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Under the microscope: Cayman regulatory updates

With the introduction of the Cayman LLC, the EU Connected Fund in its final stages of approval and a general drive towards continued regulatory evolution, the Cayman Islands is putting itself just where it needs to be to support global fund managers in today’s regulatory environment.

By James Williams

The sign of any serious fund jurisdiction is its willingness to reflect on what it offers the global investment management community and find ways to evolve and bring new solutions to market. Whether they are regulatory changes, fund product changes or legal structuring developments, anything that demonstrates the willingness of a jurisdiction to respond to market dynamics is a fillip.

In this context, the Cayman Islands is moving in the right direction. The last 12 months have seen a number of developments that reflect its desire to adapt and remain the world’s leading offshore fund jurisdiction.

**AIFMD and third country passporting**

Last summer, ESMA concluded that it would complete its assessment of the Cayman Islands when the Cayman Islands’ New AIFMD Regime and other related steps had been implemented. This is now near completion.

The implementation of an AIFMD compliant regime provides a pragmatic opt-in solution for funds/managers who wish to avail themselves of, potentially, a more streamlined European distribution strategy.

“The forward-looking and pragmatic approach adopted by the Cayman Islands in this regard is just further evidence of its continuing position as the leading offshore jurisdiction, and its commitment to constant improvement and evolution regarding its product offering and regulatory regime in order to maintain its reputation as the pre-eminent offshore jurisdiction and the jurisdiction of choice for the funds industry.

“Our view is that the adaptations made to the funds law in the Cayman Islands to cater for this European option will be positively received by clients and intermediaries,” comments Aaron Walker, Senior Associate at Stuarts Walker Hersant Humphries.

The Mutual Funds Law was revised primarily to introduce the concept of an “EU
offshore jurisdictions like the Cayman Islands. However, the actual effect appears to be that the AIFMD has led to a trend towards fund managers establishing both offshore funds in the Cayman Islands and EU-based fund products in EU member states in order to have a comprehensive offering of products that investors in different jurisdictions can choose from.

From that perspective, the AIFMD has not particularly marred the attractiveness of the Cayman Islands as a funds jurisdiction. “Rather, in some respects it has enabled service providers to develop new product offerings to better serve their fund manager clients in respect of their relevant jurisdictions,” says Walker. “It is also worth bearing in mind that the AIFMD has not hampered the ability of non-EU funds/managers to sell into the EU on a passive placement or reverse solicitation basis. However, the anticipated extension of the passport regime to the Cayman Islands will further ensure the continued attractiveness of Cayman as a jurisdiction for global fund managers as the ability to market their funds in the EU on the basis of a third country passport naturally provides a simpler platform from which they may actively distribute their fund products across the EU, rather than having to comply with national private placement regimes in respect of each jurisdiction in which they would like to market their products.”

This might be true but there is no indication yet that Cayman managers will flock to opt in to the Cayman’s AIFMD regime. Most likely the majority will chose not to, either because they view Europe as a less important market for capital raising compared to the US and Asia or are happy to continue pursuing private placement.

“My understanding is that the regulations that will implement the provisions that have been introduced into Mutual Funds Law and Securities Investment Business Law will flesh out what is required for categorisation of an EU Connected Fund or an EU Connected Manager,” says Matt Mulry, Partner at Dillon Eustace. “It would be a more highly regulated product and manager than the existing Cayman Exempted Fund and Exempted Manager.”

“The regulations were published on 20 December 2016 but will not come into force until later this year. The regulations under the Mutual Funds Law require a Cayman fund that is either marketed in Europe or that has appointed a manager in Europe to provide additional information and confirmations to the Cayman regulator. The regulations under the Securities Investment Business Law reflect similar requirements for Cayman managers who wish to market their funds across Europe to those imposed on European managers by the European AIFMD”, says Mulry.

Private placement remains vital access route

One of the stated objectives of the AIFMD was to bring ‘onshore’ funds that would typically be established in successful offshore jurisdictions like the Cayman Islands. However, the actual effect appears to be that the AIFMD has led to a trend towards fund managers establishing both offshore funds in the Cayman Islands and EU-based fund products in EU member states in order to have a comprehensive offering of products that investors in different jurisdictions can choose from.

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“I think Cayman will become stronger as a result of the granting of the passport. But it is equally, if not more important, to realise that access into Europe via NPRR is still the preferred choice.

“The Cayman Islands currently has more than 11,000 registered funds and approximately 75 per cent of these are managed by US managers or US affiliated groups so the nexus between Cayman and the US cannot be understated. The discussion around passporting has to
Cayman LLC is flexible and cost-effective

Interview with Jonathan Green

The Cayman Limited Liability Company structure has been up and running since mid-July 2016 and over that short period of time close to 200 LLCs have been registered in the jurisdiction.

One of its leading architects is Jonathan Green, head of the Cayman Islands Investment Funds team at Maples and Calder. Green was the chairman of the sub-committee that was charged with helping draft the Cayman LLC law but as he explains: “This is something Maples had been working on for more than a decade. As such, a lot of thought had been put into it before we got to the sub-committee stage.

"With the support of the Cayman Islands Government we helped develop what is hopefully a law that everyone is happy with. We are seeing Cayman LLCs formed at the rate of 1.5 per working day, on average, and I think that rate will increase over time as promoters and service providers become more aware that that option is on the table. It’s been a very successful start."

Given the work Maples did in helping bring it to fruition it is perhaps unsurprising that the firm has so far worked on more Cayman LLCs than all other service providers combined. Green’s expertise in the LLC law means that he and his team have an innate understanding for where and when the LLC can be used to solve structuring solutions that existing Cayman vehicles might be less suited to.

“I would describe the Cayman LLC law as quite pithy. It’s an easy to read law, it is straightforward and relatively concise,” remarks Green.

From a hedge fund perspective, when the decision was made to introduce the Cayman LLC there was no particular expectation that it would become a key vehicle for investment funds. After all, existing vehicles in the form of Cayman exempted limited partnerships for private equity funds and exempted companies for hedge funds are tried and tested.

“One would expect a degree of natural inertia. After all, why reinvent the wheel? Things are working fine for those investor-facing vehicles. We didn’t expect LLCs to be visible in the hedge fund world but more in the private equity space where they can be used as downstream blockers and general partner vehicles – or perhaps for management vehicles.

“For private equity funds that need to have separate legal personality – which exempted limited partnerships do not currently have – in the past this was achieved by using a Cayman exempted company. However, this meant fitting a square peg into a round hole, pushing an exempted company into a PE format using the subscription documents as a way to try and replicate some of the mechanisms that fit more freely within a limited partnership agreement.

“The LLC now offers the combination of having a partnership-style agreement, but with separate legal personality that is not constrained by share capital. The manager can make allocations of assets and profits with more of a partnership feel, and yet at the same time it offers the hard outer casing of separate legal personality and limitation of liability that therefore would tick the box for investors who prefer not to invest in a limited partnership construct,” outlines Green.

As a hybrid product it is therefore a very useful additional tool to consider.

Green says that one scenario where the LLC works very well is as a downstream blocker.

“We’ve seen in the funds space, for example, private equity funds looking to invest in certain assets that require the
investor to be a regulated entity. They’ve been keen to consider, for the sheer convenience that the LLC offers, using an LLC subsidiary as a blocker, which they register with CIMA so that it has a mutual fund level of regulation; and then using the mutual fund blocker to trade securities/ assets that need to have an investor with a regulatory complexion.

“Because of its flexibility, simplicity and cost-effectiveness, the Cayman LLC is very helpful for such downstream blockers.”

The LLC could feature in a Master Fund-type scenario for hedge funds but as Green alluded to above, there are no great expectations for the LLC to be used as an investor-facing vehicle given the popularity of existing structures. To date, says Green, Cayman LLCs are proving most popular in solving for situations that previously didn’t fit comfortably in one of Cayman’s existing vehicle constructs.

“We view the LLC as a blank canvass for sophisticated parties to construct the types of deals they would like to do, without the default provisions of the law rewriting or overwriting those deals. We are seeing it as an interesting vehicle for people to structure general corporate transactions: any situation where people need a blocker or wish to do a joint venture. The internal flexibility of the LLC lends itself well to joint ventures.

“People might decide to migrate their Delaware LLCs that act as the GP to a Cayman LLC if they have an international management team. It might be beneficial for non-US partners to have their GP carried interest in a Cayman vehicle rather than a Delaware vehicle and avoid perhaps unnecessary tax or regulatory filings.

“GP vehicles, downstream vehicles, JV vehicles: those tend to be the areas where the LLC is most attractive.”

One of the attractions of the Cayman LLC is that one doesn’t have to maintain a share register, meaning it is much harder for a promoter to foot fault on a technicality. They can set out the capital contributions and it is more intuitive and straightforward to operate. Moreover, the LLC is more in line with how administrators might be running the accounts for some of these vehicles.

“As long as you keep a record of what you are doing it is very difficult to foot fault. It’s a user-friendly vehicle that avoids people trying to contort hybrid deals into an exempted company format. We see the LLC as a supplemental vehicle for the Cayman Islands. It addresses the great majority of situations for those more exotic structuring issues where the exempted company and exempted limited partnership are not always entirely suitable,” remarks Green.

The Cayman LLC differs slightly from the Delaware LLC in that, where it has attributes that are more like an exempted limited partnership or an exempted company, “we generally follow those attributes as they would be laid out in the Exempted Limited Partnership Law or Companies Law”, adds Green.

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“It should, he says, be an easy vehicle for people to understand. Practitioners and stakeholders alike will be very familiar with the look and feel of the Cayman LLC given that it took concepts from vehicles that people have long been used to using in the Cayman Islands.

“The last time Cayman introduced a new vehicle was probably the Segregated Portfolio Company. As a jurisdiction, we see the introduction of the LLC as being responsive to the needs of stakeholders and promoters in the sense that the compliance and regulatory burden on funds are increasing.

“We wanted to come up with a vehicle that is easy to administer, is user friendly and is there as a vehicle for the future should existing vehicles not be the best fit for deal transactions. It keeps Cayman at the cutting edge of structuring solutions,” concludes Green.
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Using SPCs as emerging manager platforms

Interview with Richard Spencer

Flexibility, cost-effectiveness and speed to market are just a few of the advantages to electing to launch a fund on a pre-existing Segregated Portfolio Company (SPC) fund platform.

Alternatively, managers may choose to set up an SPC structure of their own, allowing them to add new segregated portfolios when they wish to offer separate investment strategies.

“We are seeing a lot of managers setting up their first Cayman Islands fund structure as an SPC so that if, in six or twelve months’ time they identify a separate strategy, they know that they can establish an additional portfolio and that it will be quick and inexpensive to do so,” explains Richard Spencer, Partner at law firm Campbells.

On the other hand, SPC fund platforms are offered by an increasing number of fund administration and fiduciary services companies as a turnkey solution. They are often referred to as “Emerging Manager Platforms”, or “Hosted Fund Solutions”. “Their popularity is understandable, given the increasing regulatory burden and other barriers to entry that new managers face, not to mention the time pressure that some face from prospective investors,” explains Spencer.

Whereas establishing a standalone Cayman Islands fund can be a time consuming process for an emerging manager, managers who join an existing SPC fund platform can typically get their fund up and running in no time at all.

“One of the benefits of using a platform is that there are typically a large number of portfolios in the umbrella structure, resulting in efficiencies and cost savings when taken against setting up a standalone fund. A second benefit is that the launch time is very quick; the structure is already in place and the SPC is typically registered with the Cayman Islands Monetary Authority (CIMA) as a regulated mutual fund pursuant to Section 4(3) of the Mutual Funds Law. Therefore, the creation of a new portfolio is a very straightforward process. Thirdly, some platform structures include a management company that is regulated in a jurisdiction where setting up and licensing a new manager may be prohibitively expensive and time consuming.

“A manager can start building a track record within a matter of weeks, which might enable them to gain additional investment into their fund early on. There is some desire by managers to use this turnkey solution, particularly when these platforms have well-known service providers in place,” explains Spencer.

Indeed, when a manager is marketing to new investors, the familiarity of these service providers might make it easier for an unknown manager to raise capital.

Operationally, an SPC is quite straightforward. Each segregated portfolio (or ‘sub-fund’) on a platform has its own set of fund documents, brokerage trading account and fund bank account.

“The crucial point is that there is full segregation of assets and liabilities between each of the portfolios in an SPC fund structure. In particular, where leverage is to be used by a fund manager in respect of one strategy and not another, this ring-fencing feature is crucial in order to prevent cross contamination between portfolios,” notes Spencer.

Given that SPC platforms have service agreements in place with multiple counterparties to support a wide range of sub-funds, this can create economies of scale which reduce the operating costs for a new manager. However, as Spencer points
out, if fund assets grow significantly, platform fee structures can become expensive.

“Clients should consider when to spin off the platform and set up their own fund structure, which they can typically do whilst maintaining their track record, subject to local marketing rules. It’s advisable that they speak with Cayman Islands legal counsel at the outset as to the timing, process and cost of moving off the platform in due course.

“Also, if the manager has specific service providers in mind, they should ensure that the platform they opt for allows them that flexibility. There are different types of platforms; some have a predetermined set of service providers that managers are required to engage with, some allow managers to mix and match their service providers, whilst others will allow managers to fully select their own service providers, subject to the platform board’s approval,” explains Spencer.

He outlines the usual process for joining an SPC platform, as follows:

• The emerging manager enters into an agreement with the SPC platform provider.
• The emerging manager selects audit, fund administration and other service providers, which are typically available at competitive rates.
• The directors of the SPC resolve to create a new segregated portfolio.
• A supplemental offering memorandum for the new segregated portfolio is prepared.
• Many platforms allow managers to spin off into a stand-alone fund at any time.

One point to mention is that if a manager has a standalone fund, he has full control over who to appoint to the fund’s board of directors. However, if an emerging manager engages with an existing platform, there will already be board members in place at the SPC level. When doing due diligence on SPC platforms, Spencer explains that it is worth checking who the board members are; typically they will be affiliated with the platform provider.

He says that in a world of increasing regulation, it is helpful to have a variety of SPC platform solutions available; however emerging managers should always discuss the pros and cons of platform solutions with their Cayman Islands legal counsel before committing to a fund platform rather than setting up their own standalone fund.
include both the US and Cayman in terms of
the US having eligibility as well.

“There is still a strong preference among
managers to utilise the private placement
avenue to access European investors. I
believe until NPRR disappears altogether
Cayman/US managers will take their time
considering EU Connected Funds and
availing of the passport,” comments Alex
Brainis, Partner at Appleby (Cayman).

The Brexit dilemma
One potential spanner in the works is the
small issue of Brexit. When the UK voted to
leave the EU last June it threw serious doubt
over how the UK’s financial services market
would interact with the EU. The vote to leave
meant that overnight the UK was put on
track to become a third country in its own
right, and outside of the purview of AIFMD.
This won’t manifest officially until Article 50
has been negotiated.

“The UK is currently the most important
market in Europe for Cayman funds and
its departure from Europe may have a
big impact in Cayman. When there is an
uncoupling from EU regulation in the UK it is
unlikely that there will be a massive change
in financial services regulation; the UK will
likely maintain equivalence with EU regulation
which will mean these new regulations are
likely to remain relevant to the UK at least in
the short term,” suggests Mulry.

“It’s difficult at this stage to understand
what the effect of Brexit might have on
Cayman,” cautions Giorgio Subiotto, Partner
at Ogier. “It raises a whole raft of new
issues. One of the biggest markets in Europe
for Cayman fund managers is the UK, it is
where the majority of Cayman funds are
distributed so what happens to the UK
following the completion of Article 50 will
have a big impact.

“The other big issue regarding the third
country passport is what impact that will have
on turning off the NPPR option. A lot of our
clients are quite comfortable with National
Private Placement Regimes because they
know which markets in which they want to
raise capital. I think they’ve taken this option
very much in their stride and a number of
European-based fund managers also go down
this route. To the extent that third country
passporting will bring an end to private
placement rules it will need to be properly
coordinated to ensure some third countries
are not treated any differently to others. That
could create potential regulatory arbitrage.”

There are many implications to Brexit. The
UK could, theoretically, become a competitor. There is talk of reducing the corporate
tax rate, which could lead to a scenario
where the UK becomes a low tax offshore
jurisdiction and a funds centre in its own
right, suggests Subiotto.

“We view the AIFMD opt-in regime as
an additional tool for managers – it will be
additive not subtractive. The US remains
the most important market for capital
raising. I don’t therefore expect to see too
many managers choosing to opt in to the
regime. The cost of setting up and maintain
structures here will continue to be lower than
in Europe, there’s less tax here and these
are important factors. Cayman will always
maintain that advantage over European
jurisdictions,” says Subiotto.

Cayman LLC takes off
Aside from the EU Connected Fund and
AIFMD opt-in developments, another
significant introduction to the Cayman
Islands is the Cayman LLC vehicle, which
became available last July.

This is the first new vehicle in Cayman
since the SPC and adds a further structuring
option for fund managers.

“1 think the beauty of the LLC is its
flexibility. For example, it allows for a broad
range of fiduciary standards to be imprinted
onto the LLC, at the higher end where
fiduciary duties or standards of care could
be set to be akin to an exempted company
used in a funds context, or at the lower end
where it is used as a blocker or tailored
for a joint venture vehicle. It can deliver the
bespoke fiduciary obligations and standards
of care that the parties may want.
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The growing importance of independent boards

Interview with Maree Martin

Such is the level of scrutiny facing alternative fund managers that the general trend towards increased usage of independent directors has risen in recent times. Maree Martin, Counsel at Conyers Dill & Pearman, confirms that fund boards are not only becoming comprised of majority independent directors but that a more recent trend is the use of split independent boards.

“This is adding even greater independence to the board,” says Martin. “The perception being that whilst directorships are an individual appointment, if two directors are from the same firm they may adopt the same approach to matters arising for their consideration. A split independent board overcomes this issue.”

To underscore the importance of finding well qualified, suitable independent directors, fund managers are doing more due diligence on candidates for such positions. Prior to the global financial crisis, fund managers would often be satisfied to choose a directorship provider and accept any two directors suggested to them to use on the board. This is happening far less.

“At the very least managers want to know the background of each director, interview them and in some cases, meet with them in person. It increases trust in the whole process. The independent aspect helps allay investors’ concerns when it comes to other functions being done in-house by the manager,” says Martin.

Another aspect to consider is the Statement of Guidance (SoG) that CIMA issued in 2013 and which it updated in 2016. The SOG provides a governance framework aimed at the governing bodies of entities regulated by CIMA. In short, it sets out how a board should operate and the minimum expectations for prudent fund governance.

“When it was first published there were a few items that your average small to mid-sized fund didn’t customarily comply with,” comments Martin. “Now we are seeing most managers complying with the SoG, which covers general oversight, management of conflicts, frequency of meetings, applicable fiduciary duties and the type of documentation that should be kept by the fund.”

“Whilst common for the larger fund manager, now small and medium sized fund managers are putting together their own operating manuals. There’s a general increase in the expectation that funds need to operate in a way that meets international standards rather than simply doing the bare minimum to satisfy Cayman requirements.”

Investors want to make sure that when they invest in a Cayman fund that the jurisdiction is doing everything that is expected of a leading financial centre. The updated SoG is one of the latest examples of Cayman’s commitment to transparency and effective oversight of fund operations. Martin confirms that the board always has to have “effective oversight and supervision” of all service providers including the investment manager.

“Independent directors may have more experience in complying with a range of different operational and regulatory requirements; a director from the fund manager might wish to focus more on commercial matters and the investment activities of the fund.”

“The board needs to monitor all service providers and ensure that they know what is going on in terms of the fund’s operations. It is therefore increasingly important to have independent directors who are experienced in these matters. Split boards can provide a diversity of experience and expertise that can prove valuable for funds in these times of increasing regulatory and investor scrutiny,” concludes Martin.
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- Chambers and Partners

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Below is a non-exhaustive compliance checklist of some of the measures that the Cayman Islands have taken in this regard:

**Tax Information Exchange Agreement ("TIEA")**
The Cayman Islands has signed a TIEA with some 36 countries (of which 29 are currently in force) which provide for the exchange of information on a request relating to a specific criminal or civil tax investigation or civil tax matters under investigation. The Cayman Islands also has an intergovernmental agreement with each of the US and the UK (as detailed below).

**Cayman Islands Financial Institution Reporting Regime and Automatic Exchange of Financial Information**
The Cayman Islands has entered into two intergovernmental agreements to improve international tax compliance and the exchange of information – one with the United States ("US FATCA") and one with the United Kingdom ("UK FATCA"). The Cayman Islands has also, along with over 95 other countries, committed to implement the OECD Standard for Automatic Exchange of Financial Account Information – Common Reporting Standard (the "CRS"). The Cayman Islands has issued regulations to give effect to US FATCA, UK FATCA and the CRS (together the “AEOI Regulations”).

**Alternative Investment Fund Managers Directive ("AIFMD") Passport (Pending)**
The Cayman Islands is undergoing assessment by the European Securities and Markets Authority, which it hopes will lead to its approval for the pan-European marketing passport. The Mutual Funds Law
and the Securities Investment Business Law have already been amended to establish an opt-in regime for regulating Cayman Islands-domiciled investment funds and managers with connections to the European Union (EU), in order to facilitate extending the EU’s AIFMD passport to the Cayman Islands.

Financial Action Task Force
The Cayman Islands is a member of the Caribbean Financial Action Task Force which is leading the implementation of anti-money laundering and counter-terrorist financing measures such as obtaining and storing beneficial ownership information.

Global Forum on Transparency and Exchange of Information for Tax Purposes
The Cayman Islands is a member of the OECD Global Forum on Transparency and Exchange of Information for Tax Purposes, which is the premier international body for ensuring the implementation of the internationally agreed standards of transparency and exchange of information in the tax area.

Agreement on the Enhanced Sharing of Beneficial Ownership Information
The Cayman Islands has recently entered into an agreement with the UK that would enable UK governmental agencies to have a platform to gain access to beneficial ownership information of companies incorporated in the Cayman Islands.

Conclusion
Although the Cayman Islands is a tax-neutral jurisdiction whose value in international finance transactions is well-noted and appreciated in many of the key financial markets, it is not a "tax haven". There is a raft of legislation and compliance measures in place which seek to prevent the use of Cayman Islands structures and transactions for purposes of tax evasion and which, in many cases, will also assist the interested onshore jurisdictions to identify "aggressive" tax avoidance transactions which may fall foul of their domestic legislation. Indeed, former British Prime Minister David Cameron said recently that he does "not think it is fair any longer to refer to any of the overseas territories or crown dependencies as tax havens. They have taken action to make sure that they have fair and open tax systems". Accordingly, the Cayman Islands remains an important, credible and respected jurisdiction for the conduct of legitimate transactions.

Stuarts Walker Hersant Humphries has an Investment Funds Team that is a market leader in advising managers on the set-up and establishment of a broad range of investment funds in the Cayman Islands, including hedge funds, real estate funds and private equity funds. www.stuartslaw.com
“It’s likely to serve a role for downstream structuring given that it’s a cost-efficient vehicle. I don’t expect it to be a vehicle that the investor community encounters given their market preference for exempted limited partnerships and exempted companies,” explains Jonathan Green, head of the Cayman Islands Investment Funds team at Maples and Calder.

The demand to create a Cayman LLC came from the US; principally US counsel and promoters familiar with the Delaware vehicle. This took hold and was the genesis of how Cayman initially ended up with exempted limited partnerships to respond to the US and provide a degree of symmetry with promoters’ onshore vehicles.

“Our thinking with the LLC was very similar. It also resonates well with some of the vehicles used in the Asia market but it was predominantly in response to requests from the US market,” says Green.

“The Cayman LLC takes its inspiration from the Delaware LLC and in addition draws upon the principals and concepts that stakeholders will be familiar with from our existing Cayman vehicles.”

Amongst the key benefits of the LLC are that it provides a hybrid vehicle offering the best characteristics of a limited liability company together with those of a limited partnership – including separate legal personality and limited liability, not to mention a greater degree of flexibility as to the management and internal workings of the LLC. This is because most of the features can be determined as a matter of contract between its members as opposed to being prescribed by the law.

In accordance with OECD commitments, the LLC must maintain: (a) a register of members; (b) a register of managers; and (c) a register of mortgages and charges. In a funds context, the Cayman LLC will allow closer alignment of the offshore fund structure with the onshore fund structure, making for easier and more cost-effective structuring and administration of the fund group.

Expanding on the hybrid point referred to above, Mulry remarks: “On the company side, it has a separate legal personality and it has its own obligations and liabilities distinct from those of its members. On the partnership side, it operates capital accounting mechanisms for assessing the value of an investor’s interests and the law offers wide ranging flexibility to negotiate the relationships between the members themselves and between members and managers.

“This means that administration costs may be lower for LLC funds as NAV and performance fee calculations can be more straightforward.”

Jonathan Green, Maples and Calder

“Administration costs may be lower for LLC funds as NAV and performance fee calculations can be more straightforward.”

Jonathan Green, Maples and Calder
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A professional director for a hedge fund might take an instinctive view that board observer rights are not desirable given the traditional view of separation of capital ownership and those responsible for fund governance. Professional directors confident in their abilities would, however, welcome the opportunity to show how seriously they take their fiduciary responsibilities and demonstrate their skills and knowledge of good governance under the scrutiny of a board observer.

A board observer can take different forms but the general idea is that an investor would have the right to attend formal meetings held in the context of a fund’s governance structure and be able to review sensitive board documents and reports. This poses both opportunities and challenges for those charged with governance.

The investor might have a number of reasons for seeking observer status ranging from oversight of the governance process, to a genuine desire to offer advice where the observer believes value can be added, to having access to information not normally accessible to investors. This obviously does raise some issues similar to those for side letters, an issue well understood in the hedge fund industry.

**Lessons from the financial crisis**
During the 2008 financial crisis there were instances where investors found hedge funds to be lacking transparency and felt deprived of information as they relied on directors and investment managers to make decisions on their behalf without prior consultation with investors. Frequently, this situation led to surprise communications from fund managers to investors imposing gating provisions or suspending redemptions.

Since that time, investors, especially institutional investors, have expanded the scope of their operational due diligence on hedge funds and their managers (with ever expanding questionnaires) or even sought direct participation on boards. If it is believed that “The people in charge don’t know much more than you” as observed in a 2013 article on the financial crisis in The Wall Street Journal, then why not take governance matters into your hands as an investor and be more directly involved in fund governance? This has led to the developing trend of institutional investors seeking board observer rights.

**The challenges**
Sitting on a board comes with responsibilities and challenges that investors may not be prepared to add to their risk profile. First, a director has fiduciary responsibility to a fund and has to represent the best interests of the fund which would include all the investors. By contrast, an investor having board observer rights will have access to board meetings and sensitive information without being bound by the same fiduciary standards governing directors. Second, board members should feel comfortable to discuss any issues that may be confidential in nature without revealing information that may afford an observing investor a strategic or tactical advantage over non-observing investors. This situation could give rise to significant conflict of interest issues if the observing investor gains access to negative news about the fund that could prompt the observer to act ahead of other investors in the fund.

An additional issue is that legal privilege can also potentially be compromised if an observing investor participates in a meeting where communications from legal counsel to the fund or the manager are involved. In common law jurisdictions, legal privilege protects all communications between a professional legal adviser (a solicitor,
If the challenges of having observer rights outweigh the benefits, a few alternatives could be considered. One option, often seen in the industry, is for the investor to have its own managed account or fund of one, where it can enjoy freedom and access to any information about the fund without limitation. The downside of this solution is that the costs of such a fund might be a drag on return unless the AUM is sufficient compared to a commingled fund. A second alternative would be to set up an advisory committee for a commingled fund governed by an agreement among the fund, the investment manager and the investor. This type of tri-party agreement would specify the areas of investor involvement and the type and form of information they will be provided with while managing the types of conflict of interest issues that may be associated with investor observer status. This could well be a preferred option if the investor’s intention is to offer advice and expertise to the board without being bound by the formalities of board membership.

The solution
For reasons discussed in this note, affording board observer status may give rise to inequitable treatment of non-observing investors in a fund. Therefore, allowing some investors access to certain information requires balancing the interests of those investors with equitable treatment of all investors. From a hedge fund perspective, an agreement or side letter could be a logical place to formulate the terms of board observer rights and set a range of parameters for an investor with such rights. Confidentiality clauses and minimums on the level of capital invested for the investor to be eligible for observer rights should be included. The governing principle of this agreement would be that the observing investor should act in a fiduciary manner similar to a director. In addition, the observer should commit not to act on information obtained through their status as an observer, similar to rules governing dealing with material non-public information for listed companies. Similarly, consideration should be made to disclosing in offering documents the possibility of a fund entering into observer agreements with strategic investors who meet the commercial requirements (such as minimum investment).

The future
The hedge funds industry is a dynamic and ever-changing landscape, always ready to present new challenges or opportunities. If you are a board member, brace yourself for more investor activism as investors continue to find ways to protect their capital through the governance process. While there are challenges that investor involvement could bring to boards, there are also benefits as board members will be more in touch with investor needs. If directors are open and transparent, it should become apparent that these types of directors would principally be in strong support of board observer rights.
The third quarter of 2016 saw an estimated USD28 billion of hedge fund net outflows – the highest since 2009. This brought year-to-date redemptions to USD51.5 billion. Those suffering significant outflows included high-profile stalwarts of the industry such as Brevan Howard, which saw USD3 billion in redemptions in the first six months of 2016.

“There seems to be a significant trend of institutional investors looking at the hedge fund space carefully and making assessments with a view of repositioning capital to address internal requirements and investment mandates. Institutional investors have numerous options available to them such that they can redeem with a manager if they are dissatisfied with current performance and/or fees and move to another manager,” comments Prasana, Senior Counsel, Walkers (Cayman Islands).

Even though hedge fund redemptions were significant in 1H16, the bigger picture reveals that overall net assets rose 2.5 per cent to USD2.979 trillion through Q3 2016 according to Hedge Fund Research, marking a new high.

James Melen is a Partner at Walkers (Cayman Islands). In his view, redemption levels should not always be viewed as a negative, but rather can indicate a positive reflection of the marketplace.

“In a maturing market, investor confidence rises and investors are willing to shut down investments in an underperforming fund. As hedge funds have matured over the last 15 to 20 years, investors are themselves more discerning and less inclined incur fees that are paid when the performance is not up to benchmark standards with respect to the S&P, for example.

“One has to question to what extent outflows can be attributed to hedge fund managers that are not able to deliver the kind of performance that investors want,” says Melen.

In recent years, the power balance has moved to some extent from the managers to the large institutional allocators. Pension plans, SWFs and endowments have gravitated towards billion dollar hedge funds that are better equipped to devise more creative fee structures.

But as 2016 has shown, institutions are more willing to redeem when managers fail to live up to expectations. According to Hedge Fund Research, firms with USD5 billion or more in AUM incurred USD22 billion of the USD28 billion of net inflows in Q3 2016.

This, though, should be welcomed and viewed as a proper functioning industry.

“I think it is important to draw out the positives and consider that last year’s redemptions are indicative to some extent of a maturing market,” adds Melen.

Prasana believes that the current market paradigm is driving investment managers to further innovate and find new investment opportunities. “This could be by adopting hybrid vehicles or structuring direct lending funds and CLOs for finance-driven opportunities to generate returns away from traditional equity long/short strategies,” she says, adding that a key consideration for today’s hedge fund manager is to stay close to their institutional investor base, listen effectively to market feedback, and react in a nimble fashion as required.

Manager’s responses include changing fee terms, offering innovation on how the manager receives performance fees to match up with liquidity terms, revisiting investment terms and/or market strategy, etc.

“Getting the fund terms right from the outset to match investor expectation is critical,” says Prasana.
Another sign of market maturity is the emphasis on partnership between managers and their loyal investor base.

“There is a good deal of effort put in to arriving at a mutually agreeable arrangement pre-launch or pre-closing with respect to a fund that already has an initial track record than used to be the case. We see that with the frequent use of side letter arrangements or new share classes: techniques that illustrate how managers are trying to align a closer partnership with their investors,” says Melen.

This willingness to build closer ties with investors is encouraging and tends to be overlooked in the media where large redemptions and reports of double-digit fund losses take on a degree of Schadenfreude.

“If you take a step back and look at the industry as a whole - rather than specific redemption requests - there are just as many stories and reports on net growth and creative forward-thinking managers succeeding in this space.

“Those with the greatest talent and flair are always going to make it in this industry because they are driven and committed to do so. The maturity of the market being what it is, and the harder job that new entrants have to break in to the market, is to my mind yet another sign of increasing quality,” comments Melen.

It can often be assumed that the impact of increased regulation and the higher barriers to entry are wholly detrimental to the industry. But it should not necessarily be easy to become a hedge fund manager. It should be a challenge.

“We’ve seen several examples of very successful managers being supported by the hedge fund they are leaving to set up their own vehicle. Those managers will often tend to break through, even if it takes longer. It simply makes the most committed individuals work even harder at creating a business model and fund product that can succeed.”

“It is not a market to enter without the appetite for it supported by the commitment and drive to achieve success. Managers with those elements will be successful,” adds Melen.

As with any successful investment market, however, there will be times when issues of wrongdoing are unveiled. The hedge fund industry is not immune to this. Recent alleged insider trading cases have negatively impacted the industry.

“Transparency with an ethos of sound corporate governance is very important. Furthermore, the enforcement actions by the regulators, bolstered by investor disapproval, exhibited effectively with swift withdrawals, sends a strong message to the industry,” comments Prasana.

Along with redemptions, higher barriers to entry and closer investor partnerships, such investigations and enforcements are, in Melen’s view, another sign of a properly regulated and maturing hedge fund market.

“What would be more concerning to me would be a multi-trillion dollar industry quietly getting on with its business where no one can be perfect and a bubble develops; in that environment, problems would come out in the form of some catastrophic event that leads to a permanent impairment of the industry.

“It is far healthier to have a regulated industry, as we do today, where the regulators function as they should to identify potential wrongdoing. There will evidently be moments where those who are engaged in insider trading are found out and dealt with accordingly. You have to see the industry being assessed and regulated in the right way; that gives confidence to institutional investors,” remarks Melen.

Looking ahead, Prasana sees continued opportunities for hedge funds and is confident they will innovate and move into new markets. Opportunistic credit, special situations, direct lending, hybrid vehicles and CLOs will be particular areas of expansion.

Indeed, Melen observes that some larger managers have gone from offering a traditional hedge fund to offering new platforms to operate hybrid structures. This, he says, is helping managers create entirely new business models whilst at the same time continue to run their flagship hedge funds.

“The CLO space is one we are genuinely excited about. Our funds group is working more closely with the finance lending and securities team at Walkers and that is going to increase more and more as hedge funds continue to move further into the CLO and direct lending space,” concludes Melen.
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AN ALTERNATIVE LOOK INTO INVESTMENTS

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The fourth annual Cayman Alternative Investment Summit (CAIS), scheduled for February 15-17 in the Cayman Islands, will convene leading thinkers and decision makers from across the industry as they explore this year’s theme: *Defying Gravity: The Future of Alternative Investments in Exceptional Times.*

In a change of venue, CAIS 2017 will be held at the brand new, Kimpton Seafire Resort + Spa, which is owned by Dart Enterprises, the host sponsor for CAIS. Other key sponsors this year include KPMG, Deutsche Bank, Mourant Ozannes, CIBC, Harmonic Fund Services and IMS.

The Cayman Islands, with over 11,000 regulated funds, has long been a home for the alternative industry, and CAIS regularly draws some of the top speakers and leaders in the industry.

The 2016 event, "Alternative Investments: Supercharged", was a huge success and talking to Hedgeweek about this year’s theme, Chris Duggan, Director of CAIS and VP of Community Development, Dart Enterprises, says there are so many forces working against fund managers that in order “to successfully chart these turbulent waters one effectively needs to defy gravity to overcome them.”

“Every year we like to have a novel theme which all of our speakers can centre around, and we thought defying gravity would be an appropriate theme for the 2017 event.”

In keeping with this, two confirmed special guests for CAIS 2017 are Captains Mark and Scott Kelly, retired US Navy Captains and much-vaunted NASA astronauts. One of the keynote speakers is Virgin Galactic CEO, George Whitesides, former chief of staff at NASA.

“The idea is to further our knowledge of how to send someone to Mars. Can a human being sustain prolonged exposure in space?” says Duggan.

As part of that theme, CAIS formally announced the event by launching an invitation into space: https://vimeo.com/187992935. The headline keynote speaker this year is Hollywood actor and former Governor of California, Arnold Schwarzenegger.

The following is a sample of confirmed speakers: Pippa Malmgren, Founder of DRPM Group and an American policy analyst; Nouriel Roubini, Co-Founder & Chairman of Roubini Global Economics; Mark Yusko, Founder, Chief Investment Officer & Chief Executive Officer of Morgan Creek Capital Management; Valerie Sill, President & CEO of DuPont Capital Management; Mark Okada, Co-Founder & Chief Investment Officer of Highland Capital Management; John Mauldin, President of Mauldin Economics; and, Amanda Pullinger, CEO of 100 Women in Hedge Funds.

There is an inclusive, collegiate feel to CAIS – attendee numbers are kept within the 400 to 500 range and great emphasis is placed on striking the right balance of investors to managers to service providers, and also between industry-focused panel sessions and non-industry speakers.

“We don’t want delegates to feel like it’s a sales pitch. We want there to be meaningful interaction, meaningful discussion, and meaningful takeaways to push for positive change in the industry,” says Duggan. “One leading industry professional has said that CAIS is quickly becoming ‘one of the premier events on alternative investments around the world’ which is exactly what we aim for CAIS to be.”

One can think of CAIS as being to alternatives what Davos (World Economic Forum) is to economics.

Registration for CAIS 2017 is now live at www.caymansummit.com/register. The registration deadline is February 3, 2017.
Green thinks it is unlikely that promoters or investors will want to convert all their exempted companies into LLCs, however. "I don’t see a big drive to change what already works well in the funds context, unless perhaps it involves a hybrid deal or something unusual, say a fund holding a mix of liquid and illiquid assets that intends to operate as a hybrid PE/hedge fund vehicle. It is these more exotic situations where an LLC might be a more flexible offering. I do not envisage the LLC displacing the jurisdiction’s established vehicles for run-of-the-mill structures."

No authorised share capital
The big step forward with the LLC is that Cayman has created a vehicle that allows a company to have a separate legal personality but does not have authorised share capital. That provides much more flexibility in terms of how members are admitted and the vehicle is administered. Companies with share capital can lead to people incorrectly issuing or exceeding their authorised share capital and it is rather an archaic concept.

“This constraint means that people could foot fault. It becomes very convoluted and a cumbersome structure. Dispensing with this really allows LLCs to become the vehicle of the future. They aren’t constrained around some of the more archaic constructs of company law. That’s where some of the cost-efficiency of an LLC comes from,” adds Green.

SPCs proving useful
A third area of continued growth and innovation is the use of the Segregated Portfolio Company in Cayman. Before the SPC was available, in certain situations investors would insist on separate standalone funds to pursue separate strategies, particularly where there was leverage involved in one of the strategies; investors in the non-leveraged fund did not want to be exposed to the leveraged fund. Using an SPC, the manager can set up individual sub-funds with separate share classes within the same company.

"Investors understand that the assets and liabilities of each segregated portfolio are segregated or "ring-fenced" from other portfolios, and their investment will only be deployed in respect of a designated portfolio. If one of the other portfolios does not succeed, or has exposure to non-performing or problematic investments, this will not affect their investment", comments Richard Spencer, Partner at law firm Campbells.

In terms of having separate objectives and strategies across multiple portfolios, it is possible for there to be a mixture of open-ended and closed-ended portfolios. But as Spencer points out, managers should be mindful that notifications must be made to CIMA and fees paid in respect of newly created closed-ended portfolios of existing CIMA-registered SPC fund structures, notwithstanding that closed-ended standalone funds are not subject to any registration or filing requirements.

Once a manager has made the decision to set up an offshore fund there are a variety of options. "The key Cayman Islands investment fund vehicles are exempted companies, unit trusts and limited partnerships, and of course LLCs are also now available. One of the advantages of choosing an SPC fund structure is the ability to bolt on new portfolios as and when desired. The creation of a new portfolio is a straightforward and inexpensive process," adds Spencer.

Also, it allows investors to switch between strategies (if the documents allow for it). There are tax advantages to doing this as it doesn’t require the investor to realise gains in the fund strategy they are rotating out of.

Conclusion
All told, there are significant developments taking in place to keep Cayman vital as a jurisdiction. Chris Humphries, Managing Director, Stuarts Walker Hersant Humphries, concludes on the following optimistic note: "Cayman is a pragmatic and business-friendly jurisdiction. It seeks constant improvement in its product offering and the government, with industry, recognises the need to keep its laws under constant review to maintain a competitive edge and a level of regulation and compliance, which is compliant with all applicable international standards.

"The introduction of the Cayman LLC and the EU Connected Fund developments are just recent examples of how these aspirations are put into practice and we believe that Cayman will continue to be best placed amongst the international financial centers to serve the needs of the global alternative funds industry."
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Cayman finalises AIFMD-like regime

Interview with Alex Brainis

In 2018, the National Private Placement Regime pathway to access European investors is scheduled to be phased out. But given that ESMA is yet to approve the next wave of jurisdictions to qualify for the AIFMD third country passport, this seems an unlikely timeframe.

“Given that ESMA still has to review amendments to Cayman legislation and provide its approval, there is a long road ahead and 2018 really isn’t that far away. I am of the view that NPRR will likely be extended a year or two to allow jurisdictions such as Cayman and the US to be properly considered by ESMA,” opines Alex Brainis, Partner at Appleby (Cayman).

He observes that from a client perspective the majority of managers in the non-EU space have an interest in the AIFMD passporting option to access EU investors but the level of demand is not overwhelming specifically because they have the option of using National Private Placement Regimes in EU jurisdictions.

“The initial interest is therefore to understand what the AIFMD passport is, what its benefits are, and how it could be used alongside a manager’s existing operations when the NPPR route gets phased out. However, there needs to be time to operate passporting for non-EU countries pari passu to NPPR in order to contrast and compare the two. That will take time so I would be surprised if the 2018 timeline is not extended to allow for such process,” says Brainis.

When ESMA considered the Cayman Islands it initially stated that there were no significant obstacles impeding the application of the AIFMD passport but it did state that it would not be in a position to provide specific advice or recommendations on the eligibility of the jurisdiction until specific items were addressed and finalised. These include:

- A final version of the AIFMD-like regime to be implemented into the Cayman Islands.
- Legislative amendments to give CIMA the power to impose administrative fines for certain breaches of regulation.
- The development and implementation of a policy framework by CIMA to enhance systemic risk monitoring.

“Those items should be finalised in the next month or two,” says Brainis. “Part of the legislative amendment process is to address the obligations of both regulated EU connected funds and regulated EU connected managers. The amendments being made should align Cayman with AIFMD equivalence.”

Managers will have the option of whether or not to opt in to Cayman’s AIFMD-like regime. The election to be treated as a regulated EU connected fund would be available to both open-ended funds and closed-ended funds, which are currently outside the scope of the Mutual Funds Law.

“For an initial period managers will, whilst still availing of the NPRR methodology, have the option of opting in to AIFMD in a specific jurisdiction i.e. Ireland. Upon opting in to that jurisdiction, the manager will be able to fully passport their fund(s) into the EU without having to individually register with each EU Member State.

“To qualify for an EU connected fund the manager would need to apply to CIMA for the correct license and be confirmed as AIFMD eligible. The relationship between the manager and the relevant regulator in the EU and CIMA would originate with the fact that the manager would be regulated by CIMA and would be granted the status to exercise their AIFMD opt-in,” concludes Brainis.
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As global asset management groups increasingly adopt digital platforms to connect with counterparties and investors in today’s knowledge-based economy, the risks of cybersecurity threats are rising. Funds of all shapes and sizes are susceptible to fraud committed internally by employees or external criminal groups – hactivists, terrorist groups – which can have a potentially devastating impact on shareholders, oblivious to the risks. This could lead to investors losing part or all of their investment while ongoing criminal investigations and court procedures play out. As such, the Money Laundering Reporting Officer (MLRO) is becoming a vital role in the operations of investment funds.

“Criminal activity and money laundering directly affect the confidence of the marketplace and restricts fair competition, which ultimately affects investors. MLROs are one of the key crime fighters in the chain with special skills and responsibilities to protect investors, mitigate losses and bring about confidence to the market,” says Rayal Bodden, Director, Apex Fund Services.

MLROs should have in-depth training on all aspects of money laundering, legislation and how to detect criminal activity and money laundering efforts.

“Criminal activity and money laundering never sleeps so there is no room for complacency. Vigilance on ongoing training in the determination and reporting of suspicious activities and on new trends of criminal activity is a must and is often mandated by law or by the organisation’s requirements,” says Bodden.

From a regulatory perspective, the Cayman AML regime has been in place for over 15 years and includes the provision to appoint an MLRO to Cayman mutual funds. Funds may, however, meet the MLRO requirement through the appointment of a regulated third party such as their fund administrator.

Apex offers MLRO services to support boards with their responsibility of oversight for AML compliance and appropriately communicating with the Reporting Authorities, if and when necessary. “Additionally,” says Bodden, “the MLRO will liaise with service providers such as auditors where an AML issue arises. Dealing with these matters can become challenging and complex at times, which requires special consideration from persons experienced in handling these matters.”

Bodden confirms that this year the FATF will be evaluating the Cayman Islands to its own standards. “In addition to being assessed for meeting technical requirements of the FATF 40 Recommendations, the Cayman Islands will now also be measured on the effectiveness of 11 Immediate Outcomes of enforcement mechanisms. Of specific interest is the 7th Immediate Outcome which focuses on ‘Money Laundering offenses and activities are investigated and offenders are prosecuted and [made] subject to effective, proportionate and dissuasive sanctions.’ Tied directly to this, is the responsibility of the MLRO as the designated person in the organisation, to whom all suspicious activity reports must be made and who will act as the main point of contact with the Reporting Authority to ensure compliance,” explains Bodden.

Failure to have a dedicated MLRO in place could, in a worst-case scenario, signal the death knell of a funds business should it fail to properly identify criminal activity and money laundering.

As Bodden stresses, the advice is always the same... people and process.

“Look for experienced people and service providers with organised processes. Having sound systems in place, acting quickly on intelligence and quickly reporting to the appropriate authorities can cut perpetrators off at the pass. This ensures the best chances for investors to be protected and bad actors to get subjected to enforcement.”

People and process key to effective AML framework

Interview with Rayal Bodden
The Cayman Government is currently proposing legislative changes which would give CIMA additional powers to impose administrative fines on licensed and regulated individuals and entities. The Monetary Authority (Amendment) Bill 2016 seeks to amend the Monetary Authority Law and if passed will enable CIMA to impose a range of penalties from non-discretionary fines of USD5,000 for a minor breach up to USD1 million for a serious breach. CIMA would be able to impose cumulative fines of up to $20,000 for a single minor breach.

These would include breaches of prescribed provisions of regulatory laws and money laundering regulations as pertaining to the Monetary Authority Law. As global law firm Walkers explained in an advisory note on 27th October 2016, the “regulatory laws” will include the Banks and Trust Companies Law, the Building Societies Law, the Companies Management Law, the Cooperative Societies Law, the Insurance Law, the Money Services Law, the Mutual Funds Law, the Securities Investment Business Law, the Development Bank Law and the Directors Registration and Licensing Law. The Bill inserts the new definitions of “breach”, “fine”, “prescribed provision” and “rules”. A breach is defined broadly and includes not only positive actions but also failing to act or allowing a state of affairs to exist.

This is a positive step forward for Cayman at a time when further alleged insider trading cases in the US hedge funds industry have been revealed and the risks of cybersecurity and criminal activity directed willingly on hedge funds continue to rise.
We know funds. We have been focused on funds since the beginning of the industry, many of our specialists have played a leading role in drafting key legislation that underpins fund structures in our jurisdictions. Our diverse practice provides us with valuable insight into the funds market. We pride ourselves on providing responsive and practical advice, while our hands-on, partner-led teams ensure a consistent approach.
Avoiding sledgehammers to crack nuts

Interview with Giorgio Subiotto

During the crisis in 2008, investors started to appreciate how important corporate governance was but it wasn’t until 2013 that Cayman introduced the Statement of Guidance to provide a clear framework for best practices. This was followed by the Directors Registration and Licensing Law, 2014, which applies to all directors of Cayman registered mutual funds and requires them to be registered with or licensed by the Cayman Islands Monetary Authority.

“CIMA now has a pretty detailed database of Cayman directors who are regulated and under the purview of CIMA,” says Giorgio Subiotto, Partner at Ogier. He says that when the DRLL was introduced, CIMA immediately used it to its advantage.

“Within the first 12 months CIMA sent an email out to directors enquiring about late filings of financial statements. Audited financial statements are a key tool that CIMA uses to regulate funds. Historically, however, this has been a real issue for CIMA to try and enforce late filings because Cayman doesn’t have an obligational requirement for directors to be located here.

“Sending those emails made a big change to CIMA’s power of enforcement and the fact that they were able to collect detailed data on directors allowed it to determine how serious they were taking their roles and responsibilities,” remarks Subiotto.

Now, CIMA has even greater ability to enforce the Statement of Guidance and uphold a global standard of corporate governance. This is thanks to the Monetary Authority (Amendment) Law 2016, which sets the basis for CIMA to grade the fines and impose financial penalties.

“For me that is absolutely key,” emphasises Subiotto. “Previously, the two options were to take a sledgehammer to crack a nut or to do nothing at all. CIMA didn’t want to take the first approach to avoid negatively impacting the industry, which would have been the case had there been too many large non-proportionate fines.

“No that CIMA will be able to grade the fines more specifically and more proportionately to the breach, I think we will see more fines being issued by CIMA. It will further increase the quality of fund directors and fund structures without making it any more difficult to do business in the Cayman Islands.”

This should give CIMA the tools to regulate effectively Cayman structures but it doesn’t change the obligation of Cayman directors or the basic procedures they need to follow. Nor does it change the ongoing regulatory obligations of funds on whose boards directors sit on. Rather, it means that CIMA can increase its focus on corporate governance and ensure that directors are meeting their obligations and duties in managing funds and that the audited financial statements are filed in good time and not ignored.

“It places a renewed focus on directors to implement procedures, make sure they meet on a regular basis, are fully aware of key dates for funds throughout the year, and that funds are meeting their obligations at the regulatory and corporate level. All players, lawyers as well as directors, will need to be on top of all necessary deadlines and filing requirements,” says Subiotto.

This could be a prescient move by CIMA given that Cayman is in the process of trying to get approval by ESMA for third country passporting rights. That the Monetary Authority (Amendment) Law has been passed will do its chances no harm at all, demonstrating its commitment to transparency.

“It improves the general outlook and projects CIMA as a more effective regulator. I think it is a great move because previously one of the weaknesses was that CIMA didn’t really have a realistic way of enforcing breaches; now it will,” concludes Subiotto.
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The US Foreign Account Tax Compliance Act reporting cycle has been running now for two years. As such there is a good level of visibility in terms of how this tax reporting exercise needs to be done and most financial institutions are clear on the definitions used.

But there is now a new tax reporting standard for fund managers to contend with that is global, as opposed to US-centric: The Common Reporting Standard.

Whereas financial institutions previously only had to report the tax status of their US investors, under CRS – of which the US is neither a signatory nor a recognised participating jurisdiction – they will now be required to report on each account holder’s tax residency and citizenship status.

“Whilst a lot of the work for FATCA is handled by fund administrators, multinational clients want advice from a centralised adviser with respect to both FATCA and CRS,” explains Tim Min, Managing Director, Tax at BDO (Cayman Islands).

“There is greater uniformity among the banks in terms of the documentation they require for FATCA and it appears that the implementation of CRS is going to be a bit smoother because of the experience the industry now has with FATCA filings. CRS is basically a version of US FATCA that now applies to the rest of the world.”

So far, more than 100 jurisdictions have committed to CRS, including the Cayman Islands. Financial institutions will need to report all information required under CRS to the Department for International Tax Cooperation (DITC) via the Cayman AEOI Portal. The first notification due date for CRS that fund managers need to be aware of is 30th April 2017. The first reporting due date is 31st May 2017, with annual CRS filings required thereafter.

“We’ve been helping our clients in drafting memoranda on US FATCA and we are currently doing so for CRS. We have also helped with respect to US and UK FATCA by responding to comments raised in the report filings. If a client doesn’t opt to use their fund administrator or registered office then we would provide the service to the client.

“US FATCA will remain outside of CRS but UK FATCA (‘CDOT’) will transition to the CRS after 2017,” confirms Min.

Given that the first CRS filing is less than six months away, Cayman managers should have already started thinking about preparing their first filings.

“If there are any doubts I would advise managers to seek advice as early as possible,” says Min, confirming that administrators should have a lot of the information that will be required for the CRS filing, similar to FATCA.

One of the complexities that CRS throws up is where Cayman fund managers have a broad mix of non-US taxable investors that need to be identified and reported on in addition to any US investors under FATCA. This creates a significant tax reporting and compliance burden on all fund managers, irrespective of their AUM.

“It will absolutely mean they have more considerations,” says Min.

“It is therefore important for fund managers that the due diligence on their investors is done properly and completely to identify any individuals with dual citizenship, for example, so that the proper tax reporting is done.

“One could end up doing multiple reportings for FATCA and CRS on certain investors. The big challenge is to vet those investors with two or more citizenships,” concludes Min.
A cornerstone of building this reputation is based on compliance with international standards to AML and cooperating with the international community to combat cross-border crime. Cayman has continually met or exceeded these standards over the years. Good governance thinks outside the box, it doesn’t just tick the box,” comments Bodden.

The ability to impose fines of up to USD1 million for the most serious breaches shows that Cayman is taking fund fraud extremely seriously. Considering the complexity of criminal activity today, knowing how to investigate internal suspicious activities, properly reporting to the Reporting Authority (failing to report is a criminal offense) and ongoing liaison, maintaining registers and maintaining confidentiality to avoid tipping off (which is a criminal offense) are all key components to protect a fund from fraud, criminal activity and, of equal importance, reputational damage.

“In looking around the globe, we see other jurisdictions that have implemented administrative fines systems and note that these are increasingly being used by authorities. Money Laundering Reporting Officers therefore may have a personal liability if charged with an administrative fine caused by their failure to ensure required reporting and compliance standards are met,” warns Bodden.

As part of Cayman’s drive to enhance its corporate governance environment, the Directors Registration and Licensing Law (2014) was introduced. Part of the rationale for doing this was to provide CIMA with greater transparency in respect of directors of Cayman funds. Although this has not
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Cayman LLC offers multiple applications to investment managers

The Cayman Limited Liability Companies Law (‘LLC Law’) was formerly introduced on 8th July 2016 and is expected to be used for a broad range of structuring situations.

From a US manager’s perspective, the Cayman LLC might be seen as an alternative to the Delaware LLC in setting up an investment management or advisory company or a General Partner for a Limited Partnership fund. A Cayman LLC could provide a useful synergy in a structure where Delaware entities are also used given that Cayman LLC Law is based on and uses many elements of the Delaware Limited Liability Company Act.

“A Cayman LLC can be set up with only a registration statement in the same way that a Delaware LLC might be set up where it is to be used as a single member entity. If you introduce more members then it’s sensible to enter into a full LLC Agreement to govern the relationship between those members,” explains Matt Mulry, Partner, Financial Services, Dillon Eustace (Cayman).

It should be noted, however, that whereas existing Cayman exempted companies are able to convert into a Cayman LLC this is not yet possible for existing exempted limited partnerships or segregated portfolio companies.

“The Cayman LLC could also be used as a joint venture vehicle, special purpose vehicle, holding company or as a blocker entity, and I think that these uses are in line with market expectations for the Cayman LLC,” says Mulry.

“We’ve had a number of clients interested in the Cayman LLC as a joint venture vehicle because it allows for wider drafting flexibility in its internal operations and the relationships between its members and managers than is available within the Cayman exempted company structure whilst at the same time the Cayman LLC provides a vehicle with a separate legal personality."

Mulry hopes that in addition to these expected uses the Cayman LLC will also begin to be accepted as a vehicle that is well suited for use as an investment fund.

“The LLC law has been drafted with the use of the Cayman LLC as an investment fund very much in mind. In particular the LLC law allows the use of a negative consent mechanism for obtaining member approval to changes in the operations of the Cayman LLC which is a key feature of US fund vehicles. The LLC law anticipates the use of all the core mechanisms expected of a vehicle which is to be used as an investment fund and the increased drafting flexibility available to the Cayman LLC should make it an attractive choice as a fund vehicle.

“However, it may take a while for it to be accepted by those who use existing Cayman fund structures. Our firm has developed fund documentation using the Cayman LLC and we want to actively push the use of the Cayman LLC as an investment fund product”.

“All Cayman based service providers and Cayman’s local industry body, Cayman Finance, maintain an open dialogue with lawyers and managers across the leading investment fund jurisdictions including the US, the EU and Asia. The development of the Cayman LLC product was borne out of those discussions and is evidence of the continuing active partnership between Cayman and its global client base which maintains Cayman’s position as the market leader in offshore investment funds,” says Mulry.
Looking for an independent director?

Formed in 1974, International Management Services (IMS) is one of the largest and longest established offshore company management firms in the Cayman Islands. Our Fiduciary Team focuses on the provision of directors and trustees to hedge funds. We have over 200 years of collective experience in the fund industry and provide services to some of the largest global hedge fund organizations.

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Give us a call to find out more.

Contact:
Geoff Ruddick
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Spotlight – A decade of independent governance

Q&A with Geoff Ruddick

You mentioned in your last article that ‘Governance is not a game’ – can you expand on what you meant by that statement?
Unfortunately, in the past few years fundamental governance related issues such as capacity (numbers), substance over form (form over substance), and board composition (split boards), have been used as marketing pitches. These are fundamental governance issues yet the sales side of the issue is increasingly the focus of attention.

Could you provide us with your perspective on each of these? Shall we start with capacity?
There certainly has been an extraordinary focus on capacity since the credit crisis and rightfully so, as capacity is a critical governance issue. Unfortunately though, for some time, an arbitrary number or cap had become analogous (and arguably in some cases the sole identifying factor) in determining the capacity of a director. Numbers are unquestionably relevant and therefore it is an important question to ask, but if it is the only query raised in assessing a director’s capacity it will be of limited value. Questions are fortunately far more thoughtful and thorough now and people now realise that numbers in isolation, without context or completeness, can be incredibly misleading.

So what are people asking now that is different from before?
Queries now go beyond numbers to determine what a director does day-in and day-out and how they spend their time, as well as assess the individual’s ability. Simply put, capacity is a function of time and ability. People also now consider: the composition of the clients the director serves; their role within their company; what other responsibilities they have beyond serving in a personal capacity on fund boards; their model, support infrastructure; their individual and firm capacity constraints; whether the director has any excess capacity for times of stress, and perhaps most importantly, how they personally view their role as a fiduciary.

Another debated issue is whether it is about the individual or the institution. What are your thoughts on this?
Although most consideration should be given to the capabilities of the prospective director, I don’t think it is necessarily as simple as one or the other. At the end of the day there is a component of both. That said, it is a ‘personal’ appointment and there is ‘personal’ liability that comes along with that. The personal nature of the relationship certainly is paramount, as ultimately the individual, not the institution, has the fiduciary duties to the fund. Therefore it cannot be completely ‘institutionalised’ away. Achieving the right balance is important.

You mentioned “form over substance” as well, can you give an example?
There are numerous examples from templated reports, agendas, to written resolutions versus meetings, etc. With respect to board meetings, if they are held just to tick a box where the constitutional documents, regulatory guidance notes, or institutional policies and procedures dictate, meetings being held for the sake of having meetings (i.e. form over substance) are of limited benefit.

It seems as though many have lost perspective that the underpinning of fundamental good governance is about substance, not solely form. Well thought out, planned and attended, discretionary versus mandated, meetings that are timely and properly minuted (i.e. substance over form) are incredibly important. Meetings certainly have their place and should be encouraged as appropriate, provided there is a measured and balanced approach in the decision making process.

It could be argued that matters can be documented in more detail by emails and written resolutions than they would by verbal phone conversations, meetings, and corresponding minutes. Regardless of the form of governance, it is important that there is always sufficient evidence documented to support the decisions taken by a board.
What is your take on Split Boards?
Split Boards have been the trend for the last couple of years now with investors in particular becoming increasingly interested in board composition and appointing directors with complementary skillsets from different service providers. My take is that an effective and diverse board requires competent individuals with complementary skillsets who can work collectively, irrespective of whether they come from the same shop or not. The collaborative aspect is equally as important as the individual expertise. There should ultimately be synergies gained so that the board’s collective value equates to more than the sum of its individual members. Good governance and the right board composition is really what it is all about.

What should people be focusing on when constructing a board?
Constructing an effective, diverse board does not have to be an arduous, time-consuming process. However, the decision should not be taken lightly. Given the directors are accountable for leading and directing the fund’s affairs, effective corporate governance is critical and therefore the appointment of experienced and qualified independent directors who collectively provide a diverse and complementary board composition is essential.

The industry needs to ensure the focus remains on the underlying fundamentals of good governance and the right board composition and not simply focusing on retaining directors from different fiduciary firms. Where the main consideration is only to engage independent directors from different fiduciary firms, this narrow focus, for the most part, misses the fundamental objective of establishing an effective, diverse board. So they should go beyond the ‘Split Board’ sales pitch and have a thoughtful, measured, balanced approach and give all aspects due consideration.

Are there enough directors available with the requisite experience?
There has been an influx of individuals with varying skillsets into the fiduciary space, which is a positive development, and there is certainly a greater depth of high quality directors in the space to choose from than there was a few years ago. Most are senior people who have excellent experience, qualifications, pedigree, etc. and are able to seamlessly make the transition from being an administrator, lawyer, auditor, regulator, risk or investment professional, etc. to being a director. Others, however, have difficulty making the transition, as although they have impressive technical skills, they are unable to transition into a leadership and oversight role that goes beyond their area of expertise. Individual personalities can come into play as well.

Why have we seen an influx of new directors and what do you mean by that latter comment about individual personalities coming into play?
The credit crisis was really the inflection point where governance started to be taken more seriously. As a result, there has been a flood of new entrants into the fiduciary space, which can be partially attributed to a supply shortage as long standing individuals are reaching capacity. Other newcomers are being opportunistic as they are looking for a career transition. In respect of individual personalities coming into play, some people are too passive or lack the intellectual curiosity, or gravitas, to effectively challenge management or their fellow directors, while others have domineering and controlling personalities or simply lack the aptitude to participate in a collective approach. As it is for many things in life, the right balance of individualism and collectivity is also paramount to an effectively functioning board.

In your opinion, what are the key characteristics & considerations of a good fund director?
There is a wide range of attributes and characteristics to consider from backgrounds (i.e. accountant, lawyer, ex-regulator, investment or risk expert), independence, qualifications, stage of career/life, level of engagement, technical abilities, personality and interpersonal skills, jurisdictional residence/familiarity/knowledge of and experience within the industry, capacity, support infrastructure, etc. The list goes on. I would, however, emphasise it again, perhaps most importantly is how the individual personally views their role as a fiduciary.

There is a lot of talk about directors having the right skillset. What skillsets should a director ideally have?
One important skillset that is often overlooked is corporate governance in itself. Possessing one or more of the aforementioned attributes in isolation does not necessarily make someone a good director. Perhaps even more important than having a director with a specific skillset, expertise, or being from a different fiduciary firm is to select directors who have a broad range of experience, have the innate ability to ask intelligent and probing questions, and know when and where to find expert advice when needed.

It is often more effective to engage someone with specialised expertise when needed rather than recruit it onto the board. The ability to put issues into the appropriate context is also very important – sometimes the board has to provide high level oversight and other times a more detailed approach is required. Effective and experienced directors will be able to maintain perspective and context in such situations, regardless of their specific skillset.
made any significant change to how funds operate or who may act for funds, CIMA is increasingly proactive in its collation of information and active regulation of funds. “They do conduct inspections and it is all part of the Cayman Islands adopting a more hands-on approach to the regulation of funds,” says Maree Martin, Counsel at Conyers Dill & Pearman. “They review funds’ annual returns to collate information to get a better idea of the funds they are regulating in terms of AUM, service providers, investment strategies, etc. The information is not publicly available but it is collated and does allow CIMA to be a more effective regulator.”

One clear manifestation of how much more seriously Cayman managers are taking corporate governance is the increased adoption of not just independent boards of directors, but split boards composed of directors from more than one directorship provider. This is adding more ballast to a fund board and demonstrates to institutional investors that the board has a mix of complementary skill sets being applied to the fund’s day-to-day operations.

To help put together split boards, Martin confirms that Conyers will provide a list of Cayman directorship providers for clients to choose from.

“One of the drivers will inevitably be cost, depending on the size of the fund. If it is a small start-up there are certain directorship providers in a certain fee range that would be a more obvious fit compared to other more expensive service providers. Accordingly, cost is one filter; another filter could be based on the proposed assets and strategy of the fund and whether the proposed directors have the relevant prior experience,” says Martin.

Managers can get a better feel for the appropriateness of directors by reading their biographies to see who they are impressed with and make a decision accordingly: a PERE fund manager, for example, will be looking for completely different expertise in a director compared to a basic equity long/short manager.

Not everyone is entirely convinced by the split board concept, however.

Geoff Ruddick is Head of Funds at International Management Services, Ltd (IMS). In his view, split boards unquestionably have their place depending upon the circumstances. “However, the industry needs to ensure the focus goes beyond the sales pitch and focuses on the underlying fundamentals of good governance and the right board composition and not simply retaining directors from different fiduciary firms.

“Where the main consideration or key focus is only to engage independent directors from different fiduciary firms, this narrow focus, for the most part, misses the fundamental objective of establishing an effective and diverse board. In particular, for existing funds where the incumbent directors have history and knowledge of the funds, are all engaged, work well collectively and have complimentary skillsets, there should be no good reason for a change. The benefits of going to someone new without this embedded knowledge, simply because they are from a different shop, will not necessarily enhance governance,” explains Ruddick.

Discussing governance trends, Ruddick thinks that many have lost perspective that the underpinning of fundamental good governance is about substance, not solely form.

With respect to board meetings, if they are held just to tick a box where the constitutional documents, regulatory guidance notes, or institutional policies and procedures dictate, then they are of limited benefit.

“That said, well thought out, planned and attended discretionary (versus mandated) meetings that are timely and properly minuted (i.e. substance over form) are incredibly important,” says Ruddick.

“Meetings certainly have their place and should be encouraged as appropriate. It could, however, be argued that some matters can be more timely documented and with better detail by emails and
PENTAS allows for the administration of all Private Equity Fund structures such as Master Feeder, Fund of Funds, Hybrid Funds and single Private Equity funds. It has been specifically designed by the user, for the user, in order to streamline and automate the administration requirements of a Private Equity Fund, using robust functionality. It offers flexibility and greater control to the user in the processing of transactions while automating specific processes to ensure accuracy and efficiency in the administration of these types of funds.

For more information, contact Koger at information@kogerusa.com, or at +1-201-291-7747 in USA, at +353-1-476-4120 in Europe and +61-2-9299-3161 in Australia or visit our website at www.kogerusa.com
For the past four years, alternative fund managers with US investors have been coming to terms with the far-reaching effects of the Foreign Account Tax Compliance Act or FATCA. Some 60-plus countries have signed up to cooperate with the IRS in order to enforce FATCA and this year the compliance burden is set to grow yet again for international fund managers.

On 31st May 2017, fund managers will have to submit their first filing under the OECD Common Reporting Standards initiative, which can best be thought of as global FATCA or ‘GATCA’.

This additional wave of compliance introduces a whole new set of requirements and responsibilities to fund managers and a whole new market and business opportunity to fund administrators.

Verifying whether or not their existing account holders meet the IRS criteria for US persons receiving US-sourced income – for which they must be taxed – requires intense scrutiny into their own records and collection of information from clients who may, or may not be, cooperative, was difficult in its own rights. But now having to concern yourself with US citizens for FATCA, and, also review the residence of all other investors, and create one of the different report types necessary to comply with the OECD’s effort for the automatic change of information, will at a minimum create twice the effort of identifying idicia and classifying investors.

Creating an internal programme to comply with FATCA and GATCA is the first massive hurdle for many firms. This includes, at a minimum, creating business procedures for the following critical items:

**Collection of data & documents**
- Organising and gathering all relevant account holder information, to include citizenship for FATCA and residency for GATCA.
- Tracking and storing government documentation for various countries.

**Categorisation of in-scope accounts**
- Tracking aggregate balance of the account holder and underlying beneficial owners to determine if they exceed the high value requirements for a full electronic search, or if a lower level of due diligence can be applied.
- Incorporating depository accounts, custodial accounts, equity or debt instruments, and certain insurance and annuity contracts.

**Further review and reporting**
- Internal reporting on all types of acquired data.
- Reporting to governmental agencies.

Against this complex backdrop of increased global regulation and compliance, KOGER USA has developed an efficient, scalable cure to remedy the solution known as KURE (KOGER Universal Regulatory Engine). It helps clients to coordinate the management of all aspects of compliance, providing an automated approach that reduces many labour intensive manual tasks.

Using KURE, clients can easily track, record, review and report on critical idicia in lockstep with new regulatory standards such as CRS, as they continue to be introduced into the alternative funds industry.

KURE is able to increase efficiency by offering:
• Complete tracking of underlying investments and beneficial owners, in even the most complex fund structures.
• Automatic extraction of indicia such as citizenship details, Tax IDs, Entity type, and other relevant fields from existing holder records.
• Automatic storing of all parameters and data from government forms.
• Dynamic adjustment of compliance status based on indicia documents’ expiration dates and real-time monitoring of asset levels for breach warnings when used with one of our TA systems (NTAS, PENTAs, PTAS).

KURE is also an exceptional reporting and data analysis tool with a suite of queries and internal reports that allows you to extract exactly the information you need, and XML reporting that allows the end-user to report directly to government agencies in accordance with established standards of the IRS for the US, HMRC for the UK, and all of the various permutations in existence for country by country exchange to adhere to common reporting standards.

Koger has recently introduced additional functionality to comply with EU AML IV and soon to be finalised EU AML V – European Union Fourth and Fifth Anti-Money Laundering Directive and CFT (Combating Finance of Terrorism).

Key features of the KURE AML/KYC module include:
• Custom risk scoring: We customise the system to store the specific risk assessment criteria and use the same risk level assignment paradigm as is used by your specific organisation uses. This achieves greater efficiency through customised and automated risk assessment.
• Risk-level-based document tracking: Assigned risk level dictates what specific documentation is required and monitored for receipt which creates greater efficiency through automated, risk-level based document tracking.
• Scalability for any sanction/PEP list provider on the market: Whether free or purchased, our flexible solution can interface with any single list or multiple lists one chooses to utilise.
• Ability to interface with other third party fund administration systems: KURE can serve as a central repository for all of your clients’ compliance-related data, regardless of whether or not their funds are administered by Koger products.
• Report withholding and automated email notification of outstanding documents: The system automatically withholds reports from recalcitrant investors and informs them of outstanding document requests. Requires less human resources to keep yourself and/or your clients compliant.
• A team of analysts, business users, and programmers constantly monitors industry trends and regularly enhances the system to be in sync with the latest regulatory changes and reporting standards.
written resolutions than they would by verbal phone conversations, meetings, and corresponding minutes.

“Regardless of the form of governance, it is important that there is always sufficient evidence documented to support the decisions taken by a board.”

The continuing increase in global fund regulation makes fund governance more challenging.

“It’s not only the AIFMD, FATCA and CRS that are driving change,” says Martin. “Best standards in fund governance are expected by investors, managers and regulators. We are also seeing independent directors joining the board of GP entities in private equity structures. Given the importance of verifying the value of private equity fund assets, there can be value in having independent directors with experience at evaluating liquid and illiquid assets.”

Martin agrees that increased regulation is something that funds have spent a lot of time considering in terms of their own internal procedures, documents and determining which service provider needs to deal with compliance matters from a practical perspective. “This has added time and cost to fund operations, which is an ongoing issue for start-up funds. It is increasing the barriers to entry and the cost of running a fund over the first few years,” she says.

Away from fund governance and looking at the wider picture, the Cayman Islands is further enhancing its reputation on the global stage through industry events that indirectly allow the jurisdiction to show its capabilities to visiting delegates.

One great example of this is the Cayman Alternative Investment Summit, organised by Dart Enterprises, a leading property developer that employs hundreds of people. This year’s summit, which takes place between 15th and 17th February, will be the fourth year it has run. Each year it keeps getting bigger.

Chris Duggan is Director of CAIS and VP of Community Development, Dart Enterprises. With Cayman still regarded as the industry’s leading offshore fund jurisdiction, Duggan says it is important for Dart, as the host sponsor, to help promote the industry even further.

“So often we hear about how important the industry is to the Cayman Islands but the Cayman Islands is equally important to the alternatives industry. The hedge fund industry is not a core part of our business but we recognise it is a core part of the Cayman Islands’ business. And we want to do whatever we can to continue to promote the jurisdiction and the alternatives industry that it supports.

“The Cayman Islands are an exceptionally well regulated, politically stable jurisdiction. It’s important that CAIS showcases how Cayman is a great place to do business,” comments Duggan.

CAIS and Dart Enterprises both actively promote social and economic development on the Cayman Islands. For example, Minds Inspired is a Dart-funded series of educational initiatives that provide scholarship and learning opportunities to on-island high school and university students. Dart is also the founder of Growing Communities, a park initiative to build and improve public community parks in the Cayman Islands. CAIS, meanwhile, is structured as a not-for-profit.

“Unlike many industry summits, CAIS is a not-for-profit and we really like to focus on how businesses can positively impact society through our ever-popular philanthropic panel on the final day,” says Duggan.

In their own unique way, events like CAIS, regulatory developments that help give CIMA teeth to properly enforce good corporate governance, and the growing acceptance of independent boards are helping the Cayman Islands present a unified front to the world: one that demonstrates its commitment to transparency and trust.