

Cayman Islands Fund Managers and Economic Substance Requirements

Recent Cayman Islands legislative amendments introduce important changes to the regulatory and supervisory framework applicable to Cayman Islands fund managers registered as 'excluded persons' under the Securities Investment Business Law. This article considers the impact of these changes, including with respect to the application of economic substance requirements to such entities and some of the options available.

Background

In June this year, the Cayman Islands Government passed amendments to the Securities Investment Business Law ("**SIBL**") introducing important changes to the regulatory and supervisory framework applicable to persons registered as "excluded persons" under SIBL ("**Excluded Persons**"). These amendments replace the existing category of Excluded Persons with a new category applicable to broadly the same group of entities who are now instead required to apply for registration, or re-register, as "registered persons" ("**Registered Persons**") by 15 January 2020.

Another key consequence of these amendments is under the International Tax Co-operation (Economic Substance) Law, 2018 (as amended) and the related Regulations ("**ES Law**"). A Registered Person which is a "relevant entity" and "manages securities belonging to another person in circumstances involving the exercise of discretion" for an "investment fund" (a "**Cayman Manager**") may be carrying on "fund management business" for the purposes of the ES Law and be subject to economic substance requirements.

In view of these changes, Cayman Managers that are currently registered as Excluded Persons will need to give careful consideration as to whether to (a) re-register as Registered Persons or (b) where they are not, as a practical matter, carrying on "securities investment business" under SIBL and/or "fund management business" under the ES Law, update their existing contractual arrangements to ensure that they reflect the scope of the services provided.

What has changed under SIBL?

The amendments to SIBL mean that it is no longer possible to register as an Excluded Person, and new Cayman Managers must instead apply to the Cayman Islands Monetary Authority ("**CIMA**") for registration as a Registered Person. Existing Excluded Persons are required to re-register as Registered Persons by 15 January 2020, and upon re-registration will become subject to the provisions applying to Registered Persons outlined below.

Registered Persons are subject to a number of CIMA supervisory, inspection and enforcement powers, which were previously restricted to those entities holding a full licence under SIBL ("**Licensees**"). Registered Persons are also required to notify CIMA within 21 days of any material change in the information filed by the Registered Person with CIMA. This includes the details of all directors, officers, AML officers, shareholders and beneficial owners, along with the structure chart and details of all affiliates of the Registered Person. By contrast, Excluded Persons were typically

required to update CIMA of their information only on an annual basis (when the registration was renewed).

Additionally, Registered Persons are subject to a "four-eyes" principle – that is, the requirement to have a minimum of two natural persons in management roles – which previously only applied to Licensees.

However, unlike Licensees, Registered Persons are not (a) required to submit annual audited financial statements or business plans, (b) subject to certain regulations made under SIBL (in relation to Conduct of Business and Financial Requirements), and (c) subject to pre-approval of any change of directors, shareholders or beneficial owners. Nevertheless, CIMA reserves the right to require Registered Persons to rectify or ameliorate any situation which CIMA considers unsafe or unsound (including following notification of any change of information, such as ownership or the appointment of directors or officers).

Registered Persons and Economic Substance Requirements

The ES Law introduces reporting and economic substance requirements for certain entities incorporated or registered in the Cayman Islands ("**Relevant Entities**") and carrying on specified activities ("**Relevant Activities**"). As a general rule, a Cayman entity structured as an exempted company or limited liability company that is not tax resident outside of the Cayman Islands will generally be within the classification of Relevant Entity, and will need to consider the economic substance requirements set out in the ES Law if it conducts one or more of the nine categories of Relevant Activity, which include "fund management business".

In practical terms, this means that Cayman Managers that are currently registered as Excluded Persons may be regarded as conducting the Relevant Activity of "fund management business" upon re-registration as a Registered Person. FAQs published by the Cayman Islands Government clarified that such entities will only be regarded as being subject to the economic substance requirements from 15 January 2020, even if they re-register in advance of that date.

How such economic substance requirements can be satisfied will depend on a number of factors, including the Cayman Manager's structure, operational size and approach, scope of business and relevant income. While there is currently no specific section on "fund management business" in the Guidance on Economic Substance for Geographically Mobile Activities issued under the ES Law ("**Guidance**"), the Cayman Islands Government has indicated that a further version of the Guidance will be issued later this year which will include such sector specific guidance. It is expected that the revised Guidance will provide Cayman Managers with additional clarity on satisfaction of the economic substance requirements, including the approach to be taken to outsourcing. This will be especially pertinent given the extent to which some Cayman Managers have established contractual outsourcing arrangements, including with UK investment management entities, in the context of hedge fund structures.

Next Steps and Different Scenarios

As a result of the amendments to SIBL, Cayman entities currently registered as Excluded Persons will need to re-register as Registered Persons by 15 January 2020, and where they are a Cayman Manager, may need to comply with the economic substance requirements under the ES Law from 15 January 2020. However, Cayman entities that are not, in practice, carrying on "securities investment business" under SIBL and/or "fund management business" under the ES Law, should look to ensure that their existing contractual arrangements are updated where necessary to closely reflect the prevailing factual situation and the scope of the services provided. In the context of a hedge fund structure where some or all of the discretionary management of the investment fund(s) is performed by a UK investment manager, there may be a number of different factual scenarios including:

- **Procurement Agent:** The Cayman entity may be responsible only for procuring the services of the UK investment manager (which is appointed as the discretionary manager)

for the investment funds, and may not itself carry on any securities investment business. In this scenario, Cayman entity would not be required to register (whether as an Excluded Person or Registered Person) under SIBL, and would not be considered to be conducting the Relevant Activity of "fund management business" under the ES Law.

- **Investment Advisor/Distributor:** The Cayman entity may not retain responsibility for discretionary management of the investment funds but provide other services, which can, for example, include investment advisory and distribution services, to the investment funds. In this scenario the Cayman entity would be carrying on securities investment business under SIBL (and so must re-register as a Registered Person before 15 January 2020), but may not be considered to be conducting the Relevant Activity of "fund management business" under the ES Law.
- **Holding Company:** The investment funds may directly appoint the UK investment manager as their discretionary manager, with the Cayman entity simply owning the management entities in the structure. In this scenario the Cayman entity would not be required to register under SIBL, and would not be considered to be conducting the Relevant Activity of "fund management business" under the ES Law. That said, it may be considered to be conducting "holding company business" under the ES Law if it only holds equity participations in other entities and only earns dividends and capital gains, in which case it may be subject to a reduced economic substance test under the ES Law.

The approach taken by a Cayman entity when establishing or updating its existing contractual arrangements will be driven by commercial considerations specific to each particular entity and investment fund structure, the existing factual situation, as well as the tax and regulatory considerations in the jurisdiction(s) in which the entities in the structure, and their owners, operate. Hedge fund managers looking to establishing new structures that include a Cayman Manager will also need to consider the SIBL and ES Law developments outlined above prior to commencing operations.

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