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# *Regulatory update for the Guernsey funds industry*

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# ***Agenda***

Overall high level update on key regulatory changes for non executives, fund managers & fund administrators in Guernsey.

- Dodd-Frank Wall Street Reform and Consumer Protection Act
- UKLA Listing Rules (Combined Code and AIC Code of Corporate Governance Oct 2010)
- GFSC Capital Adequacy Rules and Conduct of Business Rules
- Alternative Investment Fund Managers Directive

***Please note the warning on the very last slide of this presentation***

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# ***Regulatory update for Guernsey funds industry***

Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”)

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## ***Setting the US scene***

No matter where you operate from if you touch/impact US investors, US markets or US companies then the SEC sees that you are within their sights. Transgress or are seen to break their US laws = Problems!!



# *US financial scandals - Where was appropriate regulation and what has been done to redress?*



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## ***Overview of the impact of the Dodd-Frank Act (the “Act”) on non-US advisers/asset managers***

- **Who is covered by the Act?** – Advisers of “private funds” such as advisers of hedge funds, private equity funds, and real estate funds to the extent that they invest in securities. (Further guidance awaited as to the application to traditional funds.)
- The **Act removes the existing “private investment adviser” exemption** whereby advisers to private funds were not required to register with the SEC. Many US and non-US advisers relied upon this exemption. The result of this change – US and non-US advisers may need to register with the SEC.
- The **Act adds a “Foreign private advisers exemption”** but to be exempt an adviser must meet **ALL** of the following conditions (one fail and caught):
  - It must not have a place of business in the USA
  - It must have fewer than 15 clients and investors in the USA in private funds advised by the adviser
  - It must have less than US\$25 million in AUM attributable to US clients and US investors in private funds advised by the adviser; and
  - It cannot hold itself out generally to the public in the USA as an adviser
- **Other exemptions:** VC, Private Adviser, Family offices, CFTC.

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## ***Impact of SEC registration on operations***

If you are required to register as an adviser with the SEC then:

- Register by 21 July 2011 (file ADV form 45 days before deadline)
- Designate a Chief Compliance Officer: Existing person or a new appointment
- Implement a Compliance Program
- Implement Code of Ethics and Personal Trading Policies
- Maintain certain Books and Records (email retention key)
- Subject to SEC examination oversight and possible enforcement action
- Required SEC Reporting

SEC examination is “at any time or from time to time”. Compliance programs expected to address critical compliance risk areas, to detect, correct and prevent any violations. Compliance programs should have adequate resources for annual reviews, surveillance, testing, follow up on deficiencies and regular employee training. Special enforcement unit for asset managers

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## ***Impact of SEC registration on operations - Compliance risk***

SEC top areas of compliance risk and considerations for the appointed CCO:

- Safety of investors assets
- Valuation
- Institutional conflicts
- Personal conflicts
- Insider trading
- Market manipulation
- Marketing practices
- Regulatory reporting
- Risk disclosures
- Investment guidelines and restrictions
- Compliance and control environment
- Pay to play

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## ***Impact of SEC registration on operations - Custody rule***

As a registered adviser, managers will be subject to the Investment Advisers Act of 1940 (“Advisers Act”). Rule 206(4)-2 of the Advisers Act (“the Custody Rule”) applies to registered investment advisers that have “custody” of client assets (i.e., securities or funds...for “funds” please read “cash”)

### **What is custody?**

"Custody" has a broad definition. "The adviser or related person holds client funds or securities directly or has any authority to obtain possession of them. (Examples of the latter include trustee responsibilities, power of attorney, ability to write cheques, ability to deduct/pay own management and/or performance fees)."

### **Who has custody?**

- Applies to all investment advisers registered with the US SEC (minor exceptions)
- Advisers to funds will normally have custody because of typical GP/Manager powers over assets..decisions to buy/sell etc
- Advisers to managed accounts may have custody due to a related party holding securities or the amount of control the adviser has over the accounts
- *Failure to comply with the custody rule requirements = Fraudulent activity per SEC*

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## ***Impact of SEC registration on operations*** ***- Custody rule where adviser has “custody”***

- Must maintain cash and securities with a “Qualified Custodian”
  - Separate per client or omnibus
  - Privately issued securities considerations (PE funds)
- Qualified Custodian must send quarterly statements to the advisory clients
  - Include cash and securities held by Qualified Custodian
- Surprise examination on an annual basis unless certain exceptions met
  - Performed by PCAOB registered audit firm
- Internal controls report required
  - Only applies to advisers with self-custody as a Qualified Custodian or custody is held with a related party (not operationally independent) acting as the Qualified Custodian

Advisers have the opportunity to be exempt from certain custody arrangements, quarterly statements, and surprise examination requirements if an “audit exemption” is met.

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## ***Impact of SEC registration on operations - General exemptions***

No surprise examination required where:

- Adviser has custody only because it can deduct advisory fees
- Adviser has custody solely because a related person, that is operationally independent, has custody

No compliance with wider custody rule where:

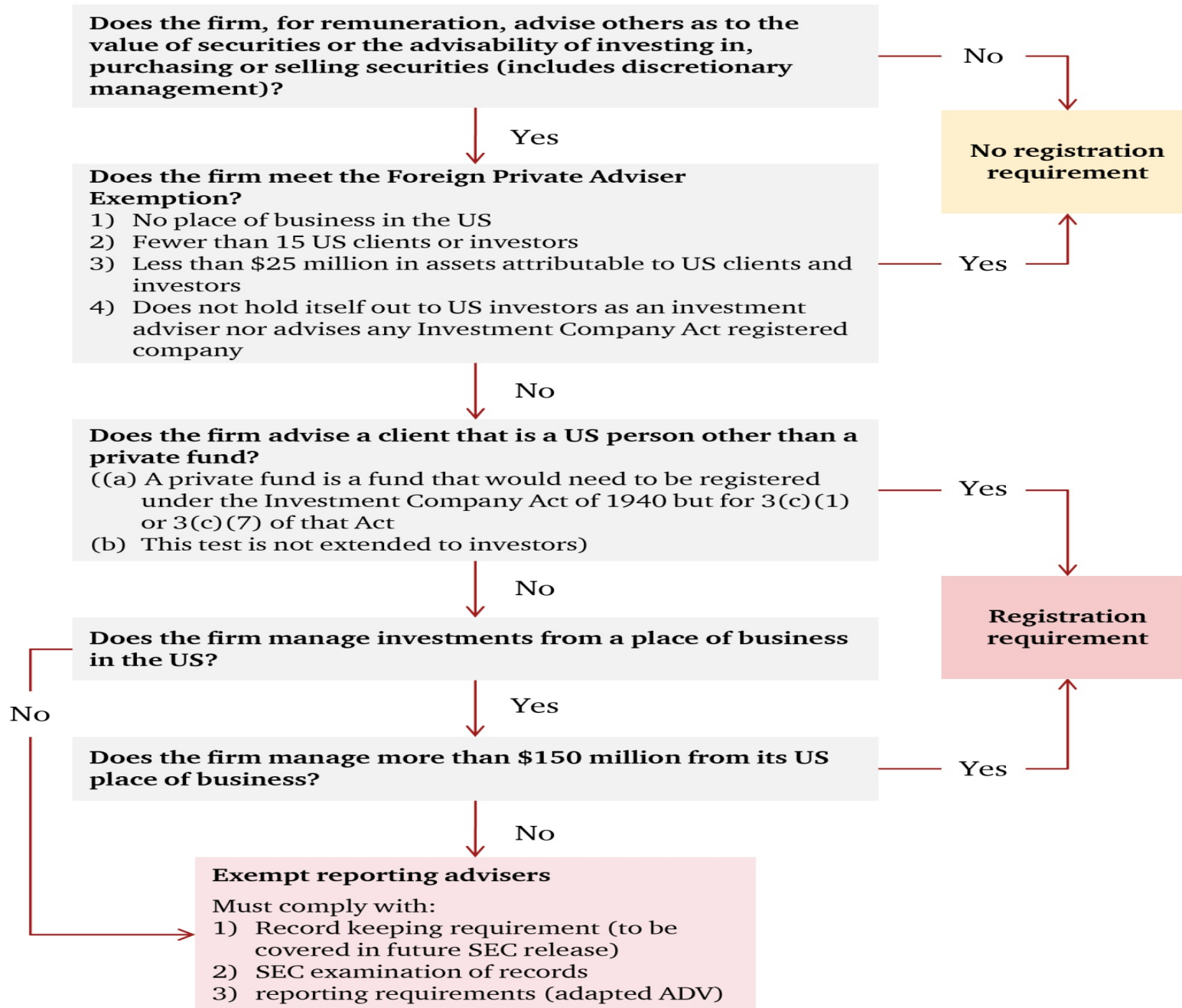
- Adviser only advisers US 40 Act mutual funds
- Adviser only invests clients assets in SEC registered open ended funds
- Adviser to a fund/pooled investment vehicle relies on the “audit provision” to the fund/pooled investment vehicle....then Privately offered securities meeting the narrow definition not required to be held with a Qualified Custodian

If a fund/pooled investment vehicle is not relying on the “audit provision”, then to the extent the fund holds “privately offered securities”, these must be held by a Qualified Custodian...effectively all securities with a Qualified Custodian

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## ***Impact of SEC registration on operations - Surprise exam (audit provision)***

- In the US, funds typically rely on audit provision exemption to avoid the annual surprise exam, the need to lodge all securities with a Qualified Custodian and the sending of account statements to investors
- Requirements of audit provision exemption
  - Fund audit done under US Auditing Standards (US GAAS - no exceptions)
  - Funds accounts prepared under US GAAP or US GAAP reconciliation inserted for US investors receiving fund accounts (FIN48/Fair Value etc)
  - The fund auditor is registered with the PCAOB in the US and subject to inspection
  - The audit firm must be independent of the fund under SEC rules
  - Post to investors (120 days after the year end for a direct fund and 180 days for a Fund of Funds)
  - Compliance determination – the registered adviser is responsible for the determination of compliance with audit provision exemption



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## ***Impact of SEC registration*** ***- Some key issues to be resolved***



- In a PE group (particularly the classic onshore adviser/offshore GP & Manager structures), who is the “adviser” that needs to register with the SEC?
- Could there be multiple “advisers” registering?
- What do Guernsey administrators need to do if a GP/Manager they are administering needs to register with the SEC?
- Who will be the Chief Compliance Officer and where located?
- Will the SEC visit and inspect in Guernsey for a Guernsey registered “adviser”?

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# ***Regulatory update for Guernsey funds industry***

UKLA Listing Rules (Combined Code and AIC Code of Corporate Governance Oct 2010)

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## ***UKLA Listing rules changes***

- April 2010 saw the categorisation of all companies listed on the London Main Market to be either “Premium” or “Standard” listed companies
- The Combined Code (now called the UK Corporate Governance Code (UK Code)) is mandatory for all Guernsey Premium listed companies in London
- Previous voluntary compliance now removed unless the Guernsey company is a Standard listed company
- LR15 deals with closed ended investments funds with premium listings
- Guernsey premium listed closed ended investment fund must comply with LR9 (Continuing Obligations) of the UKLA Listing Rules
- Para LR9.8.7 of the UKLA Listing Rules is relevant for such Guernsey companies re content of annual report
- LR9.8.6R(5) has overt requirement to state how the Guernsey listed company has applied Main Principles in Section 1 of the UK Code
- Applicable for all periods beginning on or after 31 December 2009

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## ***UKLA DTR disclosure rules and transparency rules***

- All Guernsey Main Market listed companies required to comply with DTR7.2
- DTR7.2 deals with minimum levels of corporate governance statements in annual reports
- Premium listed Guernsey companies will comply with DTR7.2 by complying with LR9.8.7 and/or complying with the AIC Code
- AIC Code is copyrighted and only fully paid up members of the AIC may state that they are following the AIC Code
- “Comply or explain” principles still exist
- AIC Code on 5<sup>th</sup> edition

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## ***AIC Code key changes 5<sup>th</sup> edition***

- Directors of FTSE350 companies should be subject to annual re-election
- Directors should consider diversity of the board, including gender; the board ensures that new directors can devote sufficient time to carry out their duties effectively and board balance recommendations should also apply to committees
- Process of board evaluation to be explained in the annual report
- FTSE350 board evaluation externally facilitated every 3 years
- No stock options or performance related pay for directors
- Chairman regularly review and agree each directors training and development needs
- Board responsible to ensure the management co maintains a sound system of internal control
- Board reports to shareholders it has undertaken an annual review of the effectiveness of system of internal control (risk mgt and internal control)

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# ***Regulatory update for Guernsey funds industry***

## **GFSC Capital Adequacy Rules and Conduct of Business Rules**

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## ***Summary***

### **Old regulations have been replaced**

The Licensees (Financial Resources, Notification, Conduct of Business and Compliance ) Rules, 1998 (the “FNCC rules”)

The Collective Investment Schemes (Designated Persons) Rules, 1988 (the “DP rules”)

### **New regulations now in place**

The Licensees (Conduct of Business) Rules, 2009

The Licensees (Capital Adequacy) Rules, 2010

## ***Financial Resources Requirement Old v New***

	<b>FNCC Rules/DP Rules</b>	<b>Capital Adequacy Rules</b>
Designated trustee/custodian of an open-ended collective investment scheme	Gross capital of £4,000,000	<b>Net assets</b> of £4,000,000 <i>(Min PI Cover of £300k or three times total revenue whichever is greater and excess no greater than 20% of total insured)</i>
Designated manager of a collective investment scheme	Gross capital of £100,000 or gross capital equal to the expenditure-based requirement as shown by the latest annual financial statements submitted to the GFSC whichever is the greater	<b>Net assets</b> of £100,000 or net assets equal to the expenditure-based requirement as shown by the latest annual financial statements submitted to the GFSC whichever is the greater <i>(Min PI Cover as noted above)</i>

# *Financial Resources Requirement Old v New*

	<b>FNCC Rules/DP Rules</b>	<b>Capital Adequacy Rules</b>
A licensee with no physical presence (staff and premises)	Gross capital 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	The higher of £10,000 or <b>net assets</b> which in the opinion of its directors is sufficient to meet its commitments and to withstand the risks which its business is subject <i>(PI Cover required at opinion of directors as to sufficiency)</i>
Other licensees	Gross capital of £25,000 or gross capital equal to the expenditure based requirement whichever is the greater and professional indemnity insurance cover of £250,000 (or three times annual gross revenue whichever is greater) the excess of which must not exceed 20% of the total insured	Net assets of £25,000 or <b>net assets</b> equal to the expenditure based requirement whichever is the greater <i>(Min PI Cover of £250,000 or three times total revenue whichever is greater and excess no greater than 20% of total insured)</i>

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## ***New liquidity requirement***

Liquidity requirement to be maintained at all times of £10,000 or 10% of annual audited expenditure, whichever is greater

The Liquidity requirement is calculated as follows when compared to the minimum levels dictated above:

(1) Value of current assets £XXX

***Less***

(2) Current liabilities £XXX

***Less***

(3) Loans to group companies £XXX

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## ***Net assets and adjustments***

Net Assets defined as...

**Total Assets less Total Liabilities after *Adjustments* of the licensee and Calculations Required by Rule 5**

**Adjustments include deductions for Non-Current Assets, Debtors arising from Sales to Associates, Liabilities of Subsidiaries exceed Assets & any Other Assets GFSC has specified**

**Calculations Required by Rule 5 are deductions for:**

Position Risk (liquidity haircut for investments held)

Counterparty Risk (haircut for certain receivable exposures)

Contingent Liabilities (Circular issue here)

## ***Worked FRR example designated manager - Part 1 net assets***

	£
Net assets per balance sheet	750,000
Adjustments: Fixed Assets	(150,000)
Adjustments: Investment in subsidiary	(310,000)
Adjustments: Loan to parent (GFSC specified)	(150,000)
Adjustments: Other liability/deferred income (GFSC specified)	300,000
Rule 5 calculation deduction (inv in open ended fund) (£100,000 investment in fund * 25%)	<u>(25,000)</u>
Net assets of licensee	<u>415,000</u>

## ***Worked FRR example designated manager - Part 2 expenditure based requirement***

	£
Expenditure per audited accounts	1,800,000
Less: Depreciation	(100,000)
Less: Directors remuneration	<u>(200,000)</u>
Annual audited expenditure	<u>1,500,000</u>
Expenditure based requirement @ 25%	<u>375,000</u>

## ***Worked FRR example designated manager - Part 3 financial resources requirement test***

	£
Net assets cannot be less than the FRR. FRR is greater of £100,000 or EBR £375,000	
Actual net assets of licensee	415,000
Financial resources requirement	<u>(375,000)</u>
Surplus of financial resources requirement	<u>40,000</u>

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## ***Extracts from The Licensees (Conduct of Business) Rules 2009***

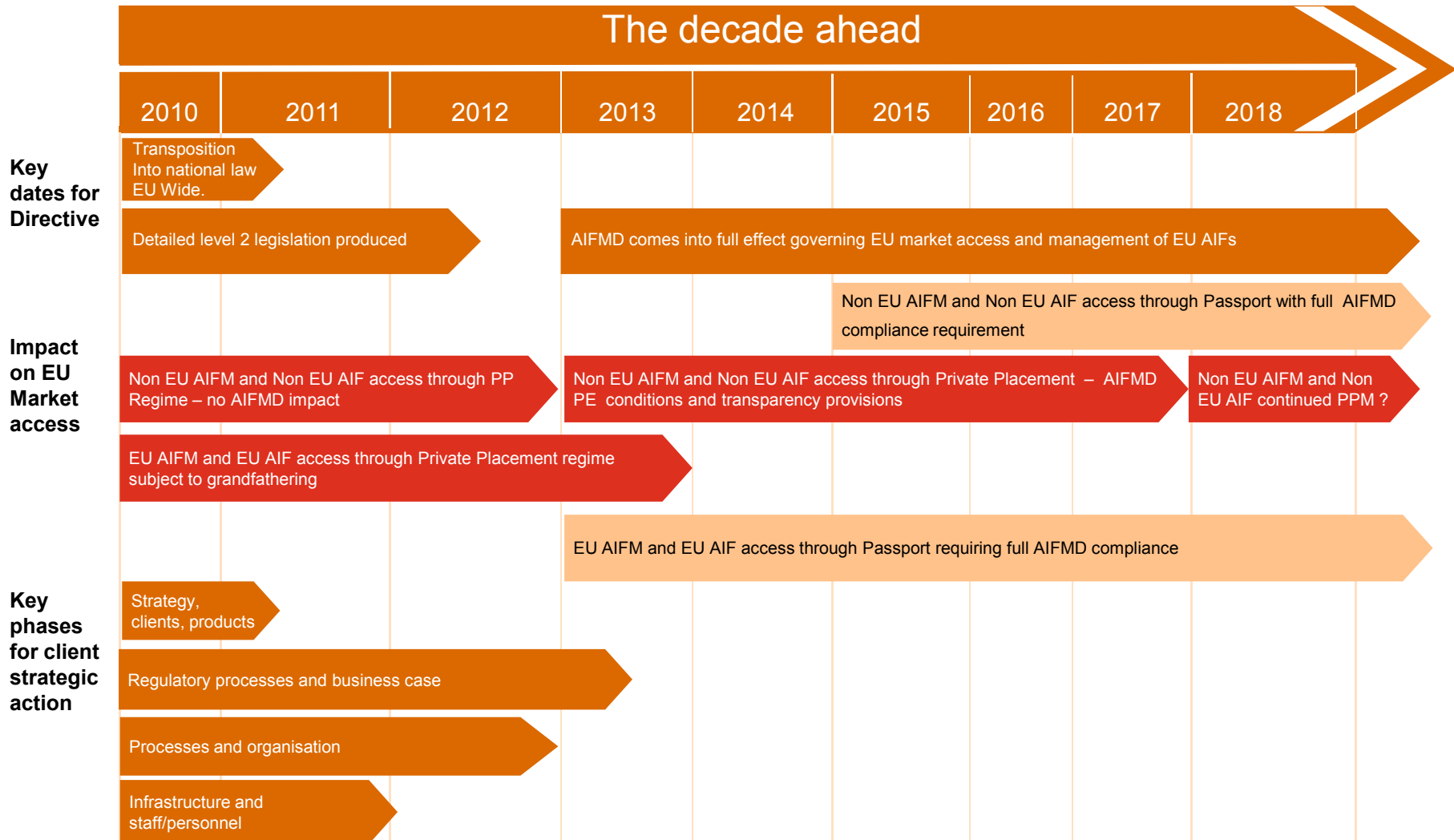
- Requirement to submit an Annual Compliance Return per Schedule 2
- Comprehensive confirmations from senior director and compliance officer
- Attach any management letters from auditors to licensee and associated funds
- Board responsibility for compliance and elevated to the Board for oversight, discussion and proper minutes of that role
- Licensee subject to the EBR under the Capital Adequacy Rules must prepare a monthly statement of financial resources

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## Alternative Investment Fund Managers Directive

# What dates impact marketing to EU investors?



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