

PRACTICAL ADVICE FOR DIRECTORS AND PROMOTERS OF CAYMAN ISLAND FUNDS

CONTENTS

PREFACE	1
1. Introduction	2
2. Who should be a Director?	2
3. Director Registration and Licensing	3
4. Establishment	3
5. Ordinary Course of Business	4
6. Crisis Management	5
7. Conclusion	6

PREFACE

The judgment in *Weaving Macro Fixed Income Fund Limited (In Liquidation) v Peterson and Ekstrom* (2011) that was delivered at the end of August 2011 has refocused the offshore hedge fund industry on the role of directors of offshore hedge funds.

This guide draws on aspects of the judge's commentary in *Weaving* and existing good corporate governance guidelines issued by the hedge funds industry¹ to provide investment managers and directors of hedge funds with practical guidance and questions that directors should be asking to ensure that they are going as far as they can in order to fulfil their duties.

We recognise that this Guide will not completely answer detailed questions which clients and their advisers may have; it is not intended to be comprehensive. If any such questions arise in relation to the contents, they may be addressed to any member of the Corporate Department, using the [contact information](#) provided at the end of this Guide.

Appleby

Cayman Islands

January 2015

¹ The "Offshore Alternative Fund Director's Guide" issued by the Alternative Investment Management Association in 2008 (the **AIMA Guide**).

1. INTRODUCTION

Weaving Macro Fixed Income Fund Limited (In Liquidation) v Peterson and Ekstrom (2011)

In this case the directors were found guilty of wilful default in the discharge of their duties and they were ordered by the Court to pay significant damages to the fund's liquidators, representing the losses suffered due to their default. As at the date of the publication of this note, an appeal against the judgment has been filed, but the grounds have not been made public.

The facts as found in *Weaving* were extreme; the judge found that the directors had subordinated their judgement to that of the investment manager and had not exercised any meaningful supervisory role at all. At the same time, and by way of contrast to his commentary on the facts in this case, the judge affirmed good corporate governance principles.

A director's duty to ensure corporate governance mechanisms are in place and the duty to act in the best interests of the fund are rooted in long standing principles of English common law and equity. The duties of a director fall into two broad groups: the duties of loyalty, honesty and good faith (known as fiduciary duties), and the duties of care, skill and diligence. In practice, corporate governance for a fund requires the board of directors to be in close consultation with the investment manager. In *Weaving* the liquidator of the fund did not allege that the directors had breached their fiduciary duties, but rather that they had acted in breach of their duties of care, skill and diligence.

2. WHO SHOULD BE A DIRECTOR?

There are many independent professional director service providers based in the Cayman Islands, including Appleby Fund Services, who are able to provide independent directors and corporate secretarial services for investment funds. When deciding on the makeup of a board of directors of a fund, a promoter should consider the following:

- What other interests a director has in the structure of the fund and its advisers. A connected person (for example a principal of the investment manager) may want to consider either not sitting on the board or making sure that they are in a minority position. This reduces potential conflicts of interest.
- A director should have sufficient and relevant knowledge and experience to carry out his duties as a director.
- A director should have sufficient time to carry out those duties and that should be reflected in his remuneration.
- While there is no requirement to be able to understand details of the trading strategies of the fund, a director does need to have a proper understanding of financial statements and be able to review balance sheets and reports provided. A director who is also a member of the investment manager is likely to be held to a higher standard on the basis of his particular skills with regard to the investment strategies being employed by the manager on behalf of the fund.
- It is up to directors to acquire and maintain sufficient knowledge to enable them to carry out the role. Directors should use the advisers of the fund to provide advice on any areas of which they are unsure.
- Even if directors are also employees or principals of the investment manager or any other connected party, their director duties remain unchanged and they should ensure that they are wearing the right "hat" when turning their minds to the fund's affairs and be aware of actual and potential conflicts of interest.

In *Weaving*, the judge divided the life of a fund into three distinct phases when examining the performance of the directors, namely: Establishment, Ordinary Course of Business and Crisis Management. Much of what the judge said is merely commentary rather than part of his findings, but it shows how the conduct of a board of directors is likely to be viewed if it is judicially considered.

3. DIRECTOR REGISTRATION AND LICENSING

The Directors Registration and Licensing Law, 2014 imposes registration obligations on directors of registered mutual funds and companies licensed under the SIB law (Covered Entities). "Professional Directors," being individuals holding directorships of 20 or more Covered Entities, are required to apply for a licence under the law. The licence fee for a Professional Director is US\$3,660. Corporate directors holding directorships over a Covered Entity must also be licensed and the fee for a corporate director is US\$9,756. Only where a Professional Director is also a director, employee, member, officer, partner or shareholder of (i) a company which holds a Companies Management Licence or a Mutual Fund Administrator's Licence in the Cayman Islands, or (ii) a Fund Manager that is registered or licensed by a specified overseas regulatory authority and such director appointment arises by virtue of the relationship with the Fund Manager, will the Professional Director be excluded from the requirement to obtain a licence under the law. All other natural persons who are directors of Covered Entities and Professional Directors who are excluded under the circumstances noted above will need to be registered (as opposed to licensed) under the law. The registration fee is US\$854 per director.

4. ESTABLISHMENT

- 4.1 Directors must satisfy themselves that the overall structure of the fund and the terms of service provider contracts (in particular those relating to the determination of NAV, remuneration, indemnification and limitation of liability) are reasonable and consistent with industry standards and to the extent that they are not, that there are reasonable reasons for the divergence. Where a fund structure or service provider agreement is not standard, then this would definitely be a matter for disclosure in the relevant offering document.
- 4.2 Directors should find out what service providers will, and will not be doing for the fund and ensure that delegation and the division of responsibilities is appropriate. For example, the directors should ensure that responsibility for calculating NAV, anti-money laundering compliance, maintaining accounts, preparing management accounts and preparing financial statements is split appropriately between the investment manager and the administrator.
- 4.3 As a practical matter, the role of independent directors is slightly different in that they won't be expected to be involved in detailed negotiations with service providers. However, when taking on a role as independent director, it would be sensible to ask that before any agreements are signed, that the manager or whoever is negotiating them lets the counterparties know that the independent directors will want to review them and approve them and may have comments or questions before doing so.
- 4.4 Directors are responsible for the contents of the offering document of the fund. As such they should ensure that the offering document is accurate and not misleading on launch and on an on-going basis. In the case of a Cayman registered mutual fund, they should be satisfied that the offering document describes the equity interests in all material respects and provides such information as is necessary for an investor to make an informed decision on whether or not to purchase the equity interests². Directors can't simply rely on the fact that the document has been prepared by reputable advisers, but should enquire as to what

² s4(6) of the Mutual Funds Law (as amended)

sort of verification exercise has been undertaken in relation to various aspects of document and satisfy themselves that it has been properly done.

- 4.5 If the appointment of a service provider is approved in resolutions, for example the auditor, then directors should make sure that the appointment actually happens and ask to see a copy of the appointment letter. For example, an auditor will be appointed annually and if this appointment has been delegated to the investment manager, the directors should ensure that the terms are consistent with industry practice.
- 4.6 If an item has been delegated to a single director to approve, for example, a final draft of an agreement or the final draft of the offering document, the directors should ensure that there is a process in place to circulate final documents to all of the board members and consider noting this as having been done at a subsequent meeting.
- 4.7 At the establishment stage, when considering their duties to act in the best interests of the fund, the directors should be thinking about potential investors.

5. **ORDINARY COURSE OF BUSINESS**

- 5.1 The directors perform a high level supervisory role. The very nature of an offshore hedge fund means that directors are non-executive and investment management, administration and accounting functions are delegated to third parties. This is acceptable but in the words of the judge in *Weavering*, “they are not entitled to assume the posture of automatons”. Simply to sit back after delegation of a role to a service provider and assume it is being done properly is not acceptable. Directors are not absolved from performing their duties and must supervise the discharge of any delegated functions.
- 5.2 Directors should hold regular board meetings. Board meetings should be held sufficiently frequently so that the board is able to carry out its role effectively. The frequency of meetings will depend on the nature of the fund and the circumstances. If market or other conditions require it, directors should consider if an extraordinary meeting is necessary (see “Crisis Management” below).
- 5.3 Agenda and underlying documents should be circulated before formal meetings with sufficient time for review of both. An agenda should reflect input from the investment manager, administrator, directors and any other relevant party.
- 5.4 Directors should not approve resolutions or board minutes which refer to documents that they have not reviewed or discussions that have not been had.
- 5.5 Detailed board minutes and minute books should be kept for all board meetings that are held. These should fairly and accurately record the matters which were considered and the decisions which were made. Discussions do not need to be recorded in detail, but should be summarised, at least to the extent necessary for the reader to understand the basis upon which the decisions were made.
- 5.6 Directors should keep evidence of enquiries made to service providers, such as emails or records of telephone conversations that take place outside of board meetings.
- 5.7 Directors should ensure that a minute book is kept and that copies (at least) are sent to Cayman counsel and the registered office in Cayman. For funds or directors based in some jurisdictions, to have the minute book offshore might be important from a tax perspective to avoid the fund’s management being “brought onshore”.
- 5.8 If using written resolutions for significant decisions, the directors should ensure that these detail the scope of enquiry made in relation to a particular issue rather than simply “noting” that something has been done. For example, if the investment manager has provided reports or detailed advice, the directors should

provide a summary of the review that they have carried out and if necessary a summary of the advice and append a copy of any reports.

- 5.9 Directors are responsible for ensuring that the financial statements of the fund give a true and fair view of the fund's state of affairs at the end of the year. This is not altered by any delegation of account preparation to the administrator or the investment manager.
- 5.10 As directors may be required to provide a letter of representation to the auditors, they should review the accounts and may wish to seek similar representations from those to whom they have delegated powers (and consider including this as an obligation in the relevant service contract).
- 5.11 The board should require regular reporting from the investment manager to ensure that investments of the fund continue to be made within the relevant investment parameters and restrictions set out in the offering document and the investment management agreement. This should be done at least at every board meeting and possibly more frequently, for example in line with redemption frequency.
- 5.12 The board should ask the investment manager to provide copies of management accounts at least as frequently as redemption frequency if not monthly.
- 5.13 The board should ask questions of all service providers; require reports and documents to be provided regularly or in special circumstances. For example, the board should require the administrator to regularly update the board either by report or attendance at a board meeting as to, among other things, AML compliance, changes in pricing sources, pricing problems, deviation from standard procedures.
- 5.14 In addition to regular management or other accounts and reports, the board should also ask for copies of all documentation that is sent to investors or regulators by the investment manager or the administrator.
- 5.15 Directors should find out how the audit is carried out and what the timing is. All registered funds have at least six months from their financial year end to finalise their audited financial statements and to file them with the Cayman Islands Monetary Authority. Directors should ensure that they are provided in plenty of time for them to review them and ask any relevant questions. For a fund of funds, for example, this is particularly important because it might not be possible to finalise the audit until very late in the six month period.
- 5.16 Side letters – although these are common, if the fund is a party or undertaking to carry out certain actions, then the directors should review them and be comfortable with their terms from a commercial perspective. For example, if the side letter imposes extra investment restrictions, can these be carried out and does agreeing to them impact on the rest of the strategy as reported to investors? It is not enough to simply know that legally they can be entered into by the fund. If the investment manager has been given delegated authority to negotiate and execute side letters on behalf of the fund, this should form part of the regular reporting to the board and the scope of such authority should be agreed.

6. CRISIS MANAGEMENT

Throughout the life of the fund, directors should be proactive in ensuring that the investment manager is required to provide information on an ad hoc basis which might require urgent action by the board. In addition to standard regular reporting requirements, the directors should be asking the investment manager or any other relevant service provider whether there is anything that should be brought to the attention of the board. A non-exhaustive list of the types of things that would fall under this heading are:

- if there is any actual, pending or threatened litigation against the fund;
- if there are any disputes with investors or counterparties that would fall short of actual litigation;
- if redemption requests are likely to have a considerable impact on any dealing day;

- if accepting subscriptions in respect of ERISA/pension assets are likely to have an impact on current investors;
- if market or other conditions are having or are likely to have a material impact on the trading strategies of the fund;
- if there is any significant counterparty risk for over the counter transactions;
- if there are large redemptions, which could destabilise/affect the liquidity of the fund; and
- if there is any move away from the investment strategy or restrictions set out in the relevant offering documents.

When a fund finds itself in difficulties, the directors cannot sit back and assume that other service providers, and in particular the investment manager, will rescue the fund without significant oversight from the directors. In *Weaving*, the judge stated that the actions of the directors in the circumstances following the collapse of Lehman Brothers in September 2008 provided “the most compelling evidence that they never intended to perform their duties as directors”.

The AIMA Guide sets out the following as primary heads of responsibility for the board of directors of an offshore fund which serves as a useful worklist for any director to consider.

- Reviewing investment performance
- Monitoring adherence to investment policy and restrictions
- Monitoring NAV calculation
- Monitoring marketing and investor relations
- Monitoring anti-money laundering responsibilities
- Reviewing the appointment and performance of service providers to the fund
- Provision of information to shareholders
- Compliance with listing rules (where appropriate) and all on-going obligations
- Reviewing and understanding side letters
- Approval of offering and constitutional documents
- Exercising discretionary waiver powers
- Ensuring governance between formal board meetings
- Use the fund’s advisers appropriately and in a timely manner

7. CONCLUSION

The judgment in *Weaving* has shown that good corporate governance is no less important for an offshore hedge fund than for a company listed on a major stock exchange. Directors must strive to ensure that their role does not become a “tick-box” function and that they are fulfilling their high-level supervisory role in a manner that is consistent with the expectations of the court in *Weaving*.

This decision may require some independent director service providers to re-evaluate aspects of their business models and standard practice. While any changes made may have an impact on fees, investors and investment managers should welcome this as a positive development. Given the enhanced focus of investors on protection mechanisms such as an experienced and professional independent board, we could well see a concerted trend for funds increasingly to employ the services of independent directors who do meet these standards, especially in a market where fundraising presents many challenges.

For more specific advice on *Weaverling* and hedge funds in the Cayman Islands, we invite you to contact one of the following:

Cayman Islands

Jeremy Walton

Partner, Group Head, Cayman Islands
Dispute Resolution
+1 345 814 2013
jwalton@applebyglobal.com

Bryan Hunter

Managing Partner, Cayman Islands
Corporate
+1 345 814 2052
bhunter@applebyglobal.com

For the convenience of clients in other time zones, a list of contacts available in each of our jurisdictions may be found [here](#).