

Investment funds are big business on a global scale and billions of dollars are invested in them on an annual basis by institutions and individuals hoping to use the expertise of fund managers to make a good return on their money. Investment funds range across a variety of different shapes and sizes. Retail UCITS funds largely invest in publicly-traded securities and are highly regulated to protect the retail investor; real estate funds focus specifically on property and are generally of interest to experienced or institutional investors who have a more detailed knowledge of the global property market.



Fund Structuring in the Channel Islands



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Hedge funds have been in the spotlight recently because of various high profile economic issues that they have been associated with (ie short selling). Hedge funds may be highly speculative and potentially high return and, because of this, have innovative and high risk or volatile strategies for investment.

Private equity is another category of investment fund that has flourished during the last decade and focuses on building a fund to invest in companies with growth potential.

Depending on the strategy and type, funds will have different structures, some will be closed ended, looking to raise a target amount of committed capital before they start to invest, others will be open ended and welcome ongoing investment. Some funds will be listed on a stock exchange or market, such as CISX, AIM or LSE, in an attempt to raise awareness with investors and increase their liquidity potential.

Almost all funds will have a strategy and a profitability goal that may simply be tracking the FTSE100, if a retail equity fund, or it could be focusing specifically on Eastern European property if a real estate fund, or Green/Clean-tech start-ups if a private equity fund.

The Channel Islands of Jersey and Guernsey are among the longest established domiciles for investment funds and have a depth of expertise across fund administration, fund legal work, fund accounting and tax advice.

Recent figures from Guernsey Finance show that the net asset value of funds under management and administration in Guernsey was at £184bn at the end of December 2009, with £136bn of that held in Guernsey domiciled vehicles. There were 1,208 funds, of which 884 were Guernsey funds - 276 were open-ended funds and 608 were closed-ended.

According to Jersey Finance, the Net Asset Value (NAV) of funds under administration decreased by £75bn (-31%) during the last year from £241.2bn to £166.2bn. The total number of funds decreased by 178 (-12%) to 1,294, but that the value of funds under investment management increased from £18.4bn to £19.7bn (4.4%) during the year 2009.

The figures further confirm that a large majority of funds activity in Jersey is in the specialist (alternative classes), with more than £20bn in private equity and £22bn in real estate.

Why choose the Channel Islands?

There are a number of issues that a fund manager must consider when setting up a fund, with things like tax, regulation, ability to list and quality of administration, chief among them.

Both Jersey and Guernsey tick all the boxes in this area and Guernsey's offering in private equity was boosted, in part, by the establishment there of the Channel Islands Stock Exchange in 1998.

Fund accounting and auditing are big considerations, given that regulations state that a Guernsey-licensed auditor must be appointed to a fund.

BDO in Guernsey has an expertise in fund auditing and currently has more than 75 funds on its audit books, both closed and open ended, listed and unlisted. These funds range through private equity, venture capital and real estate through to esoteric funds such as wine or fine art.

The firm has the expertise to make sure that funds are reporting under the International Financial Reporting Standards (IFRS), or UK Generally Accepted Accounting Practice, and calculating sums such as carried interest correctly.

Richard Searle, managing director at BDO in Guernsey, says that the firm has built up a significant expertise in real estate investing in the UK, Europe and further afield. The firm also audits a good number of private equity funds as well.

He said: "All the funds we audit are interesting, but the PE funds have more of a diverse investment class. We do have some hedge funds, but many of those within our portfolio tend to be generally domiciled elsewhere at the moment."

He added: "We are able to assist our clients by looking at the regulations and providing them with guidance about what they need to be considering moving forward."

Both Guernsey and Jersey have a favourable tax regime for investment funds and in both jurisdictions, funds are exempt from tax. According to Andrew Weaver, Partner and Head of Funds & Investment Services at Appleby in Jersey, the tax exemption for investment funds is not expected to change, irrespective of other changes to the tax regimes in each island.

Mr Weaver believes that the Channel Islands also benefit from their proximity to the major European financial centres, particularly London with its strategic trading location between US and Asian markets.

He said: "Historically, the islands have been a destination of choice for both London and mainland European fund managers. More recently this has been supplemented by significant growth in funds from the Middle East, Asia, Latin America, Africa, Eastern Europe and the US."

The figures show that both islands are popular for private equity and an expertise has been developed in this area. IPES is a dedicated private equity fund administrator with a presence in both islands and offices in London and Luxembourg.

Justin Partington, from Ipes, believes that a core of private equity expertise has been built up since the early 1980s, in the Channel Islands, out of a foundation of more than 50 years of financial services experience, including a detailed knowledge of various structures.

He said: "Ipes has an office in London, with a team of 18 people there and it is a core part of our expanded offering of wider outsourcing services to private equity funds and managers. We have migrated towards a pan-European focus, rather than a Channel Islands focus and we are diversifying our offering along the private equity value chain to also include middle office services. We enjoy convenient links between both islands and to London with regular flights, a stable and consistent legal system and a robust yet pragmatic regulatory environment in both Guernsey and Jersey. This environment enables new and

innovative fund offerings and gives both GPs and LPs a reliable framework in the event of any disputes."

Private equity

A recent report into private equity administration shows that private equity administration in the Channel Islands, in existence since the early 1980s, has flourished since the late 1990s, when private equity funds started appearing in greater numbers and needed help administering their portfolio of investments in a well regulated, tax friendly environment.

The report suggests that 55% of net assets administered in the islands are private equity in nature, compared to 37% in London and 20% in Luxembourg. Around 49% of those assets are held in medium to large buyout funds, 19% in early stage and venture capital funds and 9% in private equity real estate.

The figures also show that around 75% of funds administered are direct private equity funds, while 14% are fund of funds and 11% are master feeder funds.

Justin Partington, at Ipes, notes that an additional reason that fund managers are attracted to the Channel Islands, is that the regulation allows flexible corporate structures and LPs can amalgamate or migrate as needed. The regulations are commercially sensible, while also ensuring first-class oversight oversight recognised by inclusions in the FATF White List in April 2009 and by the IMF.

He adds that the expertise built up in private equity fund work by fund structuring lawyers, auditors, administrators and other service providers, is certainly seen by many to be extremely important in the decision making process.

He said: "I spent six years in Cayman, which has, during the last ten years, built up dominance in the hedge funds space. Jersey has done the same in property and trust work, while Guernsey had an early start in private equity. All offshore jurisdictions have branched out to other sectors and asset classes, but some, such as Cayman, are still stereotyped."

He added: "We have good relationships with London lawyers and they have extensive experience with the various jurisdictions, while taking a jurisdictional-neutral approach. The reality is that fund structuring lawyers will establish a fund in the most suitable jurisdiction, based upon tax, regulatory and investment considerations. Luxembourg has good experience in retail and regulated funds, custody and process-orientated fund work and is now building different experience in private equity administration. Private equity services are certainly not a commodity and are more about assessing unique structures and transactions and applying judgement."

Fund structuring

One of the benefits of Jersey and Guernsey is the flexibility each island has in terms of the structure and focus on a fund. Each has an updated professional investor fund vehicle which allows quick set up and flexibility whether the requirement is for an open or closed ended fund, listed or unlisted. The regulations and professionals can also easily accommodate protected cell



structures, funds of funds or funds specifically targeted at a certain asset.

Barney Lee, Group Partner and Head of Funds & Investment Services at Appleby in Guernsey, says that both Jersey and Guernsey are particularly strong as domiciles for closed ended structures, established as limited liability companies, unit trusts and limited partnerships. He believes the islands demonstrate expertise in real estate, private equity and funds investing in more esoteric asset classes.

He said: "Guernsey is also home to permanent capital vehicles, formed both as limited partnerships and as companies, established by some of the world's leading private equity and hedge fund houses including KKR, Harbourvest, Apollo and Marshall Wace. Jersey is favoured for listed investment trusts, including for houses such as Aberdeen Asset Management and 3i as well as some of the world's leading hedge fund platforms such as Lyxor and dbx."

He added: "In addition, Guernsey has carved a niche as the offshore European domicile for hedge funds and funds of hedge funds. Funds structured as protected cell companies (PCC) and Incorporated Cell Companies (ICC) are popular in both jurisdictions, the structure having been created in Guernsey almost 15 years ago."

The extra complexity of some funds creates different challenges for fund accounting and auditing, but they can be dealt with effectively with the right level of planning.

Richard Searle, from BDO, says there are a number of additional considerations in terms of open-ended funds that need to be looked at, including valuations and redemptions, as compared to the more popular closed-ended fund.

He said: "Where you have a listed closed-ended fund, they are trading at the listed price on the market, which may be at a surplus or discount to the net asset value (NAV). With an open ended fund, you need to calculate the NAV on dealing days for working out redemptions and that, of course, has a knock-on effect, in the recent climate, in terms of liquidity. This certainly adds more of a focus for those sorts of issues."

He added: "Volatility depends on the underlying assets in terms of the NAV. The pricing volatility is less of an issue for auditors if the fund is closed-ended and listed, as opposed to open-ended, which will be trading at NAV while a listed fund is trading at whatever the market says."

The complexity of fund structures offered in Guernsey and Jersey can often mean that investment or asset managers do not necessarily have the sufficient administration expertise in-house to administer their own funds and will look to outsource the work to a specialist administrator based on-island.

Ipes is a dedicated private equity fund adminis-

trator and is able to deal with the most complex of fund structures.

Justin Partington, of Ipes, says that a third party administrator can make sense from both a financial and practical point of view.

He said: "We consistently and clearly communicate to the market and gain acknowledgement that administrators can play a vital role in the fund market. We can pass on knowledge and experience, while protecting client confidentiality, we work closely with industry bodies such as the BVCA and EVCA in developing best practice standards and reporting. We train and incentivise our staff and offer a career path, meaning we are able to attract and retain the very best in the field."

He added: "When administration is outsourced, the cost is allocated to the fund and is paid by the limited partners (LPs), but if the work is completed in-house, GPs pay for the associated back office cost out of their management fee. Investors, particularly large US institutions, have recently commented to our clients that they are happy to see outsourcing and the associated additional independent oversight, controls and best practice reporting. Investors are telling our clients that they are willing to pay for the cost of third party administration. This may be a materiality issue as well, because while management fees are around 2% of assets, our administration fees are just 5-10 basis points (0.01%). It's a small fraction of fund costs for investors and there is the added benefit of qualified accountants at administrators, an extra pair of safe hands for review and evaluation that will stand up to an audit."

Listing Funds

The listing of funds has become more popular in recent times because of the perception that it creates greater liquidity at the initial listing by gaining a higher profile with investors.

One of the big decisions for a fund manager is to find a well regulated and licensed exchange that will sit well with investors, anxious that the fund is well regulated. Funds can be domiciled in the Channel Islands and list on funds elsewhere in London or Europe, but the existence of the Channel Island's very own stock exchange (the CISX) is an important draw. The CISX is licensed to operate as an investment exchange under The Protection of Investors (Bailiwick of Guernsey) Law, 1987 and is a member of IOSCO, the International Organisation of Securities Commissions. It is regulated by the Guernsey Financial Services Commission (GFSC) and approved by the UK Financial Services Authority (FSA), as a Designated Investment Exchange.

Tamara Menteshvili, chief executive of the CISX, says that fund managers do tend to

favour jurisdictions that will provide an advantage to their investors, which can include the ability to list a fund.

She said: "Fund managers gravitate to a jurisdiction that facilitates their investor base and their legal and administrative requirements. They tend to choose a place that lends itself to attract the type of investors they want and in some cases in order to attract a certain investor base a listing is required. Whether retail or institutional investor, there is an increased demand to invest in securities which are listed, giving that investment a high degree of disclosure, transparency and information flow. Insurance companies or pension funds most like have a restriction on the level of unlisted securities in which they may investment."

Liquidity is also a big consideration for fund managers and Ms Menteshvili says that it can be a much misunderstood concept.

She said: "Liquidity is a much misunderstood. With admission to the Official List of any stock exchange, there is the potential for liquidity. On one level, a listing creates an exit route for a closed-ended vehicle. A fund manager might gravitate towards a stock exchange with a higher degree of liquidity potential than others, but that is largely a perception issue."

Liquidity differs depending on whether you are talking about initial capital raisings, raising ongoing capital or trading on a day-to-day basis.

Ms Menteshvili says that most listed funds are closed ended and, therefore, liquidity in the trading sense is fairly rare, the listing is more to do with liquidity in terms of raising additional capital or trading on the secondary market dependent upon the investor base.

She said: "Investors, particularly institutional ones in closed ended funds will buy to hold, so there is no real trading likely to occur on daily basis. A new fund issuer will be interested in an initial capital raising to get a fund away, usually through a private placing. The need to raise a critical mass initially is done on our exchange quite effectively. After the initial capital raising, if a fund hasn't reached its initial offer period target, a listing can attract further investors."

AIFM Directive

The AIFM Directive has been a major talking point for those involved in the alternative investment fund industry. The movement towards greater regulation and transparency in the funds industry gained traction and momentum following the economic downturn, in which the actions of hedge funds and speculators were partly blamed for the collapse.

Since then the socialist powers within Europe have been pushing to increase the controls

placed on all alternative funds including hedge funds, private equity and real estate. One of the big proposals is a system of equivalency, under which any jurisdictions outside the European Union would have to meet strict criteria before gaining access to the European market.

Justin Partington, from Ipes, believes that the higher requirements in terms of regulation and transparency could play into the hands of the Channel Islands.

He said: "The compliance and regulatory processes in the Channel Islands have been recognised by the FATF and the IMF as some of the most robust regimes globally, and more exacting than the UK and US in some areas. Aside from the industry concerns around disclosure requirements and third-country passports, I do not perceive a threat there in terms of additional regulations and equivalency could be seen as an opportunity. We have not seen funds deciding to move from the Channel Islands to the EU because of the AIFM, and the migratory nature of fund vehicles means they do not feel under any pressure to move at present, nor are investment managers currently deterred from setting up new Channel Islands based structures."

Mr Partington notes that industry bodies such as the BVCA and EVCA do not believe that the AIFM addresses the issues it was intended to address (ie banking and the oversight of banking), and has now been extended for political gain to the private equity industry, that did not contribute to the systemic risk that precipitated the banking crisis.

He added: "Lehman was 32 times leveraged when it went under and PE funds often limit leverage to 2 to 3 times or less, as do the portfolio companies. The AIFM does not seem to be addressing the same risk."

Andrew Weaver, Appleby Jersey, believes the AIFM directive is likely to affect all offshore jurisdictions, but he suggests that both Guernsey and Jersey are best placed of all the offshore jurisdictions to fit within the equivalency regime.

He said: "The current regulatory regimes in each island will mean that there are likely to be very few changes required. The relative security and ease of doing business in Guernsey and Jersey as opposed to the more highly regulated (Luxembourg) and less developed (Malta) fund jurisdictions means that most fund managers and advisers have continued to establish funds here during this period of uncertainty. Unless the directive changes significantly, we can't see this changing."

Richard Searle, from BDO, is concerned that the directive is really more about competition and protection issues within Europe, than the regulatory improvement vehicle that it is dressed up as.

"Any directive that can alter competition and

has protection issues is concerning especially when it is dressed up behind a cloak of regulatory improvement. The key thing for Guernsey and Jersey is to make sure that we get that equivalency. We will work hard to get it and Guernsey is well known for being well regulated and keeping abreast of what the wider world authorities are looking for. We go to great pains to make sure we comply with global expectations and are there as a leading player in terms of regulation. The key thing is to continue to open the eyes of the leading players and keep the pressure on to keep it realistic," he said.

He added: "There are directives coming out all the time, for instance the audit directive. There is not really anything in there that concerns us that we are not already doing, as we always strive to comply with best practice."

The CISX takes the view that the AIFM directive must be planned for and any requirements for change built into those plans for the future.

Tamara Menteshvili doesn't see any significant impact at the moment, while the directive is still in draft form.

She said: "As a stock exchange, we have to anticipate and take stock of all elements that influence markets – we are a facilitator and concentrate on what needs to be done to facilitate our product offering – just as any business would do. The global financial crisis and recession remains a concern. The AIFM is a consideration for some, of course, and will give rise to different approaches. How significant that consideration is will depend on the marketing strategies and the underlying investor base."

The Future

The future looks bright for the Channel Islands in its quest to continue as a premier global fund jurisdiction. A recent survey shows that the Channel Islands administer the full range of private equity funds from buyout funds, venture capital, mezzanine, renewable energy, secondaries and microfinance. The survey also finds that the Channel Islands is a target destination for private equity administrators looking to expand their services, ranking alongside Luxembourg and Asia (Hong Kong and Singapore) as a top target for almost 30% of respondents. The types of services that might be expanded include the provision of valuation services, online reporting, custody services and compliance advisory services. The depth of expertise in the islands in these areas is an attractive proposition.

This positive view of growth is confirmed by Richard Searle from BDO who says his firm has been growing right through the downturn and increased staff numbers by 25%.

He said: "We want to be coming out of the downturn hitting the ground running, tak-

ing a long term view in terms of gearing up the firm. Everybody has gone through a fairly unprecedented time in the last 18 months and it has been a big learning curve. We are all much better equipped to deal with the future and it has sharpened our expertise even more in terms of servicing those clients. We are seeing a significant increase in terms of the leads coming through."

Barney Lee, at Appleby Guernsey, says that both islands are still going strong, notwithstanding the last couple of years. He says there are an increasing number of alternative investment managers setting up operations in Guernsey and Jersey.

He said: "We see this continuing to enhance the Channel Islands' status as a leading funds jurisdiction. Even if the AIFM directive is introduced in a modified form which excludes non EU funds (itself creating problems for the EU in terms of trade relations with the US and others) we anticipate increased opportunities for Jersey and Guernsey funds marketed to the growing Latin American and Asian economies as well as the US."

For its part, the CISX has grown its business drawn from other jurisdictions and has experienced dramatic growth, not only within the funds sector but also across other capital markets products, most notably specialist debt securities.

Tamara Menteshvili says that she has actively marketed the exchange's services to a wide audience reflecting the markets of particular interest to its Members.

She said: "There is a growing market for listing Eurobonds largely because the CISX is recognised by the UK HMRC for the qualified Eurobond exemption; the issuer must have a listing if they want that exemption. Many UK investors also want a fund to be listed, so they can put it into a SIPP or ISA – that is a large part of our work at the moment."

Further plans for expansion at the CISX include a new market in exchange traded open-ended funds.

Private equity administrator Ipes has already seen a significant upturn in the level of interest from fund managers and is confident that will improve during the next year or so. The firm has had 15 new enquiries during the past two months, several times greater than the same period in 2009.

Mr Partington said: "There has been an upsurge in the last few months in terms of enquiries, particularly from the Nordics, Russia, France and the UK. Funds that were raising in 08/09 and went quiet are now moving and we are seeing that. Clean-tech is one active area that investors are willing to get involved in, whether it is a buyout fund, pensions or private equity. Investors have pushed that sector through their investment committees."