

Hedge Funds in the Cayman Islands

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Tim Clipstone investigates the establishment and regulation of offshore hedge funds in the Cayman Islands

The Cayman Islands is well known as a very popular domicile for hedge funds, having over 10,000 regulated funds, representing approximately 75% of the total number of offshore hedge funds currently in existence.

What is an 'offshore hedge fund'?

An offshore hedge fund is a type of investment fund established in a tax neutral jurisdiction such as the Cayman Islands.

Such funds are usually established by an investment manager or advisor to provide a structured investment product through which they can attract and manage investments by their clients. The investment manager will generally dictate the investments made by the fund and usually will act as promoter and distributor of the fund. It is common for managers to have funds established both onshore in their home jurisdiction and offshore.

Companies, limited partnerships and unit trusts are most commonly used as the legal entities for offshore hedge funds. The offshore entity acts as a collective investment pooling vehicle which invests the capital contributed to it in securities, investments or other assets according to the fund's disclosed investment strategy.

Investment funds broadly fall into two categories: open-ended funds and closed-ended funds. The terminology is used loosely and the definitions of each vary slightly between jurisdictions, but broadly a hedge fund is an open-ended fund with a continuous offering of shares which can be bought and redeemed at the fund's current net asset value with limited redemption restrictions, whereas closed-ended funds are used for venture capital or private equity-style funds which tend to have a limited

offering period, a time when no new investors can invest and restricted rights to a return of capital and profits before the closure of the fund.

In Cayman, only open-ended funds are regulated and subject to licensing or registration. This article primarily deals with open-ended funds.

Why offshore?

Offshore vehicles are used as investment funds because they do not pay tax on their profits and payments made by the funds to their investors are not generally subject to withholding or distribution taxes in the fund's home jurisdiction.

The sums paid to investors will, of course, remain subject to tax in the hands of the investors.

Offshore vehicles have the added advantage of providing an element of confidentiality for the promoters of the funds who do not want to disclose their client base to their competitors through public filings and to the investors who do not want to have their financial affairs available to the general public.

In some onshore jurisdictions it can be beneficial for certain types of entities to invest through offshore structures, as it legitimately provides a favourable tax treatment for the investments made by such entities.

How are investments made and redeemed?

Investments are usually accepted on the first day of each month and redemptions are paid on the last day of a redemption period, based on the net asset value of the fund on the applicable days.

The calculation of the net asset value of the fund, the processing of investments and redemptions and the handling of investment cash and redemption proceeds

are usually handled by an independent administrator.

Who is responsible for the day-to-day operation of the fund?

Ultimate responsibility for the management and operation of a fund rests with the directors, general partner or trustee of that fund, although they invariably delegate the day-to-day decisions and operation to the investment manager and an administrator.

How is the investor's cash safeguarded?

An investor's cash is usually paid into a bank account maintained by the administrator of the fund and then paid on to the custodian of the fund to acquire the portfolio of assets in which the fund is to invest. While the investor remains in the fund the assets representing their investment will generally be held by the custodian and traded as directed by the investment manager. When the investor chooses to redeem, the custodian will usually sell the underlying investments and pay the cash to the account maintained by the administrator of the fund, who would then pay the redemption proceeds to the investor direct on behalf of the fund.

What are the fees payable to the fund, the manager and administrator?

The fund will generally pay a management fee to the manager based on a percentage of the assets under management (i.e. the aggregate net asset value of the fund). This is usually between 0.5% and 2%.

The fund will also usually pay a fee which is determined by reference to the performance of the fund. A common fee for this has been 20% of profits achieved in the period above a previous high-water mark.

The administrator generally receives a fee based on the value of assets under administration. It is common for small funds or start-up funds to pay an agreed minimum, irrespective of the assets under administration.

It is common for the fund to also charge a redemption fee for early redemptions or redemptions on non-standard redemption dates. This can sometimes be payable to the manager.

What are common redemption terms?

There are a wide variety of redemption terms applied in funds. Common terms would be:

- > monthly or quarterly redemption dates
- > 30-90-day notice periods
- > 30-60-day payment periods
- > payments are often staggered so that the fund pays 90 - 95% initially, with an amount held back for subsequent adjustments, often until after the audit of the relevant period.

The redemption terms should always match the underlying liquidity of the fund's portfolio.

It is common to provide for the operator of the fund to have the discretion to waive or vary redemption conditions generally or for individual investors.

How are funds regulated in Cayman?

Hedge funds established in the Cayman Islands are subject to regulation by the Monetary Authority of the Cayman Islands (CIMA).

There are three categories of Cayman regulated funds: Licensed Funds, Administered Funds and Registered Funds. There is a fourth category of funds exempt from regulation.

Managers and administrators established in Cayman are also subject to regulation by CIMA, although many managers qualify for an exemption from licensing.

Managers, administrators and other functionaries and service providers to Cayman funds do not have to be established in the same jurisdiction as the fund to which they are providing services.

Is there a compensation scheme for investors?

No, CIMA does not operate any compensation or similar scheme for investors in funds regulated by them.



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