

# Cayman Islands - Guide to Hedge Funds

## Introduction

From offices in the Cayman Islands, Dubai, Hong Kong, London and Singapore, Walkers provides Cayman Islands legal services to FORTUNE 100 and FTSE 100 global corporations and financial institutions, capital markets participants, investment fund managers and middle market companies.

Walkers' Investment Funds group has an international reputation as the leading hedge fund and private equity fund practice, advising the best-known asset managers, promoters and institutional investors in the investment world for five decades. Our global presence means we are always open and accessible to our clients in all time zones.

The purpose of this memorandum is to offer a comprehensive, commercial and concise guide to the key aspects of structuring and establishing an offshore hedge fund. The memorandum is not a substitute for seeking appropriate onshore and offshore commercial and legal advice.

## Hedge fund vehicles

There are four types of vehicle that may be used to establish hedge funds in the Cayman Islands:

1. exempted companies (including segregated portfolio companies and limited duration companies);
2. exempted limited partnerships;
3. unit trusts; and
4. limited liability companies.

We briefly summarise the characteristics of each vehicle below. Due to their popularity in hedge fund structures, the remainder of this memorandum focuses on exempted companies. Please ask your usual Walkers contact, or use the details below, for any queries relating to other Cayman Islands vehicles.

### Exempted companies

Incorporation can be rapid (often within 24 hours of receipt of instructions) and is relatively inexpensive. The initial filing requirements at incorporation are straightforward. An exempted company must have a registered office in the Cayman Islands and keep registers of its directors and officers and any security interests granted by the company at its registered office. A register of shareholders must also be maintained (although this may be maintained anywhere in the world and is a private document). Significantly, for the hedge fund industry, exempted companies may issue multiple classes of shares with rights of redemption at the option of the investor and their share capital may be denominated in any currency or in more than one currency.

An investor contributes to a corporate fund by subscribing for shares, usually under the terms of a subscription agreement and an offering document, and the fund in turn invests the capital raised from subscribers in the

investments and market(s) described in the offering document. The rights and obligations of investors as shareholders in the fund, the terms of redemption and method of valuation are typically set out in the offering document and the company's articles.

### Segregated portfolio companies

The Companies Law (2016 Revision) (the "**Companies Law**") permits any exempted company to apply to the Registrar of Companies to be registered as an exempted segregated portfolio company ("**SPC**"). Once registered as an SPC, a number of segregated portfolios can be operated by the company which each have the benefit of statutory segregation of their respective assets and liabilities. Such structures have been used for multi-class, umbrella and master-feeder hedge fund structures (see the section entitled "*Types of Hedge Fund Structure*" below) as well as multi-issuance platforms which allow single managers to establish funds with different profiles within a single structure or sponsors to employ a single vehicle into which they bring multiple managers to manage distinct funds. For further information on SPCs, please request our memorandum "*Segregated Portfolio Companies*" from your usual Walkers contact or by using the details below.

### Exempted limited partnerships

Exempted limited partnerships can be established with a single class or multiple classes of limited partnership interests and can be adapted to suit any preferred form of capital contributions and partnership style accounting. The Exempted Limited Partnership Law, 2014 (as amended) based initially on equivalent legislation in Delaware, USA, provides a simple framework for the establishment of exempted limited partnerships, which are often used as master funds in the hedge funds space (see the section of this memorandum entitled "*Types of Hedge Fund Structures*" below).

Exempted limited partnerships have a large degree of flexibility in their internal structuring and are not subject to the detailed rules that apply to exempted companies. A Cayman Islands exempted limited partnership is not a legal entity in its own right. The assets and liabilities of the partners are vested in a general partner on trust for the benefit of the limited partners. The limited partners are not liable, over and above the amounts which they have agreed to contribute to the partnership, for the debts and liabilities of the partnership unless they lose their limited liability status by participating in the conduct of the business of the partnership. An exempted limited partnership requires at least one limited partner and at least one general partner. At least one general partner (there may be more than one) must be resident in the Cayman Islands if an individual, be registered under the Companies Law if a company, be registered as a foreign company under the Companies Law if a foreign company, or be an exempted limited partnership itself. An exempted limited partnership must be registered with the Registrar of Exempted Limited Partnerships. Registration can be achieved quickly, often within 24 hours, at relatively low cost.

### Unit trusts

Unit trusts are often used for investors in jurisdictions where typically the investor may receive some beneficial tax or other treatment as a result of acquiring units in a trust in contrast to shares or interests in a company or interests in a limited partnership. In particular, the single class or multi-fund unit trust has proved attractive to Japanese corporate and institutional investors on this basis. Cayman Islands trusts law is developed from English equitable principles and English common law. The principal statute, the Trusts Law (2017 Revision) (as amended) (the "**Trusts Law**"), is based upon the English Trustee Act, 1925, with certain modifications. As with an exempted limited partnership, a Cayman Islands trust is not a separate legal entity and the trustee will act on behalf of the unit trust pursuant to the provisions of a declaration of trust or trust deed (the primary constitutional document of a unit trust).

An investor's share in the assets of a unit trust is represented by 'units' which are usually transferable, subject to any restrictions on transfer contained in the trust deed. The trust deed will usually give investors the right to redeem their units and to purchase further units. The circumstances in which an investor may purchase and redeem units normally mirror those for a corporate fund.

The trustee of a unit trust fund is usually a licensed Cayman Islands trust company although Cayman Islands law does permit non-Cayman Islands trustees to be appointed as trustee of a Cayman Islands trust. The precise obligations of a trustee will vary with the particular provisions of the trust deed. The trust deed for an investment fund unit trust customarily grants to the trustee wide powers of investment in order that the fund's investment objectives can be implemented. In turn, the trustee usually delegates the investment of the trust assets to a professional investment manager/adviser or the fund promoter and to this extent the role of the trustee is not dissimilar to that of a corporate fund's directors who will typically delegate the investment of the fund's assets to an investment manager.

### Limited liability companies

Introduced by the Limited Liability Companies Law, 2016 (as amended) (the "**LLC Law**"), any one or more persons may form a limited liability company ("**LLC**") for any lawful business, purposes or activity. An LLC is a body corporate with separate legal personality. The terms of an LLC are typically set out in a limited liability company agreement (the "**LLC Agreement**") and an LLC must have at least one member. Members can agree mechanisms such as capital accounts and capital commitments, allocations of profits and losses, allocations of distributions, voting methods (including negative consents) and classes of interests. The LLC Law purposefully drew on the Delaware limited liability company legislation; while to date it does not appear that LLCs are being routinely used as part of hedge fund structures, it remains to be seen whether they will become more popular with those accustomed to Delaware LLCs (particularly if the proposed introduction of series LLCs takes place, providing statutory segregation of assets and liabilities in the same way as under the Delaware legislation).

### Hedge fund structures

Each of the types of vehicles described above may in turn be used in a variety of fund structures, the most common of which are the following:

1. stand-alone funds;
2. master-feeder funds;
3. parallel funds; and
4. umbrella funds.

### Stand-alone funds

Stand-alone funds are the simplest of structures, being a single vehicle, with a single investment strategy. The most common vehicle used in the Cayman Islands for stand-alone funds is an exempted company and funds of this nature are often used in start-up situations or where the target market does not require the complexity of a master-feeder structure. Technically, even if such a fund is established to invest on a fund-of-funds basis, it will still be a stand-alone vehicle as its investment strategy will not alter the fact that the fund - from a structural prospective - will function on an independent basis, simply investing its own investors' monies into other funds.

### Master-feeder funds

A master-feeder structure is one in which the combined assets from multiple funds - known as "feeder funds" - are substantially invested into a separate vehicle, usually managed by the same investment manager that manages the feeder funds, known as the "master fund". The master fund then acts as the investment vehicle for the feeder funds and invests the proceeds raised by the feeder funds in the master fund by pursuing the investment strategy of the feeder funds. Structurally this is achieved by investors purchasing shares/interests in the feeder funds and the feeder funds purchasing shares/interests for equivalent consideration in the master fund, such that generally the only shareholders/interest holders in the master fund are the feeder funds.

The principal benefits of a master-feeder structure are that:

1. it enables an investment manager to benefit from having to manage only one investment vehicle instead of two or more investment vehicles following similar investment strategies and therefore reduce trading costs; and
2. it will typically be constituted of different types of entities formed in different jurisdictions in order to comply with or benefit from the regulatory environment applicable to different target investors in the fund.

The most common master-feeder structure encountered is one with a Cayman Islands exempted company as the master fund, a Cayman Islands exempted company as the feeder fund for non-US investors and US tax-exempt investors, and a Delaware limited liability company as the feeder fund for US taxable investors. Certain structures also use exempted limited partnerships as master funds. So-called "one-legged" structures in which an exempted company feeds into an exempted limited partnership which then also takes subscriptions direct from other individual investors are the preferred option for certain advisers.

Master funds may also be onshore entities. This is sometimes seen where a fund was set up as an onshore fund vehicle only, but the investment manager subsequently wishes to admit a non-US or a US tax-exempt investor. In that situation the investment manager may simply want to add a Cayman Islands feeder fund to the structure for that investor (and any future similar investors) and wishes to preserve the status quo of its existing structure as much as possible.

### Parallel funds

A parallel fund structure may be adopted for reasons similar to those driving a master-feeder structure, namely to accommodate the needs of particular investors but in such a parallel structure each fund invests alongside the other. Structurally, each parallel fund is a stand-alone entity and for Cayman Islands purposes two or more companies, partnerships or unit trusts/sub-trusts can be used. One or more of the parallel funds may also be an onshore vehicle.

### Umbrella funds

Umbrella funds are single vehicles that pursue multiple strategies and typically provide scope for the exchange of investors' interests between interests associated with these strategies. Although for corporate vehicles, this used to be achieved by using separate share classes and entrenching segregation in the constitutional documents of the relevant company, SPCs now provide the most appropriate choice of corporate vehicle for funds of this nature with differing segregated portfolios having different strategies. Investors in such vehicles can be given the ability to switch between portfolios (typically by redemption or repurchase by one segregated portfolio and a new issuance by another). Unit trusts are also often commonly used for umbrella structures with the terms of the trust documentation setting out the ring-fencing and fund-switching arrangements between separate sub-trusts. Umbrella structures are also used for multi-issuance fund programmes.

## Regulatory considerations for hedge funds

The Mutual Funds Law (2015 Revision) of the Cayman Islands (the "**Mutual Funds Law**") defines a "mutual fund" as "*a company, unit trust or partnership that issues equity interests, the purpose or effect of which is the pooling of investor funds with the aim of spreading investment risks and enabling investors in the mutual fund to receive profits or gains from the acquisition, holding, management or disposal of investments...*". For these purposes an "equity interest" is defined as "*a share, trust unit or partnership interest that (a) carries an entitlement to participate in the profits or gains of the company, unit trust or partnership and (b) is redeemable or repurchasable at the option of the investor... before the commencement of winding up or dissolution of the company...but does not include debt*".

Accordingly, the two key issues are:

1. the option of an investor to redeem; and
2. the pooling of assets.

The Mutual Funds Law makes it clear that debt-issuance vehicles do not (unless they also issue relevant equity interests) fall within its scope. The vast majority of Cayman Islands hedge funds are regulated under the Mutual Funds Law (however, see: "*Highly-Restricted Placement or Exempted Funds*" below) albeit that these are not necessarily "mutual funds" as the term is understood in certain onshore jurisdictions.

There are three categories of regulated mutual funds in the Cayman Islands, the distinction turning on the manner in which they are regulated under the Mutual Funds Law, not on the type of vehicle or configuration of vehicles that is/are being regulated. The regulator is the Cayman Islands Monetary Authority ("**CIMA**"). These three categories are as follows:

### Licensed funds

Licensed mutual funds are funds which hold a licence under the Mutual Funds Law. They must have either a registered office in the Cayman Islands or, if a unit trust, a trustee which is licensed under the Banks and Trust Companies Law (as amended) of the Cayman Islands and are subject to a prior approval process, requiring CIMA to be satisfied with the experience and reputation of the promoter and administrator and that the business of the fund and the offering of its interests will be carried out in a proper way. These types of fund are relatively rare (and in terms of the total number of the Cayman Islands mutual funds, a *de minimis* percentage) and tend to be used by certain types of retail funds as there is no minimum investment threshold. However, in practice, retail funds are more commonly dealt with under the third category of mutual fund as described below.

### Funds with no minimum investment threshold

Mutual funds with a minimum subscription level of less than US\$100,000 must have a licensed mutual fund administrator providing their principal office in the Cayman Islands. Again, given the usual hedge fund investor profile, funds regulated in this manner are fairly rare.

### Funds with a US\$100,000 minimum investment threshold

Mutual funds where either: (i) the minimum equity interest purchasable by a prospective investor is US\$100,000 or equivalent; or (ii) the equity interests are listed on an approved stock exchange or over the counter market, have the fewest regulatory burdens in the Cayman Islands. They are required to produce an offering document, appoint an administrator and have their financial statements signed off by a CIMA approved auditor in the Cayman Islands. Funds falling into this category constitute the vast majority of hedge funds established in the Cayman Islands and it is likely that any hedge fund with a sophisticated investor base will be established this way. No approval from CIMA is required prior to launch of such a fund.

### Highly-restricted placement or exempted funds

Finally, although not appropriate for a fund which will be widely-placed, there is scope for establishing an open-ended vehicle that is exempt from the prescribed registration requirements under any of the foregoing categories where the equity interests in the fund in question are held by not more than fifteen investors, the majority of whom are capable of appointing or removing the "operator" (which means the trustee, general partner or directors - depending on the structure of the relevant vehicle) of the fund. This is commonly known as the "fifteen investor exception". Such a fund is exempt from registration under the Mutual Funds Law and therefore sometimes referred to as an "unregulated" fund in the Cayman Islands. Master funds in master-feeder structures which do **not** have a CIMA regulated feeder may also be structured in this way to avoid having to be registered under the Mutual Funds

Law as a mutual fund. However, if one or more of the feeder funds in the structure are registered in the Cayman Islands as mutual funds, the master fund must also be registered and will not be able to avail itself of the fifteen investor exception.

## Corporate control and liquidity

### Capital structures

An open-ended corporate hedge fund will generally either issue voting shares to all investors or issue: (i) a small number of management shares with voting rights, with or without any economic participation in the fund to be held by or on behalf of the promoters (or in the event that this raises consolidation concerns by a trustee under a dedicated trust arrangement); and (ii) redeemable participating shares with economic rights but without any, or very limited, voting rights.

Historically in this market, having investors hold non-voting shares has been the most common approach. Splitting the economic rights of participating shares from the purely corporate rights of management shares is generally justified on one or more of the following bases:

1. Speed and efficiency

Firstly, it makes corporate management of a fund faster and more efficient as managers often want to be able to effect shareholder actions promptly without having to seek a unanimous written resolution from a large number of shareholders or convene a general meeting. Although for a fund that has sufficient headroom of authorised capital, the flexibility now included in fund documentation generally makes this justification less compelling than it was in the past, having the voting rights restricted to the management shares nevertheless may prove invaluable in a restructuring situation where matters have to be dealt with fast. As regards the protection of the rights of shareholders in the fund who do not hold voting rights, it needs to be borne in mind that such holders will still have the benefit of class rights protection with respect to material adverse changes in the fund documentation notwithstanding that they do not hold voting shares.

2. Quorum

Having management shares should avoid concerns about being able to meet quorum requirements at a general meeting, albeit that such concerns may be addressed in all-voting structures by the insertion of a proxy - generally to the administrator - in an investor's subscription documentation.

3. Control

If voting shares are offered to all investors there can be concerns that an onshore entity may, depending on the level of their holding, be said to "control" the fund which might lead to the fund falling within the tax regime of the relevant onshore jurisdiction.

### Liquidity arrangements

It is the capacity of an exempted company with appropriately drafted constitutional documents to issue redeemable shares (which do not need to be preference shares) that enables such vehicles to be used to establish corporate hedge funds - vehicles in which the core economic right of a shareholder is the ability at its option to exit all or part of its holding on specified redemption dates. The liquidity of a corporate fund stems from shareholders' optional redemption rights. Funds constituted as exempted limited partnerships and unit trusts in turn mirror this form of liquidity in their documentation.

This very flexibility is however also an issue that can give rise to areas of significant complexity when a fund is not sufficiently liquid to honour one or more investors' redemption requests, leading what was originally thought of as a liquid investment to become illiquid. This issue is generally dealt with under fund the documentation in one or more of the following three ways, each of which is a commercial decision for those structuring the relevant fund:

#### *Gates*

Some but not all funds have the ability to impose a "gate" to enable the fund to delay redemptions. Funds that permit the imposition of a gate usually provide for a particular level of redemptions (on an aggregated basis) to be reached before the gate is triggered. A fund may also have a "stacked gate" which permits gated investors to be given priority over investors subsequently seeking to redeem on the next redemption date.

#### *Suspension*

The articles of association of a fund usually provide that the directors may suspend the determination of net asset value redemption rights and the payment of redemption proceeds. There may be tightly prescribed circumstances which must exist before the suspension may be effected, or the directors may be left with a broad discretion.

#### *Redemption in kind*

Where a fund has insufficient liquid assets to meet all redemptions in cash, it may be possible to pay redemptions partly or wholly in kind, by the transfer to the redeeming investors of assets of the fund. There must be clear authority in the fund's documents.

Another mechanism to deal with liquidity issues is the use of "side pockets", although this is increasingly uncommon in the current environment. Further details can be discussed with your Walkers attorney.

## Hedge fund fee structures

### Overview

A hedge fund manager will typically receive both a management fee and a performance fee (also known as an incentive fee) from the fund. Historically, for instance, a manager might charge fees of "2 and 20", which refers to a management fee of two percent of the fund's net asset value each year and a performance fee of 20 percent of the fund's "profit". Other common fees apply to both the subscription and redemption of shares, interests or units in a fund.

### Management fees

The management fee is typically calculated as a percentage of the fund's net asset value. Management fees generally range from one percent to four percent per annum, with two percent being a common percentage. Management fees are usually expressed as an annual percentage but may be calculated and paid monthly or quarterly as opposed to annually.

The business models of most hedge fund managers provide for the management fee to cover the operating costs of the manager, leaving the performance fee for employee bonuses. However, in large funds the management fees may form a significant part of the manager's profit.

### Performance fees

Performance fees (or "incentive fees") are one of the defining characteristics of hedge funds. The manager's performance fee is calculated as a percentage of the fund's "profits" (ie any increase in its net asset value over a specified period), usually counting both realised and unrealised profits. By incentivising the manager to generate

returns, performance fees are intended to align the interests of manager and investor more closely than flat fees do. In the business models of most managers, the performance fee is largely available for staff bonuses and so can be extremely lucrative for managers who perform well.

As noted above, a hedge fund manager may typically charge a performance fee of 20 per cent of any increase in the net asset value of the fund over a specific period and these performance (and management) fees usually apply to gross asset values and gross performance. However, the range is wide with highly regarded managers charging higher fees.

Performance fees have been criticised by many people, who believe that by allowing managers to take a share of profit but providing no mechanism for them to share losses, the fees give managers an incentive to take excessive risk rather than targeting high long-term returns. In an attempt to control this problem, fees are usually limited by a high water mark.

A high water mark (or put simply, a "loss carry forward provision") is often applied to a performance fee calculation. This means that the manager only receives performance fees on increases in the net asset value of the fund in excess of the highest net asset value it has previously achieved.

In addition, some managers specify a hurdle rate, signifying that they will not charge a performance fee until the fund's annualised performance exceeds a benchmark rate, such as T-bill yield, LIBOR or a fixed percentage. This links performance fees to the ability of the manager to provide a higher return than an alternative, usually lower risk, investment.

With a "soft" hurdle, a performance fee is charged on the entire annualised return if the hurdle rate is cleared. With a "hard" hurdle, a performance fee is only charged on returns above the hurdle rate. Hurdle rates can be used independently of, or combined with, high water marks in fee structures.

### Subscription and redemption fees

Some funds may also charge an up-front "subscription fee", payable when an investor initially subscribes for shares, interests or units in the fund and some funds charge investors a redemption fee (or "withdrawal fee" or "surrender charge") if they withdraw money from the fund in certain circumstances via the voluntary redemption or shares, interests of units.

### Future market trends

One trend that is becoming more prevalent is the cutting of performance and management fees from the traditional "2 and 20" model. There have been several high profile funds that have launched with lower fees, in the "1.5 and 15" range. This trend may continue but it is likely that managers will seek to impose longer lock-up periods for lower fees going forward, and there is some anecdotal evidence that the larger institutional investors will agree to such deals, accepting the benefit of lower fees while recognising that longer lock-up periods will benefit a manager's strategy and bring greater stability to a fund.

## Key service providers - who are they and what are their roles?

There are a number of key service providers that are appointed to assist and support hedge funds in their day to day operations.

The primary ones include: the investment manager or advisor, administrator, custodian, placement agent/distributor, auditors, prime broker, independent directors, onshore counsel and (if a hedge fund is to be listed) a listing agent.

## Investment manager or investment adviser

The primary service provider appointed by a fund is invariably its investment manager or investment adviser.

An investor's primary consideration when determining whether to invest in a fund will be the identity/track record of the investment manager/adviser and/or its principals and the portfolio team which will be managing the fund. By allocating capital to a manager or a group of managers, the investor expects to participate in the skill of the manager or managers and not necessarily in a particular investment strategy or a mechanical process.

The precise role will vary depending on the terms of the contract pursuant to which the investment manager is appointed.

Its role can range from being involved in promotion and marketing, the sale and redemption of shares, ensuring adherence to the investment policies and strategy of the fund, managing the fund's assets and investing the assets of the fund, to simply acting in an advisory capacity and leaving all investment decisions ultimately to the directors.

There is no requirement that the investment manager be based in the Cayman Islands. However, it is quite common for clients to establish a Cayman Islands based investment manager to act as investment manager for their offshore fund(s), primarily because there may be onshore tax benefits if the performance and management fees are paid by the fund to an offshore manager (who can then repatriate the fees (eg by way of dividend or by way of contractual agreement) at the most advantageous time). In those situations Walkers can facilitate the incorporation and set up of the investment manager entity and ensure that it complies with any applicable Cayman Islands laws (in particular the Securities Investment Business Law (2015 Revision), or "**SIBL**") at the same time as forming the hedge fund which that new manager will manage.

Any Cayman Islands managers that we incorporate for our clients are commonly able to avoid full licensing under SIBL (which is a relatively onerous procedure) and register for an exemption under SIBL.

It is also not uncommon for funds to appoint an investment manager - Cayman Islands or otherwise - in the first instance and for that investment manager to sub-contract some or all of its functions to an onshore investment advisor.

## Administrator

The next key appointment for a hedge fund is usually the fund's administrator.

Typically an administrator will be appointed to oversee the day-to-day operations of the hedge fund, and (depending on the terms of the contract between itself and the hedge fund), assist in the calculation of (or make the ultimate determination of) the net asset value ("**NAV**") of the hedge fund, to process subscriptions and redemptions, to act as registrar and transfer agent (eg to maintain investor records), to assist with gathering of due diligence for investors for the purposes of automatic exchange of information reporting ("**AEOI**")<sup>1</sup> and usually (although not always), undertake anti-money laundering ("**AML**") procedures on behalf of the hedge fund. For further information on the AEOI or AML obligations for hedge funds, please request our memoranda from your usual Walkers lawyer or by using the contact details below.

The administrator will also usually coordinate the opening of a bank account for the fund to deal with subscriptions and redemptions. The bank account provider may be an affiliate of the administrator or it may be a bank with whom the administrator has an established relationship. There is no requirement for a Cayman Islands fund to have a bank account in the Cayman Islands.

A primary investor consideration with respect to the appointment of an administrator will be the reputation/substance of the administrator, its track record and expertise and its role in effecting NAV calculations. Investors will usually

want to see that NAV calculations are (at the very least) being signed off by an administrator separate to the investment manager and will look to see what pricing sources are used by that administrator.

For most hedge funds established in the Cayman Islands (which either have a minimum initial investment of not less than US\$100,000.00 or its currency equivalent, or are unregulated by CIMA), there is no requirement that the fund appoint a Cayman Islands based administrator.

Some funds do not appoint an administrator at all, although not all funds are able to adopt this approach. Where the fund does not have an administrator, the investment manager will usually assume certain administrative functions pursuant to the investment management agreement. This can lead to some difficult issues - for example in connection with the fund's AML obligations if the investment manager is **not** a regulated financial services provider in a recognised jurisdiction and may not be advisable from an investor perspective.

It is not uncommon for the valuation and the registrar and transfer agency functions to be separated and for a fund to appoint separate service providers to perform different functions. It is also not uncommon for fund administrators in the Cayman Islands to contract with the fund to provide administration services but then delegate some or all of the functions to affiliates in other jurisdictions.

Cayman Islands based administrators must hold a license pursuant to the Mutual Funds Law. The recent amendments to the Mutual Fund Law also require a Cayman Islands licensed mutual fund administrator to satisfy itself as to various criteria regarding the business and operation of the mutual fund and its service providers before it provides mutual fund administration to a 'mutual fund' (as defined, which includes regulated and unregulated funds). A Cayman Islands licensed mutual fund administrator has certain reporting obligations to CIMA under section 17 of the Mutual Funds Law regarding the operations of a fund that it administers.

Where the fund is a regulated mutual fund, CIMA will require the administrator to file a consent letter confirming to CIMA the specific functions the administrator will be responsible for.

Walkers enjoys a strong working relationship with leading hedge fund administrators around the world and is well placed to assist our hedge fund clients in selecting an administrator that will be best suited to their particular hedge fund.

## Custodian

A custodian is often (but not always) appointed by a fund to act as guardian of its assets pursuant to the terms of the relevant custodian agreement. If appointed, a custodian will hold in custody all of the securities and cash of the fund. It may also collect dividends and other payments due in respect of the fund's assets and make dividend and redemption payments. To this end, there can be some overlap between the role of a custodian and the role of an administrator.

There is no requirement that a custodian be based in the Cayman Islands. If the custodian is based in the Cayman Islands it may need to be regulated pursuant to the Mutual Funds Law if it has "control [of] all or substantially all the assets of the mutual fund".

## Placement Agent/Distributor

A placement agent or distributor may be appointed to market the interests of the fund.

Again, there is no requirement that the placement agent be Cayman Islands based and it is uncommon for placement agents to be Cayman Islands entities due to the requirement that they would need to comply with SIBL.

## Auditors

Hedge funds usually appoint an auditor. In the case of funds being regulated by CIMA, they are obliged to do so.

A regulated mutual fund is obliged under the Mutual Funds Law to file accounts audited by an approved auditor within six months of its financial year end (subject to such extension as CIMA may permit).

The accounts must be filed electronically by the auditors together with a "Fund Annual Return" Form.

Furthermore, the accounts of regulated funds are required to be audited by an approved Cayman Islands based audit firm (or be audited by another audit firm but be signed-off by an approved Cayman Islands based audit firm).

Where the fund is a regulated mutual fund CIMA will require the auditor to file a consent letter confirming to CIMA their acceptance of their appointment and that they are aware of their obligations under the Mutual Funds Law.

The auditor has certain reporting obligations to CIMA under the Mutual Funds Law regarding the operations of a fund that it audits.

If a fund is not being registered with CIMA, our clients often prefer to appoint the onshore auditor only, and disclose that auditor in the fund's offering documents.

Often an audit is in fact done by the office of the relevant audit firm in another jurisdiction, which then submits the financial statements to its Cayman Islands affiliate for internal sign-off, with the final audited accounts being approved and signed off by the Cayman Islands firm (and in those circumstances the auditors disclosed in the fund's documents would usually be the Cayman Islands firm).

## Prime Broker

Prime brokers and the services that they provide are essential to the operation of most hedge funds. Prime brokerage is a bundled service provided by banks and securities firms to hedge fund clients, providing them with the operational infrastructure requisite for running their business. Prime brokers typically provide hedge funds with execution and custody services as well as securities lending and margin financing capabilities.

Funds will often appoint several prime brokers.

Authority is also usually given by hedge funds to their investment manager to appoint brokers on their behalf so it is quite common for brokers to be appointed by the investment manager on behalf of the fund.

Administrators receive data files from the prime brokers detailing the activities of the hedge fund and they compare those data files with ones they receive from the hedge fund. They then reconcile the books and records of the hedge fund and keep track of portfolio accounting, official net asset value and shareholder registry.

## Independent directors

The independent director services industry in the Cayman Islands has burgeoned in the last few years, owing to a surge in client demand (which, in turn, is based on investor demand) for independent checks and balances on the actions of the fund's other service providers (principally the investment manager but the administrator as well) and, often, a desire to establish greater control of the fund's operations offshore.

The general definition of an "independent director" is a director who is not affiliated with the investment manager.

The Directors Registration and Licensing Law, 2014 (as amended) (the "**DRLL**") requires that each director of a mutual fund registered with CIMA is either registered or licensed in accordance with the DRLL. There is an annual fee to be

paid to CIMA. For further information on the DRLL, please request our memorandum "*The Directors Registration and Licensing Law*" from your usual Walkers lawyer or by using the contact details below.

There are no hard and fast rules about the composition of the board of directors of a hedge fund. Boards can be comprised wholly of independent directors, or independent directors can constitute a minority or majority on a board. The most common structure in recent years is two independent directors and one representative of the investment manager.

### Lawyers - onshore and offshore

An important aspect for any hedge fund manager is to ensure that the establishment of the fund is dealt with properly and on a timely basis. While the various service providers all have important input at the set up stage, in most cases onshore counsel and offshore counsel will have the lead role.

Onshore counsel (generally in the jurisdiction in which the investment manager is based) will outline the key features of the proposed fund, covering: structuring, investment objective, target investors, likely size of the fund, liquidity, subscriptions and onshore tax considerations. Walkers, as offshore counsel, will invest time on first instruction to gain a clear understanding of the proposed fund and the manager's objectives and aspirations.

Post formation, both onshore and offshore counsel continue to play important roles - for example, either side dealing with periodic queries and corporate housekeeping issues that arise pertaining to the day-to-day operation of the fund or to advise and facilitate any restructuring of the fund.

The most common and preferred model is for onshore counsel to take the lead on preparing the offering documents and associated transaction documents and for Walkers, as offshore counsel, to review for Cayman Islands legal compliance and to advise on all aspects of Cayman Islands law. In cases where the investment manager has not engaged onshore counsel, offshore counsel can take the lead in preparing the fund's primary documents and take a more active role in dealing with the fund's various service providers.

Combinations of the foregoing arrangements are also possible - for example, Walkers may be the only independent counsel appointed with the investment manager's legal department taking a more typical "lead counsel" type role.

There may also be other lawyers appointed (in jurisdictions other than the "home" jurisdiction of the investment manager and the Cayman Islands) to provide specific advice as well. For example, advice in relation to distribution restrictions applicable in a jurisdiction in which some or all of the fund's target investor base is located, such as Japan.

## Ongoing Obligations

Directors of Cayman Islands hedge funds have a number of ongoing obligations in connection with the operations of the fund. For further information, please contact your usual Walkers lawyer or use the details below.

<sup>1</sup> AEOI is a collective term encompassing the US Foreign Account Tax Compliance Act and the Common Reporting Standard, which impose certain obligations on financial institutions such as Cayman Islands hedge funds.

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For further information please refer to your usual contact or:

Cayman Islands - **Ingrid Pierce**, Partner | [ingrid.pierce@walkersglobal.com](mailto:ingrid.pierce@walkersglobal.com) | +1 345 814 4667

Dubai - **Daniel Wood**, Partner | [daniel.wood@walkersglobal.com](mailto:daniel.wood@walkersglobal.com) | +971 4 363 7912

Hong Kong - **Denise Wong**, Partner | [denise.wong@walkersglobal.com](mailto:denise.wong@walkersglobal.com) | +852 2596 3303

London - **Hughie Wong**, Partner | [hughie.wong@walkersglobal.com](mailto:hughie.wong@walkersglobal.com) | +44 (0)207 220 4982

Singapore - **Tom Granger**, Partner | [Thomas.Granger@walkersglobal.com](mailto:Thomas.Granger@walkersglobal.com) | +65 6603 1694

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