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INVESTMENT FUNDS



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Cayman Islands

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RETAIL FUNDS

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

Open-ended retail funds

Open-ended retail funds are considered as mutual funds that fall under the licensing category (*section 4(1)(a), Mutual Funds Law (2009 Revision) (MFL)*) (licensed funds). However, they can include funds registered under section 4(3) of the MFL that have:

- Their equity interests listed on the Cayman Islands Stock Exchange (CSX).
- A minimum aggregate investment amount above US\$100,000 (as at 1 November 2011, EUR1 was about US\$1.4).

Funds which allow investments below US\$100,000 are generally referred to as "retail" funds.

The statutory definition of a mutual fund is any company, unit trust or partnership that issues equity interests, the purpose or effect of which is the pooling of investor funds with the aim of both:

- Spreading investment risk.
- Enabling investors in the mutual fund to receive profits or gains from the acquisition, holding, management or disposal of investments.

Equity interests for this purpose means shares, trust units or partnership interests that both:

- Carry an entitlement to participate in profits or gains of the company, unit trust or partnership.
- Are redeemable or re-purchasable at the investor's option before the beginning of the winding up or dissolution of the company, unit trust or partnership.

Compared to the hedge funds market, the open-ended retail funds market is fairly small. As of the end of September 2011, there were 124 open-ended licensed funds under the MFL (compared to 9,307 registered investment funds).

Closed-ended retail funds

Closed-ended retail funds are generally understood to comprise investment funds in which the equity interests are not redeemable at the investor's option. These funds are not subject to regulation by the Cayman Islands Monetary Authority (CIMA) and, therefore, there is no available data to provide a market overview.

Regulatory framework and bodies

2. What are the key statutes, regulations and rules that govern retail funds? Which regulatory bodies regulate retail funds?

Open-ended retail funds

Regulatory framework. The primary legislation regulating investment funds is the MFL and accompanying regulations, including the Retail Mutual Funds (Japan) Regulations (2007 Revision, as amended). These regulations generally apply to investment funds licensed under the MFL (licensed funds) where the securities are marketed to the public in Japan.

Ancillary legislation affecting investment funds includes the:

- Companies Law (2011 Revision) (Companies Law).
- Exempted Limited Partnership Law (2011 Revision) (ELP Law).
- Partnership Law (2002 Revision) (Partnership Law).
- Trusts Law (2009 Revision) (Trusts Law).
- Banks and Trust Companies Law (2009 Revision) (BTC Law).
- Securities Investment Business Law (2011 Revision) (SIB Law).
- Proceeds of Crime Law 2008 (PCL).
- Money Laundering Regulations (2010 Revision) (ML Regulations), enacted pursuant to powers under the PCL.

The PCL, ML Regulations and Guidance Notes (*see below*) are together referred to as the AML Laws.

Regulatory bodies. CIMA's Investment and Securities Division is responsible for the ongoing supervision of investment funds and fund administrators. The MFL is administered by CIMA. CIMA also issues rules (under the Monetary Authority Law (2008 Revision)) applicable to regulated investment funds.

CIMA, in consultation with certain professional associations, has prepared and issued guidance notes on the prevention and detection of money laundering in the Cayman Islands (Guidance Notes) to provide guidance to service providers in complying with their obligations under the ML Regulations.

The Financial Reporting Authority (FRA) is the Cayman Islands' Financial Intelligence Unit with responsibility for receiving, analysing and disseminating disclosures of financial information concerning the proceeds of criminal conduct, money laundering



and the financing of terrorism pursuant to the provisions of the PCL. Suspicious activity or transaction reports (that is, reports on financial transactions in which there are reasonable grounds to suspect the transactions are related to the proceeds of criminal conduct as defined in the PCL) must be submitted to the FRA.

Closed-ended retail funds

Regulatory framework. Closed-ended retail funds are exempt from the application of the MFL because the investor's shares, trust units or interests are not redeemable or repurchasable at the investor's option and therefore do not fall within the MFL definition of "equity interests". However, the ancillary legislation applicable to open-ended retail funds applies to closed-ended retail funds (see above, *Open-ended retail funds*).

Regulatory bodies. CIMA, in consultation with certain professional associations, has prepared and issued guidance notes on the prevention and detection of money laundering in the Cayman Islands (Guidance Notes) to provide guidance to service providers in complying with their obligations under the ML Regulations.

The Financial Reporting Authority (FRA) is the Cayman Islands' Financial Intelligence Unit with responsibility for receiving, analysing and disseminating disclosures of financial information concerning the proceeds of criminal conduct, money laundering and the financing of terrorism pursuant to the provisions of the PCL. Suspicious activity or transaction reports (that is, reports on financial transactions in which there are reasonable grounds to suspect the transactions are related to the proceeds of criminal conduct as defined in the PCL) must be submitted to the FRA.

3. Do retail funds themselves have to be authorised or licensed?

Open-ended retail funds

Open-ended retail funds that fall under the licensing category (*section 4(1)(a), MFL*) must hold a mutual fund licence under the MFL (see *Question 1*). The application for a mutual fund licence requires filing the following with CIMA:

- A current offering memorandum, including certain particulars prescribed by CIMA, such as those in CIMA's Rule on the Calculation of Asset Values.
- A certified copy of the Certificate of Incorporation or Certificate of Registration of the company, unit trust or partnership (as applicable).
- Form MF3, which provides certain prescribed details of the fund, such as the operators' and service providers' identity, and key terms concerning subscriptions and redemptions.
- Consent letter (containing CIMA-approved wording) from the fund's administrator and a consent letter from a Cayman Islands auditor, approved by CIMA.
- A registration fee of (currently) US\$3,658.54 (as at 1 November 2011, EUR1 was about US\$1.4).

In addition to the documentation above, CIMA requires that all operators (see below) who wish to be appointed to a licensed fund

must provide the following documents, to show that the operator is a fit and proper person:

- A completed personal questionnaire.
- One financial and two character references. (Further guidance on the requirements for a reference letter can be obtained from the *CIMA Regulatory Handbook*.)
- A police certificate or an affidavit of no convictions.

Operators are:

- Directors (for exempted companies).
- Trustees (for unit trusts).
- General partners (for exempted limited partnerships).

Prior approval from CIMA is required before the fund can accept subscription monies from investors. If an existing fund is applying to be licensed, it must also file a copy of its most recent annual audited financial statements.

The MFL covers funds which are structured as companies, partnerships or unit trusts whether constituted under the laws of:

- The Cayman Islands.
- Any other jurisdiction if they are carrying on, or attempting to carry on, business in or from the Cayman Islands.

Accordingly the provisions of the MFL will apply to foreign funds if they are carrying on, or attempting to carry on, business in or from the Cayman Islands.

There are several differences between the licensing or authorisation requirements of local funds (that is, a fund which has been incorporated or established in the Cayman Islands) and the licensing or authorisation requirements of foreign funds (that is, a fund which has been incorporated or established outside the Cayman Islands) including the following:

- An exempted company (a common local fund structure) is prohibited from undertaking any business or trade with any person, firm or corporation in the Cayman Islands other than in furthering its business carried on outside the Cayman Islands (*Companies Law*). An exempted limited partnership (another common local fund structure) is also prohibited from undertaking business with the public in the Cayman Islands other than as far as necessary for the carrying on of the business of the partnership outside the Cayman Islands (*ELP Law*). Funds which are foreign companies must register with the Companies Registrar as a foreign company carrying on business within the Cayman Islands (*Companies Law*). In this context, "carrying on business" is defined as including, without limitation:
 - the sale by or on behalf of a foreign company of its shares or debentures;
 - offering, by electronic means, and subsequently supplying, real or personal property, services or information:
 - from a place of business in the Cayman Islands; or



- through an internet service provider or other electronic service provider located in the Cayman Islands.
- If a foreign fund that is a foreign body corporate is not registered in the Cayman Islands as a foreign company but is administered in the Cayman Islands, there is the risk that the foreign fund may be considered to be carrying on business in the Cayman Islands and therefore required to comply with the Companies Law and register as a foreign company, particularly if the administrator executes subscription agreements in the Cayman Islands on behalf of the foreign fund.
- An exempted company that is not listed on the CSX is prohibited from making an invitation to the public in the Cayman Islands to subscribe for any of its securities (*Companies Law*). The penalties for infringement include that every director and officer of the exempted company who is responsible for the contravention being guilty of an offence and liable on summary conviction to a fine of KYD100 (as at 1 November 2011, US\$1 was about KYD0.8) for every day during which the contravention occurs or continues. The company is liable to be immediately dissolved and removed from the Register of Companies. The term “invitation to the public” is not defined in the Companies Law. The term “public” in the Cayman Islands is generally interpreted as referring to resident companies and individuals, but not:
 - exempted companies;
 - exempted limited partnerships registered under the ELP Law;
 - exempted trusts registered under the Trusts Law;
 - ordinary non-resident companies or foreign companies registered under the Companies Law.
- There are control laws and licensing laws which respectively impose restrictions on the ownership and control of local companies and license business activity generally. However, based on exceptions in these local companies’ control laws and licensing laws, a fund which is set up as a local fund (typically Cayman exempted company, exempted limited partnership or exempted trust), or a foreign fund (for example, undertakings for collective investments in transferable securities (UCITS), or a Delaware limited liability partnership) which is registered with CIMA, licensed by CIMA or exempt under the terms of the MFL, would not be carrying on business within the meaning of these local companies control laws and licensing laws by:
 - marketing its shares to individuals or other entities in the Cayman Islands;
 - concluding the resulting investment or subscription contracts within the Cayman Islands.

Closed-ended retail funds

Closed-ended retail funds are outside the scope of the MFL (see *Question 2, Closed-ended funds*). Therefore, there is no requirement to be authorised or licensed by the MFL. However, closed-ended retail funds are subject to the Companies Law, the ELP Law, the Trusts Law and the SIB Law (as applicable).

Marketing

4. Who can market retail funds?

Open-ended retail funds

The provisions that apply are the same as for hedge funds (see *Question 18*).

Closed-ended retail funds

The provisions that apply are the same as for hedge funds (see *Question 18*).

5. To whom can retail funds be marketed?

Open-ended retail funds

The provisions that apply are the same as for hedge funds (see *Question 19*).

Closed-ended retail funds

The provisions that apply are the same as for hedge funds (see *Question 19*).

Managers and operators

6. What are the key requirements that apply to managers or operators of retail funds?

Open-ended retail funds

Managers and operators are subject to the same requirements as for hedge funds (see *Question 23*). In addition, a licensed fund must show that it is controlled and managed by fit and proper persons. Relevant circumstances to be considered include the person’s:

- **Honesty, integrity and reputation.** Police clearance certificates are required. The additional factors that CIMA takes into account are set out in CIMA’s Fitness and Propriety Guidelines.
- **Competence and capability.** Professional references are required. In addition, when determining the person’s competence and capability, CIMA considers the following, among others:
 - whether the person has the technical knowledge and ability to perform the controlled function for which the person is employed or for which the firm intends to employ that person. Recognised professional qualifications and membership of professional institutions are particularly relevant;
 - whether the person has demonstrated by experience through years of employment and positions held that the person is able, or will be able, if accepted, to perform the controlled function for which he is employed or for which the firm intends to employ him; and
 - whether he has the appropriate training, necessary to fulfil the role for which he is employed or for which the firm intends to employ him.



- **Financial soundness.** Professional and financial references are required. In determining a person's financial soundness, CIMA considers, among others:
 - whether he has been able to provide an appropriate credit reference;
 - whether he has:
 - made any arrangements with creditors;
 - filed for bankruptcy;
 - been adjudged bankrupt;
 - had assets sequestrated; or
 - been involved in proceedings in the Cayman Islands or elsewhere.

A foreign manager who has complied with the registration requirements under the Companies Law, ELP Law or the Trusts Law (as applicable) and the regulatory requirements of the SIB Law can manage a local fund.

Closed-ended retail funds

The key requirements are the same as for hedge funds (see Question 23), except that the requirements applicable to CIMA registered hedge funds do not apply.

Assets portfolio

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

Open-ended retail funds

The provisions that apply are the same as for hedge funds (see Question 21). In addition, CIMA requires the fund to ensure that investments (other than cash) are segregated and accounted for separately from any assets of any service provider.

Closed-ended retail funds

The provisions that apply are the same as for hedge funds (see Question 21).

Legal fund vehicles

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

Open-ended retail funds

Legal vehicles. The provisions that apply are the same as for hedge funds (see Question 24).

Advantages. The advantages are the same as for hedge funds (see Question 24).

Disadvantages. The disadvantages are the same as for hedge funds (see Question 24).

Closed-ended retail funds

Legal vehicles. The provisions that apply are the same as for hedge funds (see Question 24).

Advantages. The advantages are the same as for hedge funds (see Question 24).

Disadvantages. The disadvantages are the same as for hedge funds (see Question 24).

Investment and borrowing restrictions

9. What are the investment and borrowing restrictions on retail funds?

Open-ended retail funds

There are no investment or borrowing restrictions, other than those the fund contractually agrees with investors, and subject to the following exceptions:

- **Exempted companies.** An exempted company cannot trade in the Cayman Islands with any person, firm or corporation except to further its business outside the Cayman Islands. However, this prohibition does not prevent an exempted company from effecting and concluding contracts in the Cayman Islands and exercising in the Cayman Islands all of its powers necessary for the carrying on of business outside the Cayman Islands.
- **Exempted limited partnerships.** An exempted limited partnership cannot undertake business with the public in the Cayman Islands other than as far as necessary for the carrying on of business outside the Cayman Islands.
- **Unit trusts.** A trustee which is an exempted company is subject to the same restrictions as exempted companies (see above, *Exempted companies*).

Closed-ended retail funds

See above, *Open-ended retail funds*.

10. Can the manager or operator place any restrictions on the issue and redemption of interests in retail funds?

Open-ended retail funds

The manager or operator of the fund can impose restrictions on the issue, redemption and transfer of interests, as agreed with investors.

Typically, subscription restrictions concern:

- The eligibility of the persons who may subscribe for interests, shares or units.
- The day(s) on which subscriptions can be made and the minimum amount of the subscription monies.

Redemption restrictions typically include the following:

- A gate provision (that is, a device which limits the overall number of redemptions permitted on one redemption day).
- The imposition of lock-up periods, during which redemptions are not permitted or are only permitted on payment of a fee.
- Suspension or delay in payment of redemption proceeds.



- Payment of redemption proceeds in kind.
- The imposition of holdback of a proportion of redemption proceeds pending completion of next audit.
- Minimum redemption or holding amounts.

In addition, redemptions may be temporarily suspended.

Transfer restrictions typically include:

- In the case of a fund that is an exempted company, the restriction normally states that without the prior written consent of the Board of Directors (in its absolute discretion), any sale, assignment, transfer, conveyance, pledge, hypothecation or other disposition or encumbrance of shares will not be valid. Further, any sale, assignment, transfer, conveyance, pledge, hypothecation or other disposition or encumbrance of shares made without that consent may subject those shares to a compulsory redemption.
- In the case of a fund that is an exempted limited partnership, limited partners may only assign or transfer their interests with the prior written consent of the general partner.
- In the case of a fund that is a unit trust, unitholders may only assign or transfer their units with the prior written consent of the trustee.

Closed-ended retail funds

The manager or operator of the fund can place restrictions on the issue and redemption of shares, interests, or units (as applicable) in closed-ended retail funds, as agreed with investors. Typically, shares, interests, or units (as applicable) are not redeemable at the investor's option, and issues of shares, interests, or units are made a limited number of times (usually at the beginning of the investment programme). The offering documents normally restrict or prohibit any invitation to the public in the Cayman Islands to subscribe for shares, interests or units in closed-ended retail funds.

11. Are there any restrictions on the rights of participants in retail funds to transfer or assign their interests to third parties?

Open-ended retail funds

Any restrictions on the transferability of interests in open-ended retail funds depend on the fund's structure. Interests in open-ended retail funds in the Cayman Islands can typically be transferred only with the operator's consent. However, open-ended retail funds can be structured so that either:

- Interests or shares are freely transferable (other than limited partnership interests), but subject to the selling restrictions (see Question 19).
- No transfers are permitted (other than transfers of interests in funds, listed on the CSX, which generally must be freely transferable).

Limited partnership interests in exempted limited partnerships can be assigned (absolutely or by way of security) in accordance

with the provisions of the limited partnership agreement. Typically the limited partnership agreement requires the general partner's prior consent for assignment.

Closed-ended retail funds

See above, *Open-ended retail funds*.

Reporting requirements

12. What are the general periodic reporting requirements for retail funds?

Open-ended retail funds

Investors. There are no periodic reporting requirements to investors imposed by law. However, the offering documents typically contain representations concerning the requirements the fund will adopt for reporting to investors. The fund's offering document must state the nature and frequency of financial reports' distribution to investors (*CIMA's Rule on Contents of Offering Documents – Licensed Funds*).

Regulators. The promoter or operator of CIMA registered funds must file with CIMA:

- In relation to a continuous offering, an amended offering document or amended prescribed details, incorporating any change that materially affects any information in the offering document or prescribed details filed with CIMA. This must be filed within 21 days of the promoter or operator becoming aware of the change.
- Annually, within six months from the end of the fund's financial year, accounts which have been audited by an approved Cayman Islands auditor.

Closed-ended retail funds

Investors. There are no periodic reporting requirements to investors imposed by law. However, the offering documents typically contain representations concerning the requirements the fund will adopt for reporting to investors.

Regulators. There are no periodic reporting requirements to regulators.

Tax treatment

13. What is the tax treatment for retail funds?

Open-ended retail funds

Funds. The provisions that apply are the same as for hedge funds (see Question 26).

Resident investors. The provisions that apply are the same as for hedge funds (see Question 26).

Non-resident investors. The provisions that apply are the same as for hedge funds (see Question 26).

Closed-ended retail funds

Funds. The provisions that apply are the same as for hedge funds (see Question 26).



Resident investors. The provisions that apply are the same as for hedge funds (see Question 26).

Non-resident investors. The provisions that apply are the same as for hedge funds (see Question 26).

Reform

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

In April 2008, CIMA issued the following three rules to further enhance regulation of the licensed funds sector:

- The Rule on the Contents of Offering Documents, which outlines the information to be included in offering documents.
- The Rule on the Calculation of Asset Values, which requires funds to specify their policy for calculating the funds' asset values.
- The Rule on the Segregation of Assets for Licensed Funds, which calls for a fund's portfolio (that is, all financial assets and liabilities) to be segregated and accounted for separately from any assets of any service provider. This rule also states that licensed funds must ensure that service providers do not use the portfolio to finance their own or any other operations in any way.

The Cayman Islands government has considered a number of other reform proposals over the last two years. However, apart from the introduction of the above rules, no reform has as yet been introduced.

CIMA is empowered under the MFL to take all or any of the enforcement actions set out below if it is satisfied that:

- A regulated fund is, or is likely to become, unable to meet its obligations as they fall due.
- A regulated fund is carrying on, or attempting to carry on, business, or is winding-up its business voluntarily, in a manner that is prejudicial to its investors or creditors.
- A regulated fund, in the case of a licensed fund, is carrying on, or attempting to carry on, business without complying with any condition of its mutual fund licence contrary to the MFL.
- The direction and management of a regulated fund has not been conducted in a fit and proper manner.
- A person holding a position as a director, manager or officer of a regulated fund is not a fit and proper person to hold the respective position.

The actions that CIMA may take in relation to a regulated fund are to:

- Cancel any mutual fund licence or any registration under sections 4(1)(b) or 4(3) of the MFL in relation to the fund.
- Impose conditions or further conditions on any Mutual Fund Licence the fund holds and to amend or revoke those conditions.

- Require the substitution of any promoter or operator of the fund.
- Appoint a person to advise the fund on the proper conduct of its affairs.
- Appoint a person to assume control of the affairs of the fund.

If CIMA takes any of the above actions, it can apply to the Grand Court of the Cayman Islands for an order to take such other action as it considers necessary to protect the interests of investors in, and creditors of, the fund and, subsequently, take any other action provided for above.

Where it considers it necessary or appropriate to do so, and if it is practical to do so, CIMA can inform the investors of a fund of any action it is taking or intending to take in relation to the fund.

CIMA can also, at any time, cancel any mutual fund licence or any registration under sections 4(1)(b) or 4(3) of the MFL in relation to a fund if CIMA is satisfied that the fund has ceased to carry on, or to attempt to carry on, business as a mutual fund or is being wound up or is dissolved (*section 30(16), MFL*). Decision notices concerning the cancellation of mutual fund licences are normally published on the public notices section of the CIMA website. For example, in September 2011, the CIMA website shows that CIMA has cancelled mutual fund licences in relation to funds failing to:

- Prepare and submit audited financial statements for a number of years.
- Pay their annual registration fee for a number of years.

There is currently a proposal to amend the MFL to provide for the registration of master funds (see Question 28).

HEDGE FUNDS

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

An investment fund intending to carry on, or attempting to carry on, business in or from the Cayman Islands must comply with one of three requirements. (One requirement is the licensing requirement (see Question 3) under section 4(1) of the MFL, unless it is exempt from that law.)

Open-ended hedge funds usually fall within one of the two registration requirements under section 4(1)(b) or section 4(3) of the MFL. Alternatively, they can be exempt from registration if the equity interests are held by not more than 15 investors, the majority of whom are capable of appointing and/or removing the operator of the fund (that is, the directors, the general partner or the trustee(s), as applicable).

For the purpose of this chapter, hedge funds include funds registered with CIMA as well as funds exempt from registration with CIMA. The following other types of investment funds are



outside the scope of the MFL as they do not fall within the statutory definition of a mutual fund:

- Closed-ended funds (that is, funds where the investor's shares, trust units or interests are not redeemable or repurchasable at the investor's option).
- Funds that only issue debt or alternative financial instruments (debt-only funds).
- Investment funds with only one investor (even though these funds can determine voluntarily to register with CIMA).

In all cases, an investor is defined to mean the investor of record (without any consideration of possible beneficial ownership). Therefore, if all equity interests are issued as a matter of record to a single institutional nominee or custodian for the underlying investors, the investment fund is outside the scope of the MFL.

The Cayman Islands is the global leader for domiciling offshore hedge funds. It is estimated that the Cayman Islands has over 65% of the total global share of offshore hedge funds.

As at the end of September 2011 there were 9,431 investment funds, registered with CIMA, consisting of (*CIMA's website*):

- 8,877 registered funds (that is, registered under section 4(3)).
- 430 administered funds (that is, registered under section 4(1)(b)).
- 124 licensed funds.

These figures do not include the many hundreds of additional closed-ended and debt-only funds that do not require registration with CIMA.

Offshore investment funds offer many advantages to promoters and managers, including:

- The freedom to define investment strategies and objectives without restrictions imposed by onshore regulators in the name of consumer protection.
- The absence of extensive reporting requirements to onshore regulators (such as the Securities and Exchange Commission (SEC) in the US and the Financial Services Authority (FSA) in the UK).

Regulatory framework and bodies

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

Regulatory framework

The same statutes, regulations and regulatory bodies apply as for open-ended retail funds and closed-ended retail funds (as applicable) (see Question 2).

Regulatory bodies

See above, *Regulatory framework*.

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

Risk

A fund's offering document must (*section 4(6), MFL*):

- Describe the equity interests in all material respects.
- Contain such other information as is necessary to enable a prospective investor in the fund to make an informed decision about whether to subscribe for or purchase the equity interests.

The requirement to outline the risks involved in investing in the fund in the offering document is implicit in *section 4(6)* of the MFL.

Valuation and pricing

CIMA policy requires registered hedge funds to appoint an administrator. The administrator's services generally include the calculation of the net asset value of the fund. In addition, a CIMA-approved Cayman Islands auditor must be appointed and audited annual financial statements must be prepared and filed with CIMA within six months of the financial year end of the fund. These CIMA requirements do not apply to unregistered hedge funds.

Systems and controls

Other than in relation to money laundering, the fund itself is not regulated for systems and controls. However, the fund typically adopts the systems and controls of various service providers that it appoints to manage its operations.

Insider dealing and market abuse

Creating a false or misleading market in listed securities and insider dealing in listed securities are offences (SIB Law). For this purpose, listed securities are securities listed on the CSX.

Transparency

Accounts and records are not generally available to third parties, but investors have statutory rights to certain information (for example, the memorandum and articles of association of a fund that is an exempted company).

In 2010 the Cayman Islands government introduced new laws regulating all Cayman Islands companies (including exempted companies) and all Cayman Islands registered partnerships (including exempted limited partnerships) aimed at ensuring that reliable accounting records are kept for all relevant entities and partnership arrangements. In the first quarter of 2011 the same legal requirements were introduced for Cayman Islands trusts (including exempted trusts). The new laws have been introduced following recommendations from the Global Forum Review Programme of the Organisation for Economic Co-operation and Development (OECD) and require companies, partnerships and trusts to keep, or cause to be kept, proper books of account



including, where applicable, material underlying documentation including contracts and invoices, in relation to:

- All sums of money received and expended by the partnership or company and matters in relation to which the receipt of expenditure takes place.
- All sales and purchases of goods by the partnership or company.
- The assets and liabilities of the partnership or company.

While the above requirement already existed for Cayman Islands companies, it is new for partnerships and trusts. A new requirement under the new laws for companies, partnerships and trusts is for all books of account to be retained for a minimum period of five years from the date on which they are prepared.

Money laundering

Regulated investment funds, and generally unregulated investment funds, are subject to the AML Laws, as they carry on “relevant financial business”.

Short selling

There is no regulation relating to short selling.

Marketing

18. Who can market hedge funds?

The following entities must generally be licensed or exempted from licensing with CIMA under the SIB Law, to market hedge funds:

- All companies and partnerships established under Cayman Islands law.
- Foreign companies that are registered in the Cayman Islands.
- All entities that have established a place of business in the Cayman Islands, from which marketing of the fund is undertaken.

A licensing exemption under the SIB Law is available if both:

- The fund is CIMA-regulated or falls within one of the categories listed in *Question 19*.
- The entity is marketing the fund only to:
 - sophisticated persons (broadly, a listed or regulated entity or an experienced investor which invests more than US\$100,000 per transaction);
 - high net-worth persons (that is, an individual with a net worth of at least US\$1 million or a person with total assets of at least US\$5 million);
 - entities whose investors are either sophisticated persons or high net-worth persons.

19. To whom can hedge funds be marketed?

Exempted companies

An exempted company that is not listed on the CSX is prohibited from making any invitation to the public in the Cayman Islands

to subscribe for any of its shares (Companies Law). Applicable regulatory requirements under the MFL and the SIB Law would affect a foreign fund structured as a body corporate, partnership or unit trust.

The public in the Cayman Islands does not include the following:

- A sophisticated person or a high net-worth person.
- A company, partnership or trust of which the shareholders, unitholders or limited partners are all sophisticated persons or high net-worth persons.
- Any exempted or ordinary non-resident company that is registered under the Companies Law.
- A foreign company registered under Part IX of the Companies Law.
- Any exempted company or ordinary non-resident company or foreign company, acting as the general partner of a partnership, registered under section 9(1) of the ELP Law.
- Any director or officer of such exempted company or ordinary non-resident company or foreign company, acting as the general partner of a partnership, registered under section 9(1) of the ELP Law.
- The trustee of any trust, registered or capable of registering under section 74 of the Trusts Law.

The disclosure in the offering document of exempted companies typically states that the offering document does not constitute an offer of the fund's shares to the members of the public in the Cayman Islands, for as long as the fund's shares are not listed on the CSX.

There are no Cayman Islands restrictions on marketing to persons outside of the Cayman Islands.

Exempted limited partnerships

An exempted limited partnership is prohibited from undertaking business with the public in the Cayman Islands, other than as far as necessary for the carrying on of the business of that partnership outside of the Cayman Islands (*section 4(1), ELP Law*). For these purposes, the public has the same meaning as for exempted companies (*see above, Exempted companies*).

There are no Cayman Islands restrictions on marketing to persons outside of the Cayman Islands.

Unit trusts

If the unit trust intends to register as an exempted trust, the Cayman Islands Registrar of Trusts must be satisfied that the beneficiaries (that is, the unitholders) do not and are not likely to include any person, at any time, resident or domiciled in the Cayman Islands (other than any object of a charitable trust or power). A person resident or domiciled in the Cayman Islands does not include an exempted company or an ordinary non-resident company.

There are no Cayman Islands restrictions on marketing to persons outside of the Cayman Islands.



Investment restrictions

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

There are restrictions on the offer of the shares of a fund to members of the public in the Cayman Islands, for so long as the shares of the fund are not listed on the Cayman Islands Stock Exchange. "Public" for these purposes does not include:

- A sophisticated person.
- A high net-worth person.
- A company, partnership or trust of which the shareholders, unitholders or limited partners are each a sophisticated person or a high net-worth person.
- Any exempted or ordinary non-resident company registered under the Companies Law (2011 Revision), or any such company acting as a general partner of partnership registered under the provisions of the Exempted Limited Partnership Law (2011 Revision), or any director or officer of the same acting in such capacity.
- A trustee of any trust registered, or capable of being registered, under the provisions of the Trusts Law (2009 Revision).

Assets portfolio

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

CIMA's Rule on the Segregation of Assets for Licensed Funds only applies to licensed funds. Therefore there are no restrictions on the custody of portfolio assets and there is no requirement for a custodian to be appointed. Typically, funds appoint a prime broker or custodian to hold the fund's assets, but the fund can hold the assets directly. A separate bank account is usually established, maintained by the fund and operated by the fund's administrator. Subscriptions and redemptions are made through this account, to facilitate anti-money laundering procedures. The money in this account is typically transferred to or from the prime brokerage account, through which the trading is typically conducted.

Paragraph 5 of CIMA's Rule on the Segregation of Assets for Licensed Funds requires that:

- The fund's portfolio (that is, all financial assets and liabilities) is segregated, and accounted for separately, from any assets of any service provider.
- The fund ensures that service providers do not use the portfolio to finance their own or any other operations in any way.
- The fund ensures, contractually, that any service provider, holding or managing the fund's portfolio, is regulated by:
 - CIMA;
 - a recognised overseas regulatory authority; or
 - another CIMA-approved regulator.

CIMA's Rules, including the Rule on the Segregation of Assets for Licensed Funds, are clear and precise guidelines issued

to licensees that CIMA considers essential for the prudential supervision of regulated entities. CIMA's Rules create binding obligations on all licensees and a breach can result in CIMA imposing a fine or taking regulatory action against the licensee.

Requirements

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

The following procedures apply to hedge fund registration (*MFL*):

- If the minimum aggregate equity interest purchasable by a prospective investor is at least US\$100,000 (or its equivalent in another currency) or the equity interests are listed on a recognised stock exchange, including the CSX, then the registration application requires filing with CIMA:
 - a certified copy of the Certificate of Incorporation or Certificate of Registration (as applicable and depending on whether the fund is a company, limited partnership or trust);
 - Form MF1 (this form includes certain prescribed details of the fund, such as the identity of the operators and service providers and the key terms regarding subscriptions and redemptions);
 - a current offering document (for example, a private placement memorandum);
 - a consent letter from the fund's administrator and a consent letter from the Cayman Islands auditor, approved by CIMA;
 - a registration fee, which is currently US\$3,658.54.
- If a licensed investment fund's administrator provides the fund's principal office in the Cayman Islands (this may apply in the case of an investment fund that agrees to accept minimum initial investments below the US\$100,000 threshold) then the registration is applied for by filing with CIMA:
 - Forms MF2 and MF2A, completed by the administrator and the investment fund (including similar particulars to the Form MF1) (*see above*);
 - the same documents (except the Form MF1) and registration fee as above.

These are filing registration requirements. CIMA will not perform a substantive review of the filing. Generally, the hedge fund can accept subscription monies once the filing is made.

The ongoing reporting requirements for registered hedge funds are generally the same as for open-ended retail funds (*see Question 12, Open-ended retail funds*).

A fund's offering document must (*section 4(6) MFL*):

- Describe the equity interests in all material respects.
- Contain such other information as is necessary to enable a prospective investor in the fund to make an informed decision about whether to subscribe for or purchase the equity interests.



The requirement to outline the risks involved in investing in the fund in the offering document is implicit in section 4(6) of the MFL. The fund is required under the MFL to file its current offering document with CIMA within 21 days of becoming aware of any change that materially affects any information in the offering document filed with CIMA or in the prescribed details of the offering document filed with CIMA.

Other than the section 4(6) MFL requirement set out above, there are currently no Cayman Islands specific disclosure or filing requirements for side letters. However, the offering documents typically disclose that the fund can enter into side letter arrangements with certain investors.

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

The following key requirements apply:

- **Directors.** CIMA policy requires a regulated fund to appoint at least two directors (in the case of individual directors). CIMA may provide approval for the fund to appoint one corporate director. There are no Cayman Islands residency requirements for directors.
- **Trustees.** If the trustee is incorporated or registered in the Cayman Islands, it must be licensed under the BTC Law.
- **General partners.** General partners are not subject to any specific requirements, other than that at least one general partner must be incorporated or registered in the Cayman Islands (this includes a foreign entity registered as such in the Cayman Islands).
- **Investment managers.** Investment managers can be exempted companies, exempted trusts, exempted limited partnerships or foreign companies registered in the Cayman Islands. Investment managers incorporated or registered in the Cayman Islands, or with an established place of business in the Cayman Islands, must generally be licensed (or exempted from licensing) by CIMA (see *Question 18*). Investment managers who fall outside of this category are not subject to any other requirements.

A foreign manager who complies with the registration requirements under the Companies Law, the ELP Law or the Trusts Law (as applicable) and the regulatory requirements of the SIB Law can manage a local fund. It is believed that the majority of investment managers of local funds are foreign-based managers.

Legal vehicles and structures

24. 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?

A hedge fund can be established as one of the following:

- A company (usually an exempted company incorporated with limited liability), which offers shares.
- A limited partnership (usually an exempted limited partnership), which offers limited partnership interests.

- A unit trust (typically an exempted unit trust), which offers units of beneficial interest to investors.

The choice of the structure is often dictated by some or all of the following factors:

- Market practice.
- Tax.
- The regulatory requirements of the investors in the fund.
- The investors' or investment manager's familiarity or preference of one structure over another.

Exempted company structure

The vehicle that is normally used to establish a fund in corporate form is the exempted company (including the exempted limited duration company and the segregated portfolio company), which is incorporated under the Companies Law.

The constitution of an exempted company is contained in both its:

- Memorandum of Association, which sets out the company's powers and objectives.
- Articles of Association, which regulates the administration of the company, including its shareholders' rights and its directors' powers and duties.

The share capital of an exempted company incorporated with limited liability can be denominated in any one or more currencies and fractional shares can be issued. The share capital can also be issued:

- In classes, or different series of the same class or classes.
- With different rights.
- To allow participation in the same or a separate portfolio of underlying assets.

Therefore, an exempted company structure is particularly appropriate for umbrella funds or multi-class funds. Shares are normally issued with a low par or nominal value (typically 1%) and at a high premium (that is, the amount by which the issue price exceeds the par value), to provide maximum flexibility on redemption. Monies paid in as share premium are available, under the Companies Law, for distribution by way of dividend or to satisfy any premium on redemption. In addition, subject to a solvency requirement, shares may be redeemed from capital.

Advantages. A company benefits from separate legal personality distinct from its investors and administrators. Additionally, investors' liabilities are limited to the amount unpaid on their shares.

Disadvantages. The exempted company structure is subject to company law requirements (for example, capital maintenance restrictions) under the Companies Law, and is arguably not as flexible as the limited partnership structure or the unit trust structure.

Limited partnership structure

An exempted limited partnership is registered under the ELP Law. There must be at least one:

- General partner who is liable for all debts and obligations of the partnership.
- Limited partner who, subject to certain exceptions, is liable for the debts and obligations of the partnership only to the extent provided in the partnership agreement.



In addition, at least one general partner must be one of the following:

- An individual, resident in the Cayman Islands.
- A company incorporated under the Companies Law or registered as a foreign company under the Companies Law.
- An exempted limited partnership.

The partners' rights and duties in relation to one another are regulated by the ELP Law and the partnership agreement, which gives increased flexibility for fund managers and investors (in particular, seed investors or large institutional investors) to negotiate and tailor the partnership agreement as they see fit. Limited partnership interests offered to investors represent undivided interests in the partnership property. Limited partnership interests may, subject to a solvency requirement, be redeemed in accordance with the provisions of the partnership agreement.

Advantages. Limited partnership structures arguably offer more flexibility than the exempted company structure.

Disadvantages. The limited partnership structure does not have the benefit of separate corporate personality.

Unit trust structure

The unit trust is established by declaration of trust and a trust deed (together, the Trust Deed), under which a trustee issues units of beneficial interest. The trustee holds legal title to the underlying assets on trust (for the benefit of unitholders) and each unit represents an undivided fractional interest in the trust property. The trust is subject to the provisions of the Trusts Law and case law. The Trust Deed sets out all powers and duties of the trustee and beneficiaries' rights, including provisions regarding the transfer and redemption of units. All dealings with the trust property are effected by the trustee or by its delegate.

Advantages. The unit trust structure arguably offers more flexibility than the exempted company structure.

Disadvantages. The unit trust structure does not have the benefit of separate corporate personality.

25. What are the advantages and disadvantages of using onshore and offshore structures?

Onshore

Advantages. Not applicable.

Disadvantages. Not applicable.

Offshore

Advantages. See *Question 15*.

Disadvantages. See *Question 15*.

Tax treatment

26. What is the tax treatment for hedge funds?

Funds

Cayman Islands hedge funds are not subject to any income, withholding or capital gains taxes in the Cayman Islands.

An exempted company can apply for a tax undertaking, to be granted on behalf of the government for not more than 30 years (in practice, the undertaking is normally given for 20 years), that from the date the tax undertaking is issued:

- No law enacted in the Cayman Islands, imposing any tax to be levied on profits, income, gains or appreciations, will apply to the company or its operations.
- No tax to be levied on profits, income, gains or appreciations, or which is in the nature of an estate duty or inheritance tax will be payable either:
 - on or in relation to the shares, debentures or other obligations of the company;
 - by way of withholding, in whole or in part, on any dividend payment or other distribution of income or capital.

An exempted limited partnership can apply for a tax undertaking, to be granted on behalf of the government for not more than 50 years, that from the date of the tax undertaking:

- No law enacted in the Cayman Islands, imposing any tax to be levied on profits, income, gains or appreciations, will apply to the exempted limited partnership or to any partner, in relation to the operations and assets of the exempted limited partnership, and partners' interests in the exempted limited partnership.
- Any of the above taxes, or any tax in the nature of an estate duty or inheritance tax, will not be payable in relation to the obligations of the exempted limited partnership or partners' interests.

An exempted trust can apply for a tax undertaking, to be granted on behalf of the government for no more than 50 years, that from the date of the creation of the exempted trust no law, enacted in the Cayman Islands with a view of imposing any tax or duty on income or on capital assets, gains or appreciations, or any tax in the nature of estate duty or inheritance tax will apply to:

- Any trust property.
- Any income arising under the trust.
- The trustee(s) or unitholders in relation to any of such property or income.

Resident investors

Resident investors are not subject to any income, withholding or capital gains taxes in the Cayman Islands in relation to their equity interests in a Cayman Islands investment fund and dividends received on those equity interests. In addition, they are not subject to any estate or inheritance taxes in the Cayman Islands.

Non-resident investors

The tax treatment in the Cayman Islands that applies is the same as for resident investors (*see above, Resident investors*).



Restrictions

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

Redemption of interest

The provisions that apply are the same as for open-ended retail funds and closed-ended retail funds (as applicable) (see *Question 10*).

Transfer to third parties

The provisions that apply are the same as for open-ended retail funds and closed-ended retail funds (as applicable) (see *Question 10*).

Reform

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

Master fund registration

The Mutual Funds (Amendment) Bill, 2011 (Bill) has been passed by the Cayman Islands government and is expected to come into force before the end of 2011. The Bill requires the registration with CIMA of certain Cayman Islands master funds.

Master funds not affected. Importantly, not all master funds will be required to register with CIMA:

- The Bill will only capture Cayman Islands master funds which issue equitable interests which are redeemable at the option of the feeder fund, therefore a master fund which allows redemptions only with the directors' or general partners' consent will not require registration.
- A "master fund" is defined in the Bill as a mutual fund incorporated or established in the Cayman Islands that both:
 - holds investments and conducts trading activity;
 - has one or more regulated feeder funds.

Therefore a master fund where the feeder fund is not regulated by CIMA will not itself be required to register with CIMA.

- Master funds incorporated or established outside of the Cayman Islands will not be required to register with CIMA.
- Intermediate funds that do not hold investments or conduct trading activity but instead pass such investments through to a master fund will not be required to register with CIMA.
- A "regulated feeder fund" is defined in the Bill as a regulated mutual fund that conducts more than 51% of its investing through another mutual fund. Therefore master-feeder structures that have several master funds (including certain fund platforms) where the investment into any one master fund is less than 51% of its investing, will not be required to register with CIMA.
- Closed-ended private equity funds will not be subject to the registration regime.

Affected master funds. The master funds that will be affected are those mutual funds that are incorporated or established in the Cayman Islands that both:

- Hold investments and conduct trading activity.
- Have one or more regulated feeder funds.

This definition includes mutual funds which issue equitable interests that are redeemable at the option of the feeder fund.

How to register. The registration process will involve the filing of a certificate of incorporation and a new MF4 form as well as the payment of an annual fee of about US\$3,000. No separate offering document will be required for the master fund, and where the auditor and administrator of the master fund are the same as for the corresponding regulated feeder fund, a separate letter of consent will not be required.

When to register. The procedure for registering the master fund will be straightforward, and the Bill requires existing master funds (which are registrable) to register within 90 days of the commencement of the new law. There is a provision for this period to be extended by the Cayman Islands government for a further 60 days if required. New master funds will be required to register with CIMA before commencing activity.

Continuing obligations to the CIMA. Master funds will be required to file with CIMA audited financial statements, signed off by a local auditor, within six months of its financial year end and pay the annual fee.



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Recent transactions

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- Advising China-based fund manager on the establishment and launch of a private equity fund to invest primarily through direct or indirect investments in privately held growth companies in the Chinese "Cleantech" and renewables sector.
- Advising on the establishment and launch of a number of private equity funds and special situations funds for large acquisitions and private equity investments.

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