The Asset Management Review

Seventh Edition

Editor
Paul Dickson

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CONTENTS

PREFACE

While the global financial crisis of 2007 and 2008 may feel like an increasingly distant memory, its effects continue to be felt across the whole of the financial world. Despite significant improvements in the global economic landscape in the intervening years, global growth has been hampered in recent years by various geopolitical factors, including political uncertainty resulting from the change in administration in the US in 2016 and the rise of populist movements in Europe. As the UK prepares for Brexit, absent any agreement to the contrary currently set to take place in March 2019, political uncertainty remains around the form and extent of any UK–EU deal relating to financial services, and as to whether any transition period (during which UK firms would remain able to access to EU markets on current terms) will be agreed. This has had, and is likely to continue to have, a potentially destabilising effect on the UK asset management sector and its clients. The impact of the UK's decision to leave the EU is thus already being felt, not only in the UK and across the European continent, but also more widely.

Nevertheless, the importance of the asset management industry continues to grow. Nowhere is this truer than in the context of pensions, as the global population becomes larger, older and richer, and government initiatives to encourage independent pension provision continue. Both industry bodies and legislators are also increasingly interested in pursuing environmental, social and governance goals through private sector finance. For example, the European Commission has proposed a package of measures seeking to introduce sustainable finance into current regulations to make it easier for investors to identify and invest in such projects.

The activities of the financial services industry remain squarely in the public and regulatory eye, and the consequences of this focus are manifest in ongoing regulatory attention around the globe. Regulators are continuing to seek to address perceived systemic risks and preserve market stability through regulation. In Europe, further significant changes to the regulatory landscape for investment services were introduced by the revised Markets in Financial Instruments Directive regime (known as MiFID II), which has applied since 3 January 2018. In the UK, the Financial Conduct Authority continues to focus on the asset management industry. In 2017, it published its asset management market study on the performance of the asset management market for retail and institutional investors, and is beginning to implement its findings during the course of 2018. In contrast, the Trump administration in the US has signalled a deregulatory agenda, which includes plans to repeal the Wall Street Reform and Consumer Protection Act of 2010 (also known as the Dodd-Frank Act).

It is not only regulators who continue to place additional demands on the financial services industry in the wake of the financial crisis: the need to rebuild trust has led investors to call for greater transparency around investments and risk management from those managing their funds. Senior managers at investment firms are, through changes to regulatory requirements and expectations as to firm culture, increasing being seen as individually accountable within their spheres of responsibility. Industry bodies have also noted further moves away from active management into passive strategies, illustrating the ongoing pressure on management costs. This may, in itself, be storing up issues for years to come.

The rise of fintech and other technological developments, including cryptocurrencies, data analytics and automated (or 'robo') advice services, is also starting to have an impact on the sector, with asset managers looking to invest in new technologies, seeking strategies to minimise disruption by new entrants, or both. While regulators are open to the development of fintech in the asset management sector, they also want to ensure that consumers do not suffer harm as a consequence of innovations. Regulators across various jurisdictions are working together to develop a global sandbox in which firms can test their new technologies. This continues to be a period of change and uncertainty for the asset management industry, as funds and managers act to comply with regulatory developments and investor requirements, and adapt to the changing geopolitical landscape. Although the challenges of regulatory scrutiny and difficult market conditions remain, a return of risk appetite has also evidenced itself and the global value of assets under management continues to increase year on year. The industry is not in the clear but, prone as it is to innovation and ingenuity, it seems well placed to navigate this challenging and rapidly shifting environment.

The publication of the seventh edition of *The Asset Management Review* is a significant achievement, which would not have been possible without the involvement of the many lawyers and law firms who have contributed their time, knowledge and experience to the book. I would also like to thank the team at Law Business Research for all their efforts in bringing this edition into being.

The world of asset management is increasingly complex, but it is hoped that this edition of *The Asset Management Review* will be a useful and practical companion as we face the challenges and opportunities of the coming year.

Paul Dickson
Slaughter and May
London
August 2018

Chapter 9

CAYMAN ISLANDS

Jonathan Green, Tim Coak and Luke Stockdale[1]

I OVERVIEW OF RECENT ACTIVITY

Asset management vehicles established in the Cayman Islands can generally be divided into two distinct groups:

a regulated open-ended funds (predominantly hedge funds), for which there is an abundant supply of publicly available statistical information (although it lags behind the market, as is inevitably the case for information compiled by a regulator); and

b other asset management vehicles (including closed-ended and private equity funds), for which the available data is more limited.

A cornerstone to the success of the Cayman Islands' financial services sector is its strong legal and regulatory system, which equally benefits managers and institutional or other sophisticated investors. The jurisdiction is attentive and responsive to developing international trends, continually evolving to ensure it meets the requirements of finance sector participants, including governmental and regulatory authorities. Against this background, there have been a number of noteworthy developments, which are discussed in more detail below.

The Cayman Islands continues to maintain its position as the leading jurisdiction for the registration of funds, with 10,559 funds regulated under the Mutual Funds Law (2015 Revision) (Mutual Funds Law) at the end of 2017 and 10,500 at the end of the first quarter of 2018.[2] While the level of exceptional growth experienced in the years preceding the global financial crisis has ended, the industry has largely held its ground since the crisis. The industry's positive outlook is reflected in the Cayman Islands Monetary Authority's (CIMA) statistical digest for 2016, which shows growth in the net asset value of reporting funds up from US$3.575 trillion in 2015 to US$3.592 trillion in 2016.[3]

It is more difficult to obtain an accurate overview of the state of the Cayman Islands' asset management industry as a whole, which would necessarily include looking at the level of managed account activity and closed-ended fund activity. While single investor vehicles created as part of a managed account structure may involve registration of the relevant vehicle with the Cayman Islands registry, the vehicle will often not be required to register with CIMA because there is only one investor and therefore no pooling of investor funds (a requirement of the statutory definition of a mutual fund). There is also an exception to the need to register with CIMA for funds known as Section 4(4) funds, which are open-ended investment funds

1 Jonathan Green and Tim Coak are partners and Luke Stockdale is an associate at Maples and Calder.

2 Figures taken from the Mutual Funds and Mutual Fund Administrators (Annual and Quarterly) in the Investment Fund Statistics and Regulated Entities section of the CIMA website: www.cimoney.com.ky.

3 CIMA: Investments Statistical Digest 2016.

that pool the funds of 15 or fewer investors, a majority of whom are given the power to appoint and remove the fund's directors, managers (in the case of a limited liability company (LLC)), general partner or trustee, as applicable.

Closed-ended funds (i.e., funds that do not afford investors the option to withdraw all or part of their investment prior to the winding up of the fund) are not required to be registered or licensed by CIMA, so it is more difficult to gauge their numbers. The most useful indicator of the level of closed-ended fund activity (which generally includes funds investing in illiquid asset classes, such as private equity, real estate or infrastructure projects) is the number of registrations of Cayman Islands exempted limited partnerships (ELPs) and, more recently, LLCs. However, this is only a rough indicator based upon practitioners' experience that the majority of closed-ended fund structures are formed as ELPs. By contrast, CIMA's statistical digests show that only a small fraction of open-ended funds are formed as ELPs, highlighting that they are most prominent in the closed-ended sector. Figures released by the Cayman Islands Registrar of Exempted Limited Partnerships show that at the end of 2017, there were a total of 22,655 ELPs registered in the Cayman Islands. The years since the crisis have generally seen a consistent increase in the number of annual ELP registrations. In 2017, the figure for new ELPs formed stood at 3,872, compared with 3,356 in 2016, 3,377 in 2015 and 2,893 in 2014. At the end of May 2018, the figures for LLCs registered stood at 1,289. The introduction of this vehicle in July 2016 may account for the slight drop in ELP registrations in 2016, as the LLC provides similar flexibility to that which has made the ELP a popular vehicle for closed-ended structures.

ELPs are utilised for a variety of purposes within closed-ended structures. An ELP may well be the primary closed-ended fund vehicle, but often ELPs will also serve other purposes (e.g., ELPs may be used as a feeder into an onshore fund, an alternative investment vehicle, a parallel fund or a co-investment vehicle). Similarly, while still a relatively new vehicle in the Cayman Islands, experience has shown that LLCs are increasingly being used as general partners as well as feeder, blocker and aggregator vehicles in closed-ended fund structures. Changes in the rate of formation of ELPs and LLCs could, therefore, indicate fluctuations in the rate of new fundraising, but are just as likely to point to variations in the level of transactional activity by established closed-ended funds themselves.

II GENERAL INTRODUCTION TO THE REGULATORY FRAMEWORK

As noted above, pooled investment funds in the Cayman Islands are either open-ended and subject to registration with or licensing by CIMA (unless falling within the Section 4(4) exception), or closed-ended and not currently required to register with or be licensed by CIMA. The primary statute regulating Cayman Islands pooled investment funds is the Mutual Funds Law. Subject to the Section 4(4) fund exception, a Cayman Islands investment fund qualifies as a mutual fund, and is, therefore, required to be regulated under the Mutual Funds Law if:

a it is a company, LLC, partnership (including ELPs) or unit trust;

b it issues equity interests to investors (i.e., shares, partnership and LLC interests or trust units that carry an entitlement to participate in profits or gains, and which may be redeemed or withdrawn at the option of those investors prior to winding-up); and

c its purpose or effect is the pooling of investor funds with the aim of spreading investment risks and enabling investors to receive profits or gains from investments.

The key distinction between such an open-ended mutual fund and a closed-ended fund is the ability of investors to voluntarily redeem or withdraw some or all of their investment prior to winding-up, whether at will or on a specified period of notice. Where shares, partnership and LLC interests or trust units are subject to a lock-up period, Cayman Islands practitioners and CIMA generally consider that the lock-up period should be at least five years for an investment fund to be regarded as closed-ended at the outset. A fund with such a lock-up period will generally need to register with or be licensed by CIMA prior to the expiry of the relevant lock-up period.

Master funds are also potentially subject to registration with CIMA. A master fund in a multi-level fund structure will be deemed to be a mutual fund for the purposes of the Mutual Funds Law and, accordingly, will be required to be registered with CIMA, if it:

a is a Cayman Islands company, LLC, partnership (including ELPs) or unit trust;
b issues equity interests;
c holds investments and conducts trading activities for the principal purpose of implementing the overall investment strategy of a CIMA-regulated feeder fund; and
d has at least one CIMA-regulated feeder fund that conducts more than 50 per cent of its investment activity through the master fund, whether directly or indirectly via an intermediary entity.

Owing to the definition of master fund under the Mutual Funds Law, a master entity in a structure having only one investor (i.e., where there is, strictly speaking, no pooling element at the level of the master fund) will, nevertheless, constitute a mutual fund. The exact fund structure will, in each case, determine whether registration of a master entity, or any other entity, is necessary, although there are certain structural approaches that may allow such an entity to fall outside the scope of the master fund registration regime under the Mutual Funds Law. Where a fund is eligible for registration both as a feeder fund and as a master fund, CIMA has suggested that funds should generally opt for registration as a master fund, although there are certain circumstances in which this may not be appropriate.

Funds registered under Section 4(3) of the Mutual Funds Law account for approximately 96 per cent of all regulated investment funds in the Cayman Islands as of 31 December 2017.[4] The straightforward requirements for registration and the absence of a pre-approval process contribute to this popularity. The basic requirements for registration under Section 4(3) (for both traditional mutual funds and master funds) are that the minimum initial investment per investor is at least US$100,000 (or its equivalent in another currency), or that the equity interests are listed on a recognised stock exchange. Registration involves completion of an online application form by a licensed corporate services provider in the Cayman Islands, together with the online filing of the fund's offering document and consent letters from its administrator and its Cayman Islands auditor. A separate offering document is not required for a regulated master fund. On an ongoing basis, the fund must file an amended offering document within 21 days of any material change that occurs while it is still offering its equity interests. It must also file annual audited accounts, a key data elements form and a fund annual return (all submitted electronically by the fund's auditor) with CIMA within six months of the end of each financial year.

Few investment funds are fully licensed under the Mutual Funds Law, since this is generally only applicable to retail funds, while the majority of investment funds formed in

4 Op. cit. 2.

the Cayman Islands are intended for institutional or high-net-worth investors. Of the total number of 10,559 regulated investment funds at the end of 2017, only 81 were fully licensed by CIMA under the Mutual Funds Law.[5]

An alternative to obtaining a full licence under Section 4(1)(a) of the Mutual Funds Law is to be regulated as an administered fund under Section 4(1)(b) of the Mutual Funds Law. As of 31 December 2017, there were only 33 administered funds.[6]

Administered funds have steadily declined in popularity in recent years (from 435 in 2010 to 331 in 2017),[7] perhaps because the administrators who originally saw them as a source of higher fees came to realise that the higher fees were counterbalanced by higher risks. Registration as an administered fund is achieved by designating a Cayman Islands licensed mutual fund administrator as the fund's principal office. The administrator must satisfy itself that the promoters of the fund are of sound reputation, that the fund's administration will be undertaken by persons with sufficient expertise who are also of sound reputation, and that the fund's business and its offering of equity interests will be carried out in a proper manner. The administrator is obliged to report to CIMA any suspected infringements by the fund of the Mutual Funds Law (or any other law), or any suspicion that the fund may be insolvent or may otherwise be acting in any manner prejudicial to its creditors or investors. This imposes a role of quasi-regulator and compliance monitor on the administrator themselves, potentially a burdensome task to carry out effectively.

There are no local service provider requirements for CIMA-registered investment funds, save that they are required to appoint an approved local auditor and, in the case of an administered fund, a Cayman Islands licensed mutual fund administrator.

The corporate governance regulatory framework for funds is an area of consistent focus for CIMA. Partly in response to industry trends and stakeholder requests, CIMA issued a Statement of Guidance on Corporate Governance for Regulated Mutual Funds (SOG) on 13 January 2014. The SOG is relevant to all CIMA-registered and licensed mutual funds, their individual operators and their governing bodies. It does not extend to the banking and insurance sector. The purpose of the SOG is to provide individual operators and governing bodies of funds with guidance on CIMA's minimum expectations for the sound and prudent governance of mutual funds. While the SOG is not intended to be exhaustive and is not directly enforceable by CIMA, CIMA may look to the SOG should it need to consider whether the direction and management of a CIMA-registered and licensed mutual fund has been conducted in a 'fit and proper manner'.

The Directors Registration and Licensing Law, 2014 (DRL Law) entered into force in June 2014 to assist CIMA in verifying and maintaining key information on directors of companies regulated by CIMA as mutual funds under the Mutual Funds Law and companies registered with CIMA as 'excluded persons' under certain heads of the Securities Investment Business Law (2015 Revision), usually because of such companies' involvement as the investment manager in a fund structure (together, covered entities). This step was taken both for CIMA's own purposes and to assist CIMA with overseas regulator requests and, since the availability of the LLC, also extends to any manager of an LLC that is a covered entity. The DRL Law requires the directors (or, in the case of LLCs, the managers) of covered entities to be, themselves, registered with or licensed by CIMA, and allows CIMA to regulate

5 Ibid.
6 Ibid.
7 Ibid.

'professional directors' and 'corporate directors' of covered entities. The DRL Law will be relevant to any person who is, or who intends to become, a director of a company (or a manager of an LLC) that is or will be a covered entity, whether that person is resident in the Cayman Islands or elsewhere. Under the DRL Law, it is unlawful to be appointed as a director (or, in the case of an LLC, as a manager) of a covered entity without first being registered or licensed with CIMA.

The Cayman Islands has signed two intergovernmental agreements to improve international tax compliance and the exchange of information – one with the United States (US IGA) and one with the United Kingdom (UK IGA). The Cayman Islands has also signed, along with over 90 other countries, a multilateral competent authority agreement to implement the Organisation for Economic Co-operation and Development (OECD) Standard for Automatic Exchange of Financial Account Information – Common Reporting Standard (CRS). Cayman Islands regulations have been issued to give effect to the US IGA, the UK IGA and CRS (collectively, the AEOI Regulations). Pursuant to the AEOI Regulations, the Cayman Islands Tax Information Authority has published guidance notes on the application of the US and UK IGAs and the CRS. These developments are supported by a network of bilateral tax information exchange agreements (according to the OECD, as of 5 April 2018, there are over 2,700 bilateral exchange relationships activated with respect to more than 80 jurisdictions committed to the CRS), and adherence to multilateral conventions such as the OECD and Council of Europe Convention on Mutual Assistance in Tax Matters.

These initiatives further strengthen Cayman's regulatory reputation on cooperation matters and align its regulatory framework with a trend towards automatic exchange of information on tax.

III COMMON ASSET MANAGEMENT STRUCTURES

Three types of vehicle are most commonly utilised by Cayman Islands investment funds: exempted companies, ELPs and exempted unit trusts. Exempted in this context simply means that the vehicle is eligible to apply to the government for an undertaking (lasting 20 or 50 years depending on the type of vehicle) that, if any taxation is introduced in the Cayman Islands during the period to which the undertaking applies, such taxation will not apply to the vehicle in question. In return, exempted vehicles are not permitted to carry on business within the Cayman Islands. LLCs are not yet commonplace as investor-facing vehicles but are becoming increasingly common in overall fund structures, and are also eligible to apply for a 50-year tax undertaking.

Exempted companies limited by shares are the most commonly used vehicle for open-ended funds. In 2014, 77 per cent of CIMA-regulated mutual funds were exempted companies (including segregated portfolio companies),[8] and while this particular statistic was not included in the most recent CIMA statistical digest, practitioner experience suggests that this trend continues.

As previously noted, closed-ended funds established in the Cayman Islands are most commonly established as ELPs. Most jurisdictions with managers of, or investors in, such funds have become comfortable with the limited partnership structure prevalent in the United States, which is replicated to a significant degree in the Cayman Islands ELP structure. It is expected that the use of LLCs for closed-ended funds or their downstream

8 CIMA: Investments Statistical Digest 2014.

vehicles will increase over the coming years because of the substantial similarities between the Cayman Islands LLC and the popular United States limited liability company vehicles. While exempted companies are extremely flexible with regard to the extent to which voting and economic rights can be mixed among different classes of shares, companies with share capital have, by their very nature, certain structural and legal limitations that may not apply to ELPs or LLCs.

There are, for example, fewer statutory rules governing approval processes within ELPs and LLCs. For instance, general partners of ELPs or the managers of an LLC can be, and usually are, delegated a certain degree of unilateral authority to amend the constitutional documents of an ELP or an LLC, while such powers cannot be delegated to the directors of an exempted company in relation to its memorandum and articles of association (which can only be amended by special resolution of its shareholders). However, the key reasons for the use of ELPs (and now LLCs) for closed-ended funds relate to distributions. While the directors of a company are restricted by statutory and common law maintenance of capital rules, the general partners of an ELP or the managers of an LLC are generally limited only by basic solvency requirements and the agreed terms of the limited partnership or LLC agreement, as applicable, when considering which sources of funds to utilise. Even more significant, however, is the ability of partners or LLC members to directly enforce the constitutional documents against one another; and the fact that the terms of investment can easily be expressed to survive a partner's or member's withdrawal (whereas a shareholder in a company ceases to be subject to its articles of association when he or she no longer holds any shares).

Closed-ended funds generally make distributions on a waterfall basis, most commonly by paying distributions first to investors until all capital contributions have been returned and a certain level of return obtained, then to the manager or general partner until it has received a specified percentage of the aggregate amount of all distributions, and then to investors and the manager or general partner in specified percentages. Such distributions are often subject to claw back at the end of the fund's life if, once all distributions have been made, the manager or general partner has received a higher proportion of the aggregate distributions than intended, or, in some cases, from investors to fund indemnity payments. Utilising a company in this situation would generally require these obligations to be set out in a separate shareholders' or subscription agreement that is also signed by the company to ensure that the obligations survive a shareholder's withdrawal, and can be directly enforced by each investor and the company as against each other. Such considerations are also critical prior to the drawdown of funds from investors in a closed-ended vehicle, who may be bound by a limited partnership agreement or an LLC agreement prior to funding, but will generally not be bound by the articles of a company until such time as they actually subscribe for and are issued with those shares.

Investment funds structured as unit trusts are primarily formed in the Cayman Islands for distributions in Japan, where the demand is generated by familiarity with the unit trust structure and historical local tax benefits relating to unit trusts as opposed to company shares or limited partnership interests. The Cayman Islands also has specific regulations[9] that such investment funds can elect to comply with when applying for a licence under the Mutual Funds Law, which under current guidelines set by the Japan Securities Dealers Association

9 The Retail Mutual Funds (Japan) Regulations (2018 Revision).

permit them to be marketed to the public in Japan. Although companies and limited partnerships are also eligible to use this regime, the popularity of unit trusts with Japanese investors means that funds regulated under this regime are usually unit trusts.

IV MAIN SOURCES OF INVESTMENT

The disparity of available information between open-ended and closed-ended investment funds in the Cayman Islands is evident when analysing the source and value of investments in such funds. CIMA's published statistics[10] provide a useful indication of the scale of the open-ended industry, with the net asset value of reporting funds in 2016 being almost US$3.6 trillion, and reported inflows and outflows during 2016 from such funds of US$1.221 trillion and US$1.307 trillion respectively. It is worth bearing in mind that the actual figures for open-ended funds alone will exceed these amounts, because CIMA's figures are based only on the 88 per cent of regulated funds as at December 2016 that had actually filed their fund annual returns for 2015, and they do not capture open-ended funds exempted from regulation under Section 4(4) or funds held in managed accounts.

We can speculate that the size of the closed-ended fund industry in the Cayman Islands is of a similar order. However, as previously noted, the exact number of closed-ended fund vehicles is difficult to establish, and the details of equity holders in those vehicles and the size of their investments is not publicly available information. Therefore, it should be noted that this is, at best, an educated guess.

V KEY TRENDS[11]

The Cayman Islands has consistently adapted its regulatory and legal system to meet the demands of the finance sector and align it with international best practice. As a jurisdiction, it has proven to be highly responsive to the needs of the global financial industry through industry consultation projects, statutory amendments and new legislation, and through the growth and development of a commercially sophisticated judicial system.

Increasingly, the majority of inflows to hedge funds are from institutional investors. Institutional money has typically favoured larger managers, and this trend, together with recent positive industry performance, is reflected in the increasing total assets under management (AUM) figure for the industry, which is currently estimated to be over US$3 trillion.

Approximately 57 per cent of new funds were launched by managers with over US$1 billion AUM at the time of launch (whether from pre-existing funds in the market or because of a launch that exceeded US$1 billion). On the other hand, approximately 27 per cent of new funds were launched by managers with under US$100 million AUM at the time of launch, showing that there are a number of new start-ups out there despite the increased regulatory burden and other challenges faced by emerging managers in the current environment.

Over the four years prior to 2017, there was a steady increase in specific Employee Retirement Income Security Act of 1974 (ERISA) funds, and in funds allowing ERISA

10 Op. cit. 3.

11 The following trends and statistics are based upon our own client and transaction experience.

investors on the traditional limited basis, up to 84 per cent of funds in 2016. This position was, however, reversed in 2017 with a 24 per cent reduction in new funds permitting ERISA investors.

Equity long-short funds have consistently constituted the highest proportion of funds launched since 2010. Other strategies such as managed futures and fixed income have fluctuated in popularity, while more recently multi-strategy funds have become more popular, perhaps reflecting the current economic uncertainty in the global markets.

Since 2010, there has, unsurprisingly, been a steady increase in the number of regulated managers. This is undoubtedly driven by the Dodd-Frank Wall Street Reform and Consumer Protection Act, which was signed into US federal law on 21 July 2010, and which removed certain exemptions to registration with US regulatory bodies. For 2017, the general upward trend in the number of regulated managers continued, with at least 85 per cent of new funds being launched by regulated managers.

Both investors and regulators have pushed for greater transparency and accountability, which has led to changes in board composition. While the use of independent directors has steadily increased, we have also seen a trend for a segment of the launch market towards split boards consisting of independent directors appointed from more than one service provider as well as a manager-affiliated director. This trend has been more marked in the US than other regions. Independent directors are now regarded as significant to the overall structuring of a fund, as a robust board can be critical to the fund's success, and significant decisions in crisis situations (such as gating and suspending redemptions) can rest with the board. There has also been an increase in the use of independent advisory committees or independent directors on the boards of general partners where funds – particularly master funds – are structured as ELPs. Beyond a general uptick in the use of independent directors, there has been a significant shift in the manner in which directors engage with a fund, its service providers and investors. The institutionalisation of the industry and the impact of new regulatory initiatives aimed at protecting investors has led to a much greater degree of scrutiny on corporate governance, resulting in more proactive and engaged directors than ever before.

Preserving liquidity continues to be a key priority for investors. There has been a significant decrease in funds launching with a fund-level gate, although this has recently been accompanied by consistent use of investor level gates. Following an increase in the use of investor-level gates in 2016, 2017 saw a return to 2014 and 2015 levels, with almost equal numbers of funds using both forms of gates, and with the number of 'no gate' funds increasing.

Liquidity has recently become the most common side letter term (along with transparency) in place of fees. However, liquidity needs to be tailored to the asset class, and many investors understand that it is not always preferable to have greater liquidity. As a result, we still see a number of funds retaining the ability to, *inter alia*, create side pockets and effect suspensions.

i Statutory revisions and new legislation

A key strength of the Cayman Islands' funds regime continues to be the ability to combine robust yet flexible laws, which are updated to keep pace with industry needs, with a commercial approach to business. The past few years have been a particularly busy period for Cayman Islands legislation in this regard. Legislation and regulations have been amended when necessary to meet OECD, AIFMD, the US Foreign Account Tax Compliance Act and other external requirements, but change for its own sake has been avoided, and this approach can be expected to continue. The Cayman Islands fund industry is focused on, and responsive to, the legal and regulatory changes taking place worldwide, particularly in the US, Europe and Asia.

The Cayman Islands, through the applicable regulatory agencies, continues to engage proactively with counterpart international regulators (such as the Securities and Exchange Commission and the Financial Conduct Authority), and so remains at the forefront of evolving transparency and cooperation initiatives.

In addition to the previously mentioned amendments to the Mutual Funds Law, the SOG and the DRL Law, there have been a number of other more recent legislative updates.

The government has announced the establishment of two new 'opt-in' regulatory regimes that are consistent with (and intended to provide equivalency to) the EU Directive on Alternative Investment Fund Managers (AIFM Directive). In August 2015, the amendments to the Mutual Funds Law and Securities Investment Business Law required to implement the new regulatory regimes were passed, and in December 2016 the relevant supporting regulations were passed (although the regimes are not yet in force). The European Securities and Markets Authority (ESMA) is currently considering a number of jurisdictions, including the Cayman Islands, with a view to making recommendations as to their eligibility for a 'third-country passport' under the AIFM Directive. Once enacted, it is expected that the new regulatory regimes will mean the Cayman Islands is well placed for a favourable recommendation from ESMA in due course.

The enactment of the Limited Liability Companies Law in July 2016 and the provision of a new type of vehicle – a Cayman Islands limited liability company – served to strengthen the Cayman Islands' reputation as an innovative jurisdiction committed to developing its legislation to meet the needs of the global financial services industry. The LLC offers a new form of corporate vehicle similar in concept to the Delaware limited liability company in that it combines the most desirable features of both the exempted limited partnership and a company limited by shares. The LLC is a body corporate with separate legal personality but with substantially equivalent flexibility to an ELP in terms of operational structure. Critically, the liability of members is limited to the amount that each member has undertaken to contribute as expressly provided in the LLC agreement or other agreement between the member and the LLC. Unlike the ELP, where the general partner retains unlimited liability, all members can benefit from the limited liability provisions of an LLC.

In June 2017, the Cayman Islands passed legislation to allow for the establishment and registration of another new Cayman Islands vehicle: the limited liability partnership (LLP), and the registrar of LLPs in the Cayman Islands is expected to commence accepting applications to register LLPs in due course. An LLP combines the flexible features of a general partnership with the benefit of separate legal personality and affords limited liability status to all its partners. The LLP is expected to become the preferred manner by which professional firms operating in the Cayman Islands structure their businesses, but the LLP's features and flexibility may also provide an additional structuring option for investment funds as, by way of example, a general partner or management vehicle, or as a holding or fund of funds partnership.

From 1 July 2017, certain companies and LLCs are required to maintain a beneficial ownership register that records details of the individuals who ultimately own or control more than 25 per cent of the equity interests or voting rights, or who have rights to appoint or remove a majority of the company directors (or LLC managers), together with details of certain intermediate holding companies through which such interests are held. The new beneficial ownership regime, which is similar to that being concurrently implemented by other Crown dependencies and overseas territories, codifies a commitment agreed between the Cayman Islands and the UK government in April 2016 to enhance existing robust arrangements on the exchange of beneficial ownership information to assist law enforcement agencies combat tax evasion and money laundering. It is expected that most managed investment funds will fall within an exemption from the requirement to maintain a beneficial ownership register, for example because they are already regulated by CIMA or because they are managed by a manager that is itself regulated in an approved jurisdiction under the relevant legislation (i.e., other oversight and avenues of accessing information already exist).

In the litigation context, statutory amendments[12] have been introduced to allow the Grand Court to grant interim relief (including by way of a freezing order) in support of foreign proceedings without the need for substantive proceedings in the Cayman Islands (i.e., 'free-standing' interim relief). Prior to this legislation, in the absence of substantive proceedings, relief of this nature could only be granted against a defendant located in the Cayman Islands. Since its introduction, this legislation has been used a number of times to obtain interim relief in the Cayman Islands in support of foreign proceedings.

The Anti-Money Laundering Regulations, 2017 came into force on 2 October 2017, and were amended on 1 November and 12 December 2017 (AML Regulations). The AML Regulations updated the Cayman Island's anti-money laundering (AML) and combating of terrorist financing (CFT) regime to align it more closely to the FATF Recommendations and global practice.

The AML Regulations now apply to a wider range of Cayman Islands entities, including unregulated investment entities (e.g., all private equity or closed-ended investment funds and structured finance vehicles that are not registered with CIMA).

It is also a requirement that each investment entity designate natural persons in the roles of anti-money laundering reporting officer, money laundering reporting officer and deputy money laundering reporting officer (together, AML officers). Previously, CIMA-registered investment funds were able to rely on the AML/CFT internal controls of their administrators, where such administrators were suitably regulated. Accordingly, all Cayman Islands investment entities must maintain AML procedures in accordance with the AML Regulations, and designate AML officers. However, subject to certain conditions, AML compliance functions (including those of AML officers) can be performed by third-party service providers, so long as such delegation or reliance is formally recorded.

ii Recent case law

In the Cayman Islands court system, commercially significant cases are handled by the Financial Services Division of the Grand Court (FSD), and each proceeding is assigned to one of the FSD's highly experienced commercial judges. Appeals from the Grand Court, including the FSD, are to the Cayman Islands Court of Appeal (CICA), with a further potential right of appeal to the Privy Council in London. The courts deal with a wide variety of complex commercial disputes, including disputes between investors and funds that have suspended redemptions or are being wound down. Liquidations arising out of investment fund collapses also continue to give rise to litigation before the Cayman Islands courts.

12 The Grand Court (Amendment) Law, 2014 and related Grand Court Rules.

In two recent decisions, the courts have considered issues relating to the position of investors following the collapse of an investment fund. These decisions highlight the challenges faced by liquidators looking to claw back redemption payments from redeemed investors, or to adjust the rights of non-redeemed investors, after a fund enters liquidation. The decisions reflect the important role that legal certainty for investors plays in the resolution of such disputes in the Cayman Islands courts.

In *DD Growth Premium 2X Fund v. RMF Market Neutral Strategies (Master) Limited*,[13] the Privy Council held that redemption payments made by a fund in breach of applicable statutory provisions are not automatically void or repayable. DD Growth Premium 2X Fund (DD Growth) was an open-ended investment fund. Shortly before it was placed into liquidation, the fund made redemption payments to RMF Market Neutral Strategies (Master) Limited (RMF). It later came to light that DD Growth was insolvent at the time it made the payments because its net asset value (NAV) was grossly overstated as a result of fraud. The liquidators sought to claim back the redemption payments from RMF as voidable preferences. That claim failed in the Grand Court and the CICA because the liquidators were unable to show that DD Growth's dominant intention in making the payments had been to prefer RMF over other creditors. In the Privy Council, the liquidators argued that the redemption payments were unlawful because they breached the statutory provisions governing share redemptions. The court agreed that the payments were unlawful.[14] However, the more significant aspect of the decision was the question of whether the payments to RMF could be recovered. The court held that the liquidators could not bring a claim in unjust enrichment because the payments had discharged a valid legal entitlement of RMF to be paid for its redeemed shares. Accordingly, the court held that if the redemption payments could be recovered at all, they could only be recovered on the basis that RMF had received the payments in the knowledge that they had been authorised by the directors of DD Growth in breach of their duties. The Privy Council remitted the case back to the Grand Court to determine whether such a knowing receipt claim was available on the facts. In doing so, the court noted that proving RMF had such knowledge based on the internal affairs of DD Growth was likely to be difficult.

The position of non-redeemed investors was considered by the CICA in *Primeo Fund v. Additional Liquidator of Herald Fund SPC*.[15] It had been held in the proceedings in the Grand Court that where a fund's NAV has been materially misstated as a result of fraud, a liquidator could use the power to rectify the register of members of a solvent company in Section 112(2) of the Companies Law to look behind the fund's contractually binding NAV and adjust the register so as to reflect the 'true' NAV (i.e., the NAV taking into account a now-discovered fraud).

Overturning the Grand Court's decision, the CICA held that the power to rectify the register in Section 112(2) does not give liquidators a discretionary power to calculate a 'correct' NAV and substitute it for the 'misstated' NAV, which, despite the misstatement, has been calculated in accordance with investors' contractual rights in the fund's governing documents. The Court held that the power to rectify the register of members could not be used

13 [2017] UKPC 36.

14 This finding is now largely academic due to changes made to the Companies Law in 2011.

15 CICA, 27 February 2018.

in this way to override investors' legal rights. In light of this decision, a fund's contractually binding NAV will remain binding in a liquidation even though the later discovery of fraud shows the NAV to have been misstated.

Another topical issue in the funds context is the function and effect of side letter agreements. A side letter is a familiar feature of Cayman Islands funds and is typically used to provide large cornerstone investors with more favourable commercial terms than the fund might otherwise provide in its standard constitutional documents. There is now a series of decisions[16] that establish that, to ensure the validity and effectiveness of a side letter agreement, it should be executed by the correct parties (i.e., executed between the fund and the investor of record and not, for example, the underlying beneficial owner or an unauthorised agent of the fund such as an investment manager), and its terms must be consistent with the fund's constitutional documents. Although careful not to undermine the important principle that companies are not obliged to look behind their registers of members, as well as privity of contract, the court has found that principles of agency and estoppel may operate to avoid commercially unreasonable results.[17]

Many Cayman Islands funds conduct their business and hold their assets outside of the jurisdiction. Therefore, especially in the context of a winding-up or restructuring, the Cayman Islands courts have had to deal with complex cross-border and conflicts of laws issues. In recent years, the courts have demonstrated their willingness to facilitate cooperation in cross-border and foreign proceedings to ensure the efficient administration of justice. In a number of cases,[18] the courts have used the flexibility of the Cayman Islands provisional liquidation process to support a restructuring Chapter 11 procedure in the US. The Cayman Islands has no restructuring process equivalent to Chapter 11 or administration in the UK, so in circumstances where a Cayman Islands fund intends to undergo a restructuring, the provisional liquidation procedure is being more commonly used in support of such foreign restructuring proceedings.

A recent example of the flexibility of the provisional liquidation process when combined with a scheme of arrangement is the Ocean Rig restructuring. A scheme of arrangement is a court-approved compromise or arrangement between a company and its members or creditors that can be used to effect either a solvent or insolvent reorganisation of a company or group of companies. In *Re Ocean Rig UDW Inc and Ors*,[19] the Grand Court sanctioned four complex schemes of arrangement that resulted in the compromise of US$3.69 billion of New York law-governed debt for the Cayman Islands parent company of the group and

16 *Re Medley Opportunity Fund Ltd* [2012] (1) CILR 360, *Lansdowne v. Matador Investments Limited* (in official liquidation) [2012] (2) CILR 81, *Swiss-Asia Genghis Hedge Fund v. Maoming Fund* (Grand Court, 24 July 2013) and *KBC Investments Limited v. Varga* (as Official Liquidator of Lancelot Investors Fund Ltd) [2015] (1) CILR 328.

17 The Contracts (Rights of Third Parties) Law, 2014 is an important tool in dealing with these issues. This legislation allows parties to contracts to agree expressly to extend the right to rely upon and sue under a contract to non-parties, and so offers comfort to non-parties seeking to enforce the terms of properly drafted side letters.

18 See for example *Re Fruit of the Loom* [2000] CILR N-7; *Trident Microsystems (Far East) Limited* [2012] (1) CILR 424 and *Arcapita Investment Holdings Limited* (Grand Court order, 19 March 2012).

19 Grand Court, 18 September 2017.

three of its subsidiaries registered outside the Cayman Islands. The restructuring involved a number of novel aspects, including:

a the use of a Cayman Islands scheme of arrangement in relation to foreign registered companies;

b the appointment of Cayman Islands restructuring provisional liquidators and their recognition in the United States to ensure the effective implementation of the restructuring; and

c the entry into a court-to-court protocol between the Cayman Islands and New York courts.

This case may provide a model for future restructurings in the Cayman Islands, including of Cayman Islands investment funds and other structures.

VI SECTORAL REGULATION

i Insurance

There are no specific rules that apply to insurance asset management in the Cayman Islands. Local insurance companies licensed by CIMA under the Insurance Law 2010 may have restrictions imposed on them by CIMA regarding the classes of assets in which they are permitted to invest.

ii Pensions

There are no specific rules that apply to pension asset management in the Cayman Islands. Local pension plans must be registered with the Supervisor of Pensions under the National Pensions Law (2012 Revision), and the administrators of such plans are subject to statutory duties of care, diligence and skill (comprising both objective and subjective tests) in their management of the plan assets.

iii Real property

There are no specific rules that apply to property fund management in the Cayman Islands.

iv Hedge funds

Hedge funds will generally be open-ended vehicles, and therefore need to comply with the provisions of the Mutual Funds Law, as described in Section II.

v Private equity

There are no specific rules that apply to private equity funds in the Cayman Islands. However, the recent changes to the Exempted Limited Partnership Law bring the law more into line with the current commercial demands of private equity funds.

VII TAX LAW

The Cayman Islands imposes no taxation on the income or capital gains of investment funds or their investors, and no transfer taxes on the transfer of interests in investment funds. Exempted companies, LLCs, limited partnerships and unit trusts can obtain undertakings from the government that if any such taxation is introduced during a 20-year period (companies) or 50-year period (limited partnerships, LLCs and unit trusts),[20] as applicable, from the date of the undertaking (or date of creation of the unit trust), such taxation will not apply to the entity to which the undertaking is given.

VIII OUTLOOK

As the Cayman Islands continues to respond and adapt to regulatory changes and improve the laws relating to the fund vehicles preferred by sponsors and investors alike, we expect the next few years will witness ongoing growth in the jurisdiction's share of the hedge, private equity and venture capital fund formation market.

Further, the demand for an inexpensive, tax-neutral and secure method of pooling capital from multiple jurisdictions, and of transmitting that capital to where it can best be employed, is unlikely to disappear in the near future, as demographics continue to drive increased demand for alternative investment classes. The Cayman Islands' secure legal and regulatory framework and level of specialist expertise, combined with a proactive regulator, should enable the Cayman Islands to continue taking advantage of this demand, and to maintain its position as a premier jurisdiction for offshore investment funds.

20 Companies are entitled to a 20-year undertaking under Section 6 of the Tax Concessions Law (2018 Revision), limited partnerships are entitled to a 50-year undertaking under Section 38 of the Exempted Limited Partnership Law (2018 Revision), LLCs are entitled to an undertaking for a period not exceeding 50 years under Section 58 of the Limited Liabilities Companies Law (2016 Revision) and trusts are entitled to an undertaking under Section 81 of the Trusts Law (2018 Revision).

Appendix 1

ABOUT THE AUTHORS

JONATHAN GREEN

Maples and Calder

Jonathan Green is head of the Maples and Calder Cayman Islands investment funds team. He advises on all aspects of investment funds, specialising in private equity and hedge fund formation. Jonathan has extensive experience of corporate, partnership and trust structures, establishing and operating fund platforms, advising on fund regulatory matters, structuring downstream transactions and advising funds on matters arising throughout their life cycle. Jonathan was the chairman of the subcommittee that helped draft the Limited Liability Companies Law and is an alternate director of Cayman Finance (as well as being the chair and co-chair of a number of committees and subcommittees of Cayman Finance).

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Tim Coak is a partner in the Maples and Calder investment funds team. He specialises in the establishment, launch, ongoing maintenance and restructuring of all types of Cayman Islands investment funds, particularly hedge funds and private equity funds. He advises on commingled funds and managed accounts, and acts for a wide variety of clients, including large financial institutions and investment managers and smaller, start-up investment managers. He also regularly advises clients on a broad range of corporate and commercial transactions.

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Luke Stockdale is a member of the Maples and Calder litigation team, and has a broad range of experience in commercial litigation with an emphasis on complex and multijurisdictional matters. He has worked across a range of industry sectors, and has considerable experience in banking and finance and investment fund disputes, company law and trust disputes.

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