Introduction of Registration Regime for Closed-Ended Funds

On 8 January 2020, the Private Funds Bill, 2020 was published (the “Bill”). We expect the Bill will become law by the end of January 2020. While the timetable for implementation of the Bill and certain other key questions are still to be confirmed, this advisory summarises its key features and its likely impact on closed-ended funds and their managers.

This advisory is based on the Bill as published, and many of the practical details of the regime it introduces will need to be confirmed in due course in regulations and guidance. While we do not expect the text of the final law to differ in any material respect from the Bill, this advisory is necessarily a preliminary summary of how we expect the Bill to affect closed-ended funds. Walkers has been a leading part of the industry consultations and will remain closely involved in any consultations on ancillary regulations and guidance. As any of the matters discussed in this advisory develop in the coming months, we will publish additional advisories and guidance.

Which funds does this apply to?

In summary: Most closed-ended investor-facing fund vehicles, which encompasses most private equity, infrastructure and real estate funds, will be required to register under the regime introduced by the Bill and will be subject to the ongoing requirements it contains. The Bill includes exemptions for a series of non-fund arrangements, and provisions that relieve most alternative investment vehicles from certain provisions.

The Bill applies to ‘private funds’, which for these purposes are any company (including LLCs) unit trust or partnership whose principal business is the offering and issuance of investment interests, the purpose or effect of which is the pooling of investor funds with the aim of spreading investment risks and enabling investors to receive profits or gains from the entity’s acquisition, holding, management or disposal of investments, where:

(a) the holders of investment interests do not have day-to-day control over the acquisition, holding, management or disposal of the investments; and

(b) the investments are managed as a whole by or on behalf of the operator of the private fund, directly or indirectly, for reward based on the assets, profits or gains of the company, unit trust or partnership.

The Bill includes a substantial list of ‘non-fund arrangements’ which are excluded from the definition of private funds and therefore outside of the scope of the Bill altogether. In addition, the Bill provides that significant aspects of the regime, including the requirements to file audited financial statements, will not apply to alternative investment vehicles of registered private funds.

The full list of ‘non-fund arrangements’ is set out in Schedule 1 to this note, but includes the following which will be of particular interest to fund managers:
The exact scope of these 'non-fund arrangements' is expected to be clarified in rules and/or guidance issued by the Cayman Islands Monetary Authority ("CIMA") in due course.

In addition, funds with a single investor will be out of scope of the requirements, as they do not involve pooling of investor funds.

Although the primary focus of the Bill is on Cayman Islands vehicles, private funds that are incorporated or established outside of the Cayman Islands but which make an invitation to the public in the Cayman Islands to subscribe for investment interests would also fall within the scope of the Bill.

The Bill does not affect funds registered as ‘mutual funds’ under the Mutual Funds Law, which encompasses most open-ended hedge fund structures. The Mutual Funds Law will continue to govern the regulation of these structures.

The key features of the Bill and their practical impact

In summary: The Bill requires private funds to register with CIMA. While details of this registration regime are to be confirmed, we expect it will be similar online submission to the well-established CIMA registration regime applicable to open-ended hedge funds. Private funds will also be subject to requirements in relation to audit (including the requirement to have their audit issued or undertaken by an auditor approved by CIMA, which in practice will generally be the Cayman Islands branch of the fund’s auditor), valuation, safekeeping of assets, cash management and identification of securities they hold. In practice we expect most managers will be able to satisfy these obligations with minimal impact on their existing operational setup, by way of additional disclosures to investors.

Initial registration

A private fund may not commence its business unless it has submitted an application for registration with CIMA. It must submit this application within 21 days of accepting capital commitments from investors for the purposes of investments. The registration application will require the filing of certain prescribed details, which will be confirmed in due course by CIMA but we expect it will involve an electronic submission confirming the key fund terms, an affidavit from a director or authorised signatory of the fund, and certain high-level ancillary details.

The registration will also require the first year’s annual registration fee to be paid. The amount of this fee has yet to be confirmed.

Practical impact: The registration application will become part of the launch process for private funds, and will be handled primarily by Walkers as Cayman Islands counsel.

Ongoing obligations: Fees and Filings

Private funds will be required to pay an annual fee by 15 January in each year. The amount of this fee has yet to be confirmed.

To the extent any of the information submitted on the initial registration changes materially, or if the private fund changes the location of its registered office or principal office, the private fund will be required to file the details of this change with CIMA within 21 days of the change. This is similar to the existing obligations on CIMA-registered hedge funds.
Practical impact: Annual fees to CIMA will be paid on the fund's behalf by its registered office in the same way as annual registration fees are currently paid. Updates to CIMA in respect of material changes would generally be performed by Walkers as Cayman Islands counsel to the fund, although there may be situations where registered offices make certain filings.

Ongoing obligations: Audit and Annual Return

Private funds will be required to have their accounts audited annually by an auditor approved by CIMA. In practice this means the audit will be issued or undertaken by the Cayman Islands branch of the relevant auditor (though it may well be that the auditor in the home jurisdiction of the manager performs the substantive audit process). The audit will need to be filed with CIMA within six months of the end of the financial year to which it relates (though the fund can apply for an extension if necessary).

The accounts must be prepared in accordance with the International Financial Reporting Standards or the generally accepted accounting principles of the United States of America, Japan, Switzerland or a non-high risk jurisdiction, and the audit must be carried out in accordance with the International Standards on Auditing or the generally accepted auditing standards of the United States of America, Japan, Switzerland or a non-high risk jurisdiction.

CIMA has the power to issue waivers from the audit requirements. While the parameters of these waivers are to be confirmed, we would generally expect them to follow the limited parameters that apply to CIMA-registered hedge funds, for example for funds that register but never admit investors or draw down capital.

In addition, a private fund will be required to submit an annual return each year to CIMA in the prescribed form. The content and details of this form are to be confirmed.

In practice: As most funds are required by their constitutive documents and/or by the legal and regulatory framework applicable to the fund's investment manager to perform an audit, the principal new obligations here relate to the issuance of these audits being by a CIMA-approved auditor (i.e. one located in the Cayman Islands), and their filing with CIMA. We expect that these filings will be handled by the auditors via CIMA's online portal, in a manner consistent with the way audited financial statements are currently uploaded for registered hedge funds. Subject to confirmation of the details of the annual return process, we expect it will broadly follow the annual return required of registered hedge funds, and will be uploaded by the fund's auditors with the financial statements.

Ongoing obligations: Valuation, Safekeeping, Cash Monitoring and Identification of Securities

Private funds will be required to have appropriate and consistent procedures for the purposes of proper valuations of their assets. These valuations must be carried out with such frequency as is appropriate for the assets and at least annually. The valuation may be carried out by an independent third party or administrator, or by the manager or operator of the fund, provided in the latter case that the valuation function is independent from the portfolio management function, or potential conflicts of interest are properly identified, managed, monitored and disclosed to the investors of the fund.

Private funds will be required to appoint a custodian to hold custodial fund assets and verify that the fund holds title to other fund assets, and keep a record of those assets. However, a fund may notify CIMA that it is neither practical nor proportionate to do so, having regard to the nature of the fund and the type of assets it holds. In these circumstances, verification of title may be carried out by an independent third party or administrator, or by the manager or operator of the fund, provided in the latter case that the title verification function is independent from the portfolio management function, or potential conflicts of interest are properly identified, managed, monitored and disclosed to the investors of the fund.

Private funds will be required to appoint a person to monitor their cash flows. This includes ensuring that all cash of the private fund has been booked in cash accounts opened in the name, or for the account, of the private fund, and that all payments made by investors to the private fund in respect of investment interests have been received. The fund may appoint an administrator, custodian or another independent third party, or may rely upon the manager or operator of the fund, provided in the latter case that the cash management function is independent from the portfolio management function, or potential conflicts of interest are properly identified, managed, monitored and disclosed to the investors of the fund.
Private funds that regularly trade securities or hold them on a consistent basis will be required to maintain a record of the identification codes of these securities and shall make this record available to CIMA upon request. The records must include the ISINs where available, or an alternative identification code or legal entity identifier of the issuer of the relevant securities.

In each of these cases, CIMA will have the power to require funds to have the relevant function verified by an appropriately professionally qualified independent third party.

In practice: We expect most private equity managers will avail of the ability to conduct these functions internally, to the extent required. Fund offering documents may require additional language to disclose potential conflicts of interest (to the extent not already covered).

CIMA’s additional supervisory and enforcement powers

The Bill includes a range of new powers for CIMA, modelled on CIMA’s existing powers applicable to hedge funds that it regulates. These include the ability to require funds to provide information or documents as CIMA may reasonably require in connection with its functions, and the power to apply to court in respect of such orders as it sees fit in respect of funds operating without the required registrations. Where CIMA considers that a private fund has breached or is at risk of breaching any of its obligations under the Bill, it has certain powers to enforce special measures against the fund, including a requirement to perform a special audit or provide other reporting as CIMA may request. Additionally, CIMA has certain powers where it satisfied that a private fund is or is likely to become unable to meet its obligations as they fall due, or is carrying on business fraudulently or otherwise in a manner detrimental to the public interest, or to the interests of its investors or its creditors (among other things). These powers include the ability to cancel registrations, impose conditions, or ultimately require the substitution of operators (directors, general partners, trustees, etc.) or to assume control of the affairs of a private fund.

The operative provisions of the Bill are supported by penalties on funds and, in some cases, their operators that fail to comply.

Background to the Bill

In October 2019, the Cayman Islands government announced its intention to modernise funds regulation in the Cayman Islands, by introducing a registration regime for closed-ended funds.

This initiative arose from an ongoing dialogue the European Union has been conducting with many jurisdictions to ensure they meet EU requirements in respect of good governance. The EU recognises the Cayman Islands as a leading jurisdiction for investment funds and it is therefore unsurprising that they have focused on the Cayman Islands’ investment fund regulatory framework. Bermuda, the British Virgin Islands and the Bahamas are also expected to be required to implement similar regulatory frameworks.

To ensure that the Cayman Islands was not considered to be facilitating offshore structures which attract profits without real economic activity, in 2018 and 2019 the Cayman Islands adopted a series of measures to introduce ‘economic substance’ legislation. These measures were modelled on OECD best practices for combatting ‘base erosion’ – i.e. the use of lawful tax structures to reduce taxable profits in a jurisdiction.

The economic substance legislation introduced so far has not directly impacted investment funds (indeed, investment funds were expressly out of its scope), and the EU Council has long acknowledged that the activities of investment funds (‘collective investment vehicles’, in the EU’s terminology) are of a different nature from pure equity holding companies, intellectual property holding companies and similar entities that may pose base erosion concerns.

In May 2019, the EU issued technical guidance on the specific economic substance requirements for investment funds, which draws on concepts introduced in the EU’s AIFMD. These requirements fall into four groups (termed the ‘four pillars’ in EU publications): (i) authorisation or registration of fund vehicles, (ii) supervision and enforcement of rules, (iii) robust valuation, accounting and auditing requirements and (iv) depositary requirements.

While the Cayman Islands has long had a regulatory regime for open-ended funds that requires (among other things) hedge funds and other vehicles that permit redemptions/withdrawals to register with CIMA, closed-ended funds have not thus far required registration. The new regime will ensure that the Cayman Islands remains the offshore financial centre of choice for fund managers seeking to do business in Europe, and supports the Cayman Islands’ broader aim of adopting global standards in areas such as anti-money laundering and economic substance.
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Schedule 1

The Bill provides that the following arrangements, to be defined in rules and guidance to be issued by CIMA, constitute non-fund arrangements:

a. pension funds
b. securitisation special purpose vehicles
c. contracts of insurance
d. joint ventures
e. proprietary vehicles
f. officer, manager or employee incentive, participation or compensation schemes, and programmes or schemes to similar effect
g. holding vehicles
h. individual investment management arrangements
i. pure deposit-based schemes
j. arrangements not operated by way of business
k. debt issues and debt issuing vehicles
l. common accounts
m. franchise arrangements
n. timeshare and long-term holiday product schemes
o. schemes involving the issue of certificates representing investments
p. clearing services
q. settlement services
r. funeral plan contracts
s. individual pension accounts
t. structured finance vehicles
u. preferred equity financing vehicles
v. a fund of whose investment interests are listed on a stock exchange (including an over-the-counter-market) specified by CIMA by notice in the Gazette
w. occupational and personal pension schemes
x. sovereign wealth funds
y. single family offices