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SPECIAL REPORT

CAYMAN 2013

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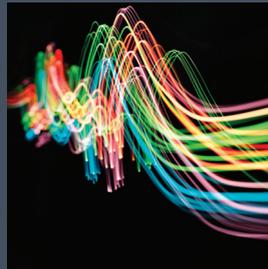
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SIDE LETTERS IN THE CAYMAN ISLANDS

CHRIS HUMPHRIES, OF STUARTS WALKER HERSANT, EXPLAINS THE ISSUES SURROUNDING SIDE LETTERS AND THE PRACTICES THAT SHOULD BE ADOPTED BY FUND MANAGERS



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Side letters have long been used by Cayman Islands funds in the form of additional agreements that are separate and distinct from the original subscription agreement, offering memorandum and constitutional documents of the fund to agree preferential terms with certain investors.

REGULATORY CONCERNS

While the scope and frequency of regulatory scrutiny varies from jurisdiction to jurisdiction, both the Securities and Exchange Commission in the United States and the Financial Services Authority in the United Kingdom have raised concerns regarding the use of side letters. These concerns focus on enhanced liquidity and transparency rights for certain investors and whether the use of side letters and, in certain instances, the terms therein, have been adequately disclosed to prospective and existing investors. For example, a smaller investor with less favourable liquidity options may find that by the time his shares are redeemed, prices have moved against him as certain other investors have been able to liquidate their positions more quickly.

The Cayman Islands Monetary Authority (Cima), which regulates investment funds domiciled in the Cayman Islands, has expressed the view that standard blanket disclosures permitting the use of side letters in offering documents may not be sufficient, and that side letters should preferably be entered into by the relevant fund and not the fund manager. Cima has, however, fallen short on issuing any specific guidance on the matter; it believes that such issues should be resolved by market participants and that any legal and regulatory issues are adequately addressed by the application of the current law including the Mutual Funds Law (as Revised) of the Cayman Islands.

SIDE LETTERS

Below are some specific considerations requested by investors when negotiating side letters:

Confirmation of existing terms

Often an investor will seek a contractual confirmation of certain representations, warranties or other terms that might be contained in the offering documents. Such confirmation would provide the investor with better protection and, although these provisions are not typically problematic, careful consideration should be given as to whether the correct party is giving such confirmation and whether they have the requisite knowledge to do so.

Directors' discretion

Typically the articles of association of a fund will provide that the directors may exercise their discretion in relation to, for example, the transfer of shares, the payment of redemption proceeds in-kind or a compulsory redemption of shares. Such terms should not, if properly drafted by legal counsel, cause unnecessary concern.

Variation of existing terms

Broadly speaking, terms in a side letter which purport to vary the existing terms of the shares must be considered on a point by point basis. However, generally where the proposed terms are contrary to the articles of association of the fund, the terms of the articles (being the constitutional documents of the fund) will prevail and terms which have the effect of varying the rights of existing shareholders in a class will require such shareholders prior consent. In cases where the consent of the existing shareholders is not considered, necessary consideration should be given as to whether the terms should be extended to all shareholders to mitigate the impact on them.

Most favoured nation (MFN)

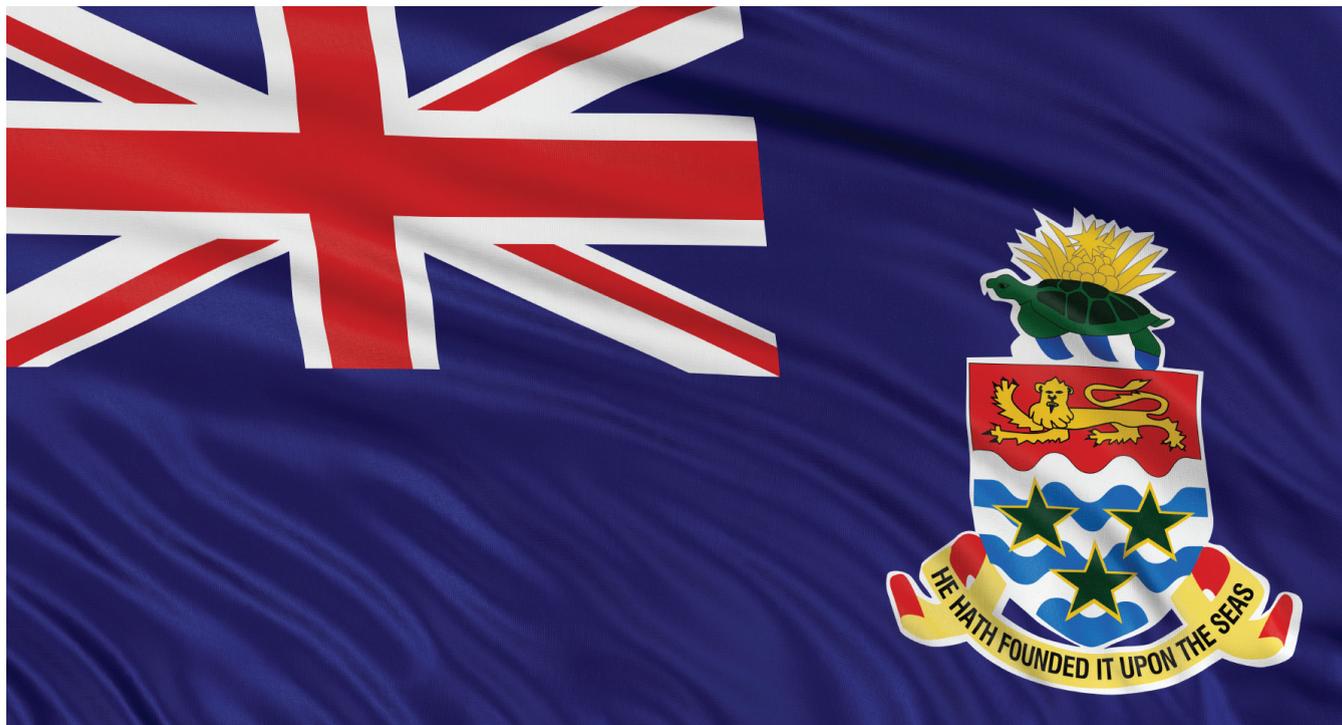
Since these provisions typically level the playing field between investors, the concerns they raise are usually administrative only. To the extent that MFN protection has been extended to one or more investors, a fund manager will need to establish a method for distributing side letters to those investors with MFN election rights and recording provisions elected by such investors. If the side letter contains a confidentiality provision requiring the contents of one side letter to be kept confidential, this will limit the ability to comply with MFN provisions in subsequent side letters.

Investment strategy

Terms which permit certain investors to opt out of certain types of investments will require a new class of shares. In this case, consideration must be given to how such provisions concentrate the remaining investors in such strategies and to how such provisions may impact the investment strategy of the fund as a whole.

Fee concessions

A simple discount on the fees may impact the net asset value of the shares and might need to be tracked separately as a separate class. However, if the discount is affected by way of a rebate from the fund manager then the net asset value will be unaffected.



Information rights

In an era where transparency is becoming more important to investors, it is common for certain investors to demand enhanced information rights. However, disclosing information on underlying portfolios may give certain investors the advantage of being able to determine whether to exit the fund ahead of other investors. The effect of these provisions can be mitigated by delaying the information to be provided or by making such information available to all investors with suitable confidentiality provisions.

More favourable liquidity rights

Terms which can present the greatest difficulty are those which purport to enhance the liquidity rights of certain investors, which might include: shorter redemption notice periods, key man redemption provisions, variation of lock-up or gate provisions or provide additional redemption dates.

As stated above, where these terms are contrary to the articles of association such terms will be unenforceable. Careful consideration should be given as to whether a new class of shares should be created and consequently what supplementary information should be provided to the Cima and any other consequential implications, such as the calculation of Employee Retirement Income Security Act 1974 (ERISA) thresholds.

BEST PRACTICES AND CONSIDERATIONS

Fund managers should adopt the following practices:

1. Ensure the offering documents alert investors to the existence or the possibility of the arrangements, so there is no question of non-disclosure or misrepresentation. Consider notifying investors of any subsequent arrangement.

2. Consider obtaining express consent from investors if it is anticipated that the arrangements may be such as to potentially vary the rights of the shares or other interests. Alternatively allow investors to redeem (without penalty) prior to the change being effective.

3. Directors, general partners and fund managers should carefully consider their fiduciary and contractual obligations to all investors before and when proceeding with these arrangements.

4. Ensure the correct parties enter into the side letter. Following the ruling of the Grand Court of the Cayman Islands in *Medley Opportunity Fund Ltd. v. Fintan Master Fund Ltd & Nautical Nominees Ltd* (21 June 2012), the Cayman Courts will always regard a custodian or a nominee as the shareholder of the fund for legal purposes. Therefore, ideally, the custodian or the nominee as well as the fund ought to be a party to the side letters.

5. Develop a procedure to monitor any MFN and other provisions and standardise side letter language to address areas of overlapping concern.

6. Consider:

- a) whether the terms are likely to conflict with the articles of association of the fund;
- b) whether a new class of shares may be required;
- c) if directors will be required to exercise discretion;
- d) whether shareholder consent is required; and
- e) whether extending the terms (if invoked) to all investors would mitigate any inequality between investors brought about by any enhanced liquidity terms.

7. Consult with Cayman Islands legal counsel on the use of side letters from the formation of the fund to the point of negotiating, agreeing and execution of a side letter. In some cases a legal opinion on the enforceability of the side letter may be warranted. ■



Stuarts Walker Hersant is a leading Cayman Islands legal practice with international reach. Our attorneys specialise in providing unsurpassed professional service to the world's leading fund managers, corporations, financial institutions and high net worth individuals.

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