professional qualifications. England and Wales, Solicitor, 2004

Areas of practice. Corporate; commercial; investment funds.

Recent transactions

- Advised Permira on the launch of Permira Credit Solutions Managed Account, Permira Growth Opportunities, Permira Sigma V and Permira VII funds.