

Cayman Islands hedge funds

Jonathan Culshaw gives an introduction to the Cayman Islands as a domicile for hedge funds

By Jonathan Culshaw, Partner, Harney Westwood & Riegels

2008 proved the ultimate stress test for all kinds of investment methodologies and asset allocations. Many hedge funds suffered severe crises of liquidity and required major restructuring, some suffered major losses as a result of strategy failure or investing in the Madoff Ponzi scheme, but when the dust had cleared it became apparent that as a class hedge funds had continued their outperformance when compared to more highly regulated retail funds adopting simpler and supposedly less risky methodologies¹. Hedge funds are here to stay because hedge funds work.

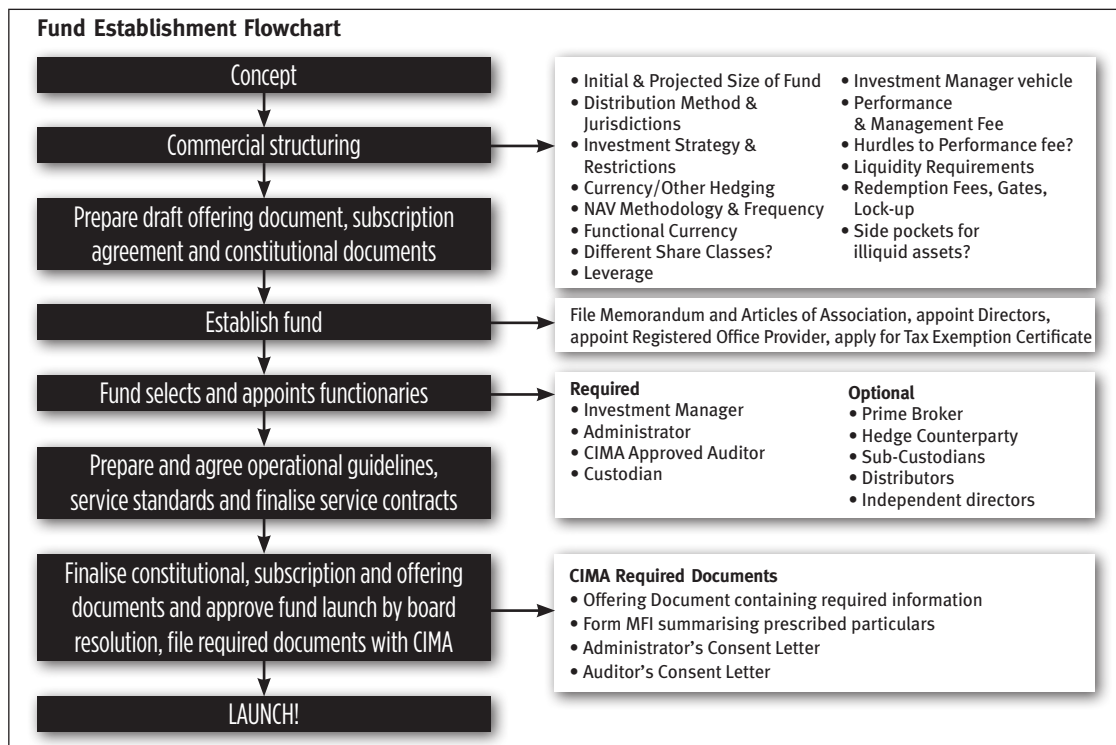
with AUM dwarfing competitors as many Cayman funds are amongst the largest established. Reasons for Cayman's pre-eminence as an offshore funds jurisdiction are set out below.

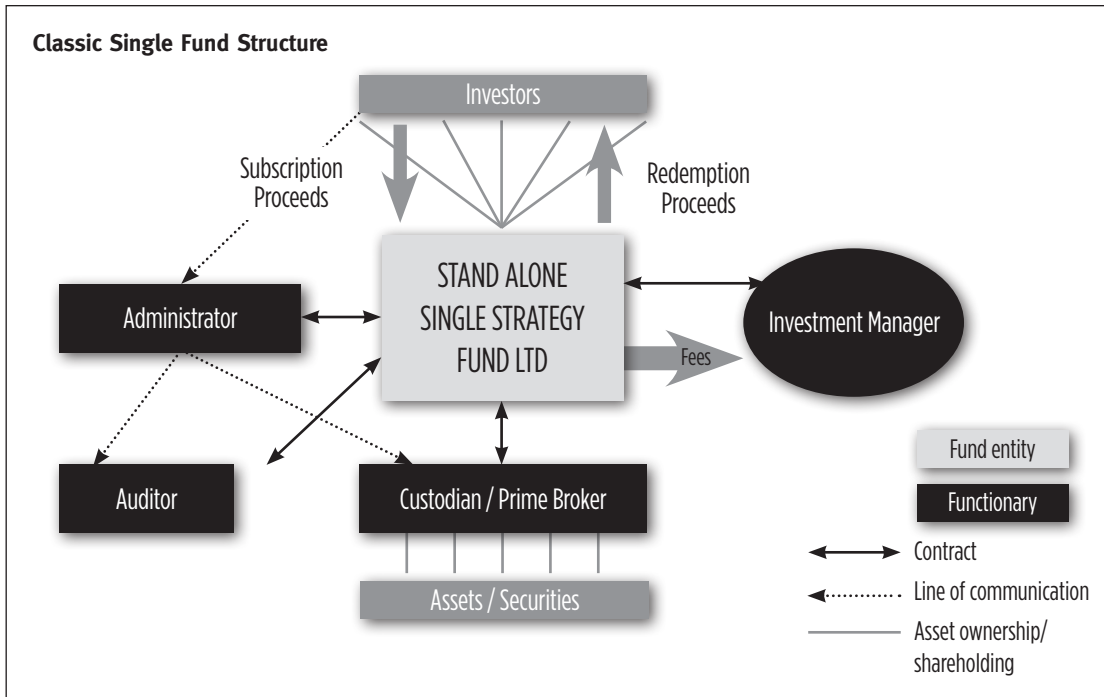
The Cayman Islands is a stable common law jurisdiction where bonafide contractual relations are not generally subject to judicial or governmental interference. Funds can be established and registered quickly and the Cayman Islands does not seek to impose material conditions on the terms of securities offerings by open-ended funds to non-retail investors.

General advantages of Cayman as a fund jurisdiction

The Cayman Islands is the jurisdiction of choice worldwide for the establishment of offshore open and closed-ended funds. In the case of open-ended funds, Cayman has three times as many funds as the second largest offshore jurisdiction for funds (BVI)

There is no limit to the asset classes which a fund can acquire or to the leverage it may employ. The service provider pool is deep, and in particular the leading law firms field experienced lawyers, many with top tier onshore experience, who appreciate the need for diligence and the rapid closure of transactions. Cayman has full membership of IOSCO² and has been commended by the IMF for having





a strong compliance culture in relation to anti-money laundering requirements. With the signing of a 12th tax information exchange agreement in August 2009 Cayman is on the OECD’s whitelist of countries complying with the global standard for tax cooperation and exchange of information.

Setting up a Cayman hedge fund

This note is intended to provide a brief road map for Sponsors looking to establish a stand alone corporate Cayman Islands hedge fund (the **Fund**). It therefore assumes that the Fund will not be set up as a retail or a closed-ended fund but will offer redeemable equity securities to investors in minimum subscriptions of US\$100,000 or more in which case the Fund will qualify to be treated as a Registered Fund under Section 4 (3) of the Mutual Funds Law.

It is possible to set up a Registered Fund as an exempted company (the usual Cayman offshore corporate vehicle), a limited partnership or a unit trust. In practice most Registered Funds are set up as exempted companies limited by shares as, unless special considerations apply, this is the simplest vehicle to establish and administer and the one with which investors are most familiar.

Stage 1 – Commercial Structuring

Before instructing counsel a Sponsor should consider the proposed commercial terms of the Fund; what investment strategies and restrictions will be applied and in particular thought must be given to matching the asset base of the Fund to the liquidity being offered to investors. The recent market turmoil has thrown up many examples of funds with mismatched asset/liquidity terms with illiquid assets such as property interests being unable to support the cash required for investor redemptions.

The next key question will be the nature of the interests to be offered to investors. Should the Fund issue one class of shares or many classes with different fee structures, functional currencies or rights to separate pools of assets? How should performance and management fees be calculated?

An investment management vehicle should be selected and while there is no need for this entity to be a Cayman entity, investment managers advising Registered Funds are not subject to regulation under Cayman’s Securities Investment Business Law but qualify for an annual exemption so a Cayman company is often used. The adjacent flowchart shows just a few of the other issues that should be considered at this stage, but a good funds lawyer should be able to provide you with a Sponsor with a more exhaustive list of the issues that should be considered and provide guidance on any problematic areas.

¹ The Barclays Hedge Fund Index was down -21.63% in 2008, the S&P500 which outperforms most retail funds dropped -38.43%. In 2009 the Barclays Hedge Fund Index rose 23.74%.
² The International Organization of Securities Commissions, the principal global standard setting body for the regulation of securities market.

Stage 2 – Prepare draft documents

Once the commercial structure has been broadly agreed, a draft offering document should be prepared describing the shares in all material respects and containing such other information as is necessary to enable a prospective investor in the Fund to make an informed decision as to whether or not to purchase shares. Draft constitutional documents enshrining share rights and subscription agreements governing the terms on which investors will subscribe for shares and containing subscriber eligibility representations and anti-money laundering KYC requirements should also be prepared.

Stage 3 – Incorporation

The Fund can be established at this stage by filing a standard incorporation form with the Registrar of Companies and the Fund can request its tax exemption certificate guaranteeing freedom from all Cayman taxes for 20 or 30 years irrespective of any subsequent change in law.

Stage 4 – Functionaries

The Fund will need to negotiate terms with and appoint key functionaries. The Fund will ordinarily require at least two directors who will be responsible for overall supervision of the Fund although in practice day to day management is delegated to an investment manager.

There is no requirement for the directors to be Cayman residents and often officers of the investment manager will also act as directors but independent directors can be appointed to provide some level of oversight and assist in resolving conflicts which might arise between the investment manager and the Fund.

The key third party service provider to the Fund will be the administrator who will be required to be located in Cayman or another jurisdiction approved by the Cayman Islands Monetary Authority (CIMA) as having an equivalent anti-money laundering KYC regime. The administrator will be responsible, inter alia, for the calculation of the net asset value of the Fund, the processing of subscriptions and redemptions and the compliance with the AML requirements applicable to the Fund’s investors.

The Fund will also need to appoint one or more independent custodians and/or prime brokers and an auditor approved by CIMA to prepare and file accounts and submit other financial and operating information in respect of the Fund to CIMA through an e-reporting approved portal.

Stages 5/6 – Finalise documentation/agree operational guidelines

Commercial terms will need to be agreed and documents finalised and executed with functionaries but this is also the time for the investment manager’s staff to discuss and familiarise themselves with the actual operating procedures of the functionaries and in particular the administrator of the Fund.

Stage 7 – CIMA filing

The offering and constitutional documents are finalised, adopted and approved and the documents required to establish the Fund³ are filed with CIMA. Unlike retail funds where considerable diligence will be done on promoters and managers, in the ordinary course CIMA does not usually raise any issues on the documents filed for a Registered Fund and will normally issue a fund registration within five business days of filing. From this point the Fund may begin accepting subscriptions from investors as a registered Cayman fund.

	Name: Jonathan Culshaw Title: Partner Firm: Harney Westwood & Riegels Email: jonathan.culshaw@harneys.com Phone: +44 (0) 207 842 6085 Web: www.harneys.com
--	---

³ See flowchart