

## III Benefits of establishing a fund in the Cayman Islands

BY MUAZZIN MEHRBAN



The attraction of offshore funds in locations like the Cayman Islands stems from their provision of regulated, tax neutral and flexible investment vehicles, allowing for capital from various countries to be pooled together for deployment. These vehicles provide all the benefits of corporate vehicles, including the ability to limit the liability of their investors, without incurring an extra layer of tax. “Other than the modest annual fees paid to the government and the regulator, there is no additional tax burden arising from the use of a Cayman Islands entity,” says Tim Clipstone, a partner at Harnes. “It is therefore ideally suited for use in collective investment schemes, as the scheme itself can benefit from being a corporate entity without imposing a large tax cost on the structure.” Of course, having a fund based in the Cayman Islands does not mean that investors in these structures do not pay tax – the fund pays any transactional and other relevant taxes in the jurisdictions in which it trades and an investor pays tax in their home jurisdiction on the profits from the fund when they receive or are deemed to receive them under their home jurisdiction’s tax laws.

The fund formation procedure that must be adhered to in the Cayman Islands depends on numerous factors. “This includes the type of legal entity that is being used – whether corporate, partnership or unit trust – and whether it will be open-ended or closed-ended,” states Bryan Hunter, a partner at Appleby. “Closed-ended funds are not subject to regulation in the Cayman Islands. On the other hand, open-ended funds are subject to regulation by the Cayman Islands Monetary Authority (CIMA), unless they satisfy an exemption that applies to a fund that has no more than 15 investors, a majority of whom are able to appoint or remove the operators of the fund.” Before an open-ended fund, such as most hedge funds, can begin to trade and make profits or even take in investor money, it must first register with CIMA. Firms are required to file an offering document, statutory particulars, and a letter of consent from the proposed auditors and administrators of the fund together with the requisite fee to CIMA. Generally, Cayman based hedge funds and administrators are subject to regulation under the Mutual Funds Law (MFL) and Cayman investment managers are subject to regulation under the Securities In-

vestment Business Law (SIBL). In certain circumstances, exemptions from requirements to obtain full-blown licences are available. Only in very limited cases are activities fully exempt from the regulatory regime.

Offshore financial centres like the Cayman Islands have different principles governing the relationship between fund managers and their investors, depending on the structure of the fund. In a conventional corporate structure, a manager’s investment powers are derived from the directors of the fund. As such, the formal relationship is between the manager and the fund and not the manager and the investors, as shareholders, in the fund. Shareholder claims against management would only really be possible if brought forward by the fund itself. But past cases show that claims are often unsuccessful. “This is different in a limited partnership arrangement, where the manager, or an affiliate, usually acts as general partner to the limited partnership and the investors are the limited partners,” says Mr Clipstone. “The terms of the limited partnership agreement govern the role and scope of powers of the general partner and provide the basis for any claim by investors against the general partner.”

Cayman has also been doing its part to rise to the challenges facing the world economy in reviewing and improving its legislative framework. Effective 1 March 2009, changes to the Companies Law came into effect. The changes both preserve established principles of Cayman insolvency law, clarifying some historical areas of uncertainty and enhancing provisions which encourage good corporate governance. Richard Addlestone, a partner at Walkers, says “The changes to the Companies Law go a long way in improving practices and procedures, bring the law into line with international practice and, by introducing new criminal offences, provide fresh tools to protect creditors and investors against fraud. This is all part of Cayman’s ongoing commitment to be a responsible member of the financial community.”

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**Fund structures and transparency issues**

Experts suggest the last few months have been a tough test for fund structures because of the lack of liquidity in current financial markets. This has put more strain on managers operating funds out of the Cayman Islands, who are now looking for ways to improve the structure of their funds. According to Mr Addlestone, there are the usual traditional methods. "A fund can be established as a master feeder structure. This simplifies matters at a trading level, as often only one trading platform or bank account is required. Onshore and offshore investors 'feed in' to the master via separately established vehicles," he explains. "In addition, provisions can be made for issuing multiple classes of shares to which fund managers can dictate that different rights, fees or investment strategies apply." Methods used to deal with liquidity issues include changes to redemption gating language, changes to the language that allows redemptions-in-kind, and changes to the language that allows suspensions of the determination of NAV and redemptions. Funds are also looking

to permit the creation of side pockets, allowing for less liquid assets to be dealt with separately.

While optimising structures is a key part of maximising tax benefits in the current downturn, governments around the world are looking to recover, through taxation, the large sums spent shoring up their domestic economies. "Their current rhetoric is indicating this may lead to pressure on those who have structured themselves efficiently in the past to eschew the offshore structures they have created and pay more tax in their home jurisdictions," says Mr Clipstone. "Whether this will remain as rhetoric or will take the form of more direct action remains to be seen." In the US, as part of the TARP legislation, there have already been revisions the tax regime so that additional tax revenues can be sourced from US managers operating alternative investment structures and more is being proposed by certain legislators.

The issue of fund transparency is also on the political agenda, and the outcome could affect the Cayman Islands. On both sides of the Atlantic there is a general consensus that more regulation of hedge funds and their managers is required. It has also been suggested in some circles that greater disclosure should be imposed on offshore funds. However, it is not clear what form additional regulation will take. For example, the alternative investment industry, in light of the current crisis, could be forced to move away from self regulation and be governed by a supervisory model. In addition, there have been discussions among the G20 nations about possible sanctions against 'tax havens' that do not agree to provide sufficient transparency on tax matters, so as to enable the G20 countries to better combat tax evasion by their respective citizens. Although the Cayman Islands should not fall into this category, a knee-jerk political reaction could have consequences for offshore centres collectively. But despite the pressures on offshore funds to increase their transparency, local professionals say we are unlikely to see a requirement to make public the identity of investors, despite media speculation suggesting this could be the case.

As it stands, there is currently little information on funds, managers and performance returns publicly available in the Cayman Islands, since the structures are private investment vehicles. However, all regulated funds are required to submit a Fund Annual Report (FAR) which provides annual information regarding their financial status and trading activities to CIMA. The Cayman Islands is also in the process of adding to its tax information exchange agreements, which currently include reciprocal agreements with the United States and the

seven Nordic countries in order to facilitate tax investigations into deliberate tax evasion by residents of those countries. For the future, there is discussion in the industry as to how further transparency could be aided. These moves are continuing the Cayman Islands' transition towards a more transparent financial centre.

The requirement for greater transparency could affect key aspects of funds including structure, size and investment positions. Suggested changes to the SIBL, which regulates activities of managers in the Cayman Islands, could see fewer managers registering as exempted persons. The new legislation could see managers become more exposed to client action if they have not undertaken their responsibilities. As such, risk management techniques will become more important to reduce the threat of lawsuits. "The AIMA and the MFA, which are both industry associations for the hedge funds industry, produce from time to time best practice guides for managers and hedge fund boards to follow in this area," says Mr Hunter. "The Asset Managers' Committee established by the President's Working Group on Financial Markets has also recently produced a report outlining best practices in relation to various areas, including risk management." Following such guidelines could prevent firms from future litigation and fines. In addition, risks of legal action can be reduced by understanding and complying with the Island's legal codes. Providing more information to investors regarding the risks of investment is important of itself, especially when investments are leveraged and higher levels of disclosure also serve to mitigate the risk of claims made by investors.

The hedge fund industry has traditionally been entrepreneurial and managers have operated at relatively low cost and adhered to lighter regulations. Mr Clipstone thinks the industry is set to undergo a major split, with funds taking different stances depending on their size. "Medium sized and large managers will have to become more institutional in their approach. They will need to spend more time designing their fund, disclosing and sticking to their strategy, ensuring manager and fund compliance with regulation and anti-money laundering requirements, and demonstrating that they are doing these things. Inevitably, this will lead to an increase in back-office costs, reducing the profitability and agility of the fund."

Yet Mr Clipstone believes that smaller funds may not have to adapt to the same extent. "Smaller managers may still be able to navigate below the full burden of regulation and maintain their entrepreneurial culture," he says. "But this model will not be very scalable. ►►

If any real size is to be achieved the entrepreneur manager will have to gear up to meet both the regulatory burden imposed on him by on and off shore regulators and the transparency requirements of institutional investors." Furthermore, in support of regulation, enhanced disclosure in specific areas could also be on the horizon, according to Mr Hunter. "Another area in which additional regulation may be introduced is in relation to certain types of investment strategies or investment instruments that hedge funds use frequently, such as short sales and credit default swaps. There appears to be a desire, particularly within Europe, to introduce regulation in this area," he says. Strategies such as short selling financial stocks have in the recent past been suspended by governments seeking to reduce volatility within their markets, with little apparent effect, but such decisions made onshore can have severe knock-on effects for activity offshore, with many funds suffering due to the suspensions.

The future of offshore hedge funds is not only tied to the impact of regulation, however, but is also intrinsically tied in to the appetite of onshore investors to make or maintain broad investment portfolios. Net assets of funds have fallen substantially in the last year. "The hedge funds industry will not rebound until such time as those investors decide to redeploy their capital," thinks Mr Hunter. "Even then, the ex-

tent to which they will invest in hedge funds is uncertain, given the recent performance of hedge funds and the calls for greater regulation of hedge funds. Although the timing of the recovery is anyone's guess, I do believe that we will see a resurgence in hedge fund formations, but perhaps not to the extent of the new fund formations that occurred during the two years prior to the recent downturn." Offshore funds could be at the forefront of a revival because of the speed and cost effectiveness of establishing operations there.

Such pressures mean the next 6-12 months will see managers concentrating on restructuring their offerings. The more optimistic managers may seek to start funds at this point in the markets believing the market has reached the bottom. Experts feel that despite the overall gloom, there is some cause for optimism. Statistics for Cayman show that registration of new hedge funds has slowed but a large number of new funds are still being registered. The rate of hedge fund terminations has also slowed and seems to have steadied.

In the current crisis, managers of private equity funds are not so much making deals as trying to save them. Mr Addlestone says, "Private equity houses are looking at how to deleverage and reorganise the deals completed at the peak of the market so as to get back into the black. It is fortuitous timing that Cayman is shortly

to make further changes to its Companies Law to permit Delaware style mergers and consolidations of companies, which are key tools to restructuring experts. Currently, such transactions can only be effected by complex and time consuming schemes of arrangement. If these new provisions are enacted quickly, this would show Cayman responding in real time to the needs of the investment world and further enhance its reputation".

In general though, analysts expect fewer funds to be formed than at the industry's peak, with all but the smallest of funds being subject to more regulation. This will, in turn, raise the barriers to entry, resulting in greater critical mass requirements to create a viable fund. The entrepreneurial approach to offshore investments will be restricted and replaced by a more institutionalised one. Firms still harbour vast amounts of cash on their balance sheets, which require investing in order to obtain returns. Despite undergoing wholesale changes, the Cayman Islands investment fund industry will continue to play a key role throughout the financial crisis. That said, experts are concerned about the negative propaganda flying around at the moment. They argue that offshore funds are crucial in the fight to restore the global financial economy and that rising criticism of offshore fund centres is blatant politicking that will be ineffective in solving the crisis. ■



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Bryan Hunter is a Partner and the Corporate and Commercial Practice Group Head in Cayman. He has extensive experience in the structuring and formation of hedge funds, funds of funds and private equity funds and regularly advises on various operational and regulatory issues in relation to these funds. His practice also includes general corporate matters, project finance, corporate finance and merger and acquisition transactions.

In 2007, IFLR1000 described Bryan as follows, "Bryan Hunter is admired by clients for his international perspective". "These guys (Putterill and Hunter) are on a par with senior partners at

any European or US firm".

Bryan has been ranked by PLC Which Lawyer? as a Recommended Lawyer for Investment Funds (2009); for Corporate/ M&A (2007 & 2008); and for Private Equity/Venture Capital (2008). He has also been noted as a Leading Lawyer for Corporate/ Commercial in IFLR1000 (2007).

Bryan was admitted as an Attorney in the Cayman Islands in 1997. He is a Notary Public in the Cayman Islands, and a member of the Board of the Civil Aviation Authority, the Cayman Islands Law Society, the Caymanian Bar Association, the Managed Funds Association and the Insurance

Managers Association of Cayman. He is currently serving as a member of the Financial Services Council. This is a working group established to assist the Cayman Islands government in devising strategies and policies to address international developments affecting the financial services industry.

Bryan has served as a Council Member of the Chamber of Commerce where he chaired various committees. He is also the immediate past President of the Caymanian Bar Association. Bryan has contributed to various legal publications including Legal Week and the Cayman Financial Review.