GOVERNANCE
Cayman board diversity essential to fund managers

STRUCTURING
New fund products enhance domicile’s appeal

GLOBAL OUTLOOK
Domicile services global funds market

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he ongoing march of regulatory change affecting the alternative investment management industry continues with global, regional and jurisdictional initiatives such as Common Reporting Standards, Fatca, AIFMD, Form PF and others continuing their progressive implementation and application. Each of these initiatives impacts the structuring and operation of every fund domiciled in the Cayman Islands, whether a regulated entity or otherwise. At the same time, domestic Cayman regulation and legislation continues to evolve, in some cases alongside global initiatives and in others, to address particular issues of concern affecting the industry. Thus, the entire industry has faced the practical implementation of initiatives such as the registration and reporting requirements under Fatca (both US and UK), the particular jurisdictional nuances in Cayman of the local Cayman reporting requirements under the Model 1 Inter-Governmental Agreement, the continuing uncertainty over the implementation of the AIFMD and its passporting/private placement rules provisions and the introduction of a new licensing and registration regime for all directors serving on the boards of Cayman domiciled, regulated corporate funds.

The latter is a clear example of the progressive approach taken by the Cayman Islands Monetary Authority and the Cayman Islands Government to concerns within the alternative investment industry regarding relevant risk. The solution, in the form of the Director Registration and Licensing Law, is pragmatic in the manner that it facilities additional regulatory oversight of the provision of directorship services without seeking to impose a prescriptive, one-size-fits-all interpretation of corporate governance. Common law remains the primary determinant of good corporate governance and developing case law continues to ensure that the law amends and adapts to the modern requirements on key issues such as duty of care, conflict of interest and independence.

Cayman continues to offer managers and promoters a regulatory environment which provides constitutional certainty, speed to market and practical reporting requirements (which are often a subset of onshore regulatory reporting and cost certainty) backed by quality legal, accounting, administration, governance and support services which remain recognised by managers, promoters and investors as among the best in the world.

Industry chatter suggests that the regulatory barriers to entry onshore are responsible for the reduced number of new managers establishing, promoting and raising capital for new funds, over the past 12 to 24 months. The statistics produced by the Cayman Islands Monetary Authority for 2014 appear to substantiate this but also show that existing managers and promoters continue to develop new and innovative products to attract capital and exploit opportunities within global markets. The public/private partnership within Cayman continues to explore ways in which Cayman can provide the right legislative and regulatory environment for the growth of the alternative investment industry. Notwithstanding the challenges for new managers looking to enter the industry, the overall strength of capital raising and new fund formation suggests that the industry, as a whole, continues to grow and that investment return opportunities exist.

Alan Milgate
Alan Milgate is the chairman of the Cayman Islands branch of the Alternative Investment Management Association (AIMA). AIMA represents more than 50 Cayman based industry participants including audit, legal, administration and governance providers, as well as locally based investment managers.
FUND ADMINISTRATION
WHAT’S NEW IN CAYMAN?
Appleby senior associate Christian Victory updates HFMWeek on the latest changes to Cayman’s regulatory framework.

FINANCIAL SERVICES
THE EVOLUTION OF FUND OF FUNDS ADMINISTRATION
Julie-Ann Allard, executive director at UBS Fund Services (Cayman) explains how the role of a fund of funds has developed over the years.

LAW
THE BENEFITS OF AN INDEPENDENT BOARD
Managing partner of offshore law firm Carey Olsen’s Cayman Islands office, Jarrod Farley, explores the benefits of an independent board of directors.

FINANCIAL SERVICES
INDEPENDENT DIRECTORS AND THE SPLIT BOARD SAGA
Geoff Ruddick, head of funds for IMS Fund Services, sheds light on ‘split boards’ – engaging independent directors from different fiduciary firms.

LAW
CAYMAN ISLANDS FUNDS
Chris Humphries, managing director at Stuarts Walker Hersant Humphries, discusses what the Cayman Islands has to offer prospective hedge funds.

TRADE BODY
PROVIDING EXCELLENCE ON A GLOBAL SCALE
Newly appointed CEO of Cayman Finance Jude Scott sets out his plans for expanding the market leading reputation of the Cayman Islands as an international fund domicile.

FINANCIAL SERVICES
VALUATION PITFALLS AND EFFECTIVE DUE DILIGENCE
PwC’s Simon Conway sets out the dos and don’ts when it comes to analysing potential partners and investment opportunities.

LAW
EXEMPTED LIMITED PARTNERSHIP LAW, 2014: ONE YEAR ON
Susan Lock and Richard Spencer of Campbells reflect on the success of the Cayman Islands’ new exempted limited partnership legislation one year after it came into force.

LAW
KEEPING CAYMAN A LEADING-EDGE JURISDICTION
Harneys’ Cayman managing partner Marco Martins talks to HFMWeek about developments to Cayman’s regulatory framework and Harneys’ strategy for the coming year.

FINANCIAL SERVICES
THE DIRECTOR REPORT CARD
Harbour Trust’s Leanne Golding and Michelle Morgan speak to HFMWeek about the importance of holding fund directors to account.

LAW
ACHIEVING SUCCESSFUL CORPORATE GOVERNANCE
Jonathan Law, of Dillon Eustace explains why directors looking to achieve compliance and best market practice should look to CIMA and AIMA for guidance.

FINANCIAL SERVICES
CAYMAN: LEADING THE PACK
Colin MacKay, group director of Elian Fiduciary Services, discusses the evolving and expanding regulatory requirements for Cayman-based funds.

FINANCIAL SERVICES
CAIA OPENS CAYMAN BRANCH
HFMWeek speaks to William Kelly, CEO of The Chartered Alternative Investment Analyst (CAIA) Association and Daniel Santiago, director of Harmonic Fund Services and chapter head at CAIA Cayman Islands to learn more about the CAIA’s newest Cayman chapter.

CONSULTING
KEY CONSIDERATIONS FOR FUND MANAGERS
Margaret Thompson and Michael Parton, of KB Associates, discuss fund directors’ fees, capacity and the board of directors’ selection process.

FUND SERVICES
FATCA – TAXING ISSUES FOR SELF-ADMINISTERED FUNDS
Maples and Calder and Maples Fund Services representatives explain how US and UK Fatac will impact Cayman-based funds.

LAW
CALIFORNIA DREAMING: OF AN INSTITUTIONAL EXIT FROM HEDGE FUNDS?
Ashley Gunning and Ed Pearson of Walkers examine the evolution of hedge funds and fund investors in recent years and what’s driving change.

ASSET MANAGEMENT
PROFESSIONAL DIRECTORS – HOW DO WE RAISE THE STANDARD?
William Jones of ManagementPlus Group highlights key areas where the selection and management of fund directors can and should be reviewed.
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A number of developments have taken place in the Cayman Islands recently affecting both mutual funds and their service providers in response to global regulatory requirements and reflective of Cayman’s continuing commitment to meet and exceed international standards. The following is a list of some of the headline developments and their current status.

1. FATCA
Following the signature of a US Foreign Account Tax Compliance Act Model 1 intergovernmental agreement with the US in December 2013 (the Fatca Model 1 IGA), requiring Cayman entities to report information with respect to bank accounts and ownership interests of US persons to the Cayman Islands government rather than directly to the Internal Revenue Service, the Cayman Islands Department for International Tax Cooperation has launched an automatic exchange of information portal that allows Cayman’s financial institutions to register and report Fatca customer data at http://www.tia.gov.ky.

The deadline for Cayman Islands financial institutions to register with the TIA on the AEOI Portal was 29 May 2015 and reporting Cayman Islands financial institutions must report on US reportable accounts on or before 26 June 2015. It is not known at the time of writing whether these deadlines will be extended.

There has been a recent change in reporting which means that Cayman Islands financial institutions that do not have US reportable accounts are no longer required to make a report (although it is still possible to voluntarily submit a ‘nil’ report). Such Cayman Islands financial institutions are still required, however, to complete registration on the portal website as soon as possible.

2. DIRECTOR REGISTRATION AND LICENSING LAW
The Directors Registration and Licensing Law (2014) imposes registration obligations on directors of registered funds and certain securities investment businesses referred to as covered entities. The law was passed in May 2014 and the provisions requiring registration and the payment of fees came into force on 4 June 2014. An initial and annual fee of $854 is payable by individual registrations (meaning directors who are natural persons with less than 20 covered entity directorships). Higher fees and different requirements apply to professional directors (with
3. AIFMD
The European Union Alternative Investment Fund Managers Directive (AIFMD) was required to be implemented by EU member states by 22 July, 2013 and contained a one-year transitional period within which EU alternative investment fund managers (AIFMs) could apply for authorisation under the AIFMD to market alternative investment funds (AIFs) in the EU. The transitional period expired on 21 July 2014 and focus is now on the availability of ‘passports’ for non-EU AIFMs seeking to market opportunities across the EU – particularly the extension of the AIFMD passport to a number of third party jurisdictions including the Cayman Islands.

The European Securities and Markets Authority (Esma) is required, by 22 July of this year, to issue an opinion on the EU marketing of AIFs by non-EU AIFMs and advice on the application of the passport to such marketing to the European Parliament, the Council of the European Union and the European Commission. There is no guarantee, however, that Esma will compel the European Commission to activate the AIFMD passport provisions so this will be monitored closely over the coming months as non-EU AIFMs continue to adhere to applicable national private placement regimes.

AIFMD exempts certain specific categories of investment vehicle including small funds (with assets under management of less than €500m, aggregated across all funds under management), intra-group investments, for example, where the manager is supervising funds whose only investors are the manager, the parent, subsidiaries or affiliates, provided that none of the investors is an AIF, occupational pension fund, holding company, joint venture or family office vehicle.

Existing closed-ended funds which are fully invested before 22 July 2013 are not caught. Those closed-ended funds whose subscription periods closed before 22 July 2013 and which terminate by 21 July 2016 are also exempt from the annual report and private equity provisions. A manager who merely accepts EU investors through reverse solicitation does not have to comply with the AIFMD. An exception also exists for those managers who have no risk or portfolio functions in the EU, and only manage EU investor money on a single investor basis (a fund of one) although a strict look through approach will be applied.

4. LLCs
A draft Exempted Limited Liability Companies Law was circulated for public consultation in the Cayman Islands in May 2015 with a view to submission to the Cayman Islands Legislative Assembly in September of this year. The new law will provide for the formation of a new form of Cayman Islands vehicle, the exempted limited liability company (ELLC), similar to the Delaware LLC, being a corporate entity with separate legal personality with at least one member. It is expected that the key characteristics of the ELLC, similar to the Delaware LLC and distinguishing it from a Cayman Islands exempted limited company, will include that the arrangements for the management and administration of an ELLC are a matter for negotiation between the members and to be set out in an ELLC agreement (which will not have to be filed with the Cayman Islands Registrar of Companies), that a manager or member of an ELLC will not owe any duty to the ELLC or any member or any other person except the duty to act in good faith (subject, however, to whatever is contained in the ELLC Agreement) and the establishment and ongoing maintenance of ELLCs should be less time-consuming and less expensive than current Cayman Islands alternatives.

5. LLPs
Similarly, it is anticipated that a new Cayman Islands Limited Liability Partnerships Law will be in force by the end of 2015 or early in 2016. The key feature is the LLP’s independent legal personality.

The draft law states that an LLP will be a legal person (other than a body corporate) separate and distinct from its partners and that, unless otherwise provided in the partnership agreement, an LLP shall be capable of exercising all the functions of a natural person of full capacity irrespective of the question of benefit. With a few exceptions, no partner or former partner in an LLP shall be liable for any debt or loss of the LLP, including any debt or loss caused by the act or omission of another partner or former partner in the LLP.

“IT IS ANTICIPATED THAT A NEW CAYMAN ISLANDS LIMITED LIABILITY PARTNERSHIPS LAW WILL BE IN FORCE BY THE END OF 2015 OR EARLY IN 2016. THE KEY FEATURE IS THE LLP’S INDEPENDENT LEGAL PERSONALITY”
STANDARD HEDGE FUND SERVICES ARE JUST TOO STANDARD.

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The environment we find ourselves working in today in the world of fund of funds (FOF) is very different to the one 10 years ago when FOF was a pen to paper type process with very little automation and technology. Manual processes such as spreadsheets, stamps, and fax machines were the industry norms 10 years ago. A high percentage of funds were large comiled funds with multiple share classes and new fund launches were from both existing and emerging managers entering the FOF world for the first time. Most offering memorandums did not even make mention of the word side pocket.

Roll forward to 2015 and we have not seen emerging managers enter the FOF space for many years. New FOF launches are typically customised products for larger institutional investors and more often than not are hybrid in nature with a co-investment element. Fee structures are considerably more complex and unique to each fund. Investors are also a lot more sensitive to fees, negotiating lower management, performance and administration fees while demanding more reporting and transparency than ever before both from the investment manager and the independent administrator.

Everyone in the industry is finding their revenues squeezed while costs continue to rise and as a result are constantly looking for new ways to obtain efficiencies and outsource the work that is no longer deemed necessary to do in-house.

Four years ago, Stuart Reed, who heads up our FOF Integrated Solutions Division, had a vision of operating in a daily environment for fund of funds administration, similar to the way in which the direct investment world operates. The result was the creation of our FOF Platform – an internally developed electronic repository of key documents for the fund universe our clients invest into, together with a robust pricing module that facilitates daily pricing of our clients’ portfolios.

When asked what the driving force behind the creation of the FOF Platform was, he said: "It was driven by the question of why FOF administration shouldn’t be as automated as the direct investment administration process. If we could solve the issue of not receiving daily position data from prime brokers by creating our own internal equivalent, we would be able to leverage off our existing direct investment technology and move the FOF administration process into the same daily environment.”

The challenge was the way the investment information is received for FOFS. Rather than receiving daily broker reports summarising all position data, the investment information is received directly from hedge fund administrators. The position data is typically contained within a PDF statement that is delivered once a valuation period either by email or via a website. This creates a number of issues for FOF administrators that have historically been solved using manual processes. Some of the more significant issues included:

- Statements are delivered individually throughout the month; therefore the latest information for each fund position needs to be collected for each FOF valuation period.
- Reporting timelines of investment funds do not always match up with the FOF client; therefore fund valuations are often calculated using a mixture of final and estimated value. Estimated values have to be calculated based on the last final price and subsequent performance estimates.
- Any changes in positions held can only be identified by reviewing each statement and reconciling the closing number of shares back to the custody system. Any transactions such as investment activity, series rolls, side pocket allocations etc. will then be identified and booked to the custody account.

The FOF platform addresses these issues by allowing us to capture all investment information from the source documents and automatically converting the data into an electronic format as soon as it becomes available. We can then price investment portfolios on demand for any
valuation date and have pricing information flowing directly into the custody/accounting system without any manual intervention. On a daily basis an equivalent of a broker file is created from the platform containing all the updated fund positions held by our clients. This file is pushed to a position reconciliation tool, where it is reconciled to the quantities in the custody system to create a report of all quantity breaks.

When asked if there had been any other technology enhancements to the FOF process, Reed commented: “FOF trading was the other area that historically has been driven by manual processes. We introduced a trading and workflow application a few years ago which allowed us to execute FOF trades through their life cycle automatically from the desktop; we were also able to integrate the application with client portfolio management systems to receive approved trades instructions electronically. More recently we have integrated the trading and workflow application with our web portal to allow clients to deliver and monitor trades in a real time environment giving complete transparency to the trading process.”

HOW HAS ALL THIS TECHNOLOGY BENEFITED OUR CLIENTS AND INVESTORS?

- We have been able to offer fully integrated solutions to our larger investment managers for pricing, quantity and trading – by capturing price and position data electronically we are able to integrate with our clients and their systems to provide them with daily performance and valuation feeds. This has allowed our clients to reduce the resources previously allocated to capturing data and focus on the validation of the data. One of our large clients commented that this has provided greater transparency into our processes and streamlined the valuation period, making them more scalable as they continue to take on new business. Another client commented that their ability to monitor the lifecycle of the trade in a live environment, including access to all the supporting documents, has put us ahead of the technology game in FOF.

The FOF space continues to change and as a result both investors and investment managers continue to have different requirements and demands from their service providers. I asked Monette Windsor, UBS global head of FOF, what she thought was key for FOF administrators to stay ahead of the game. She said: “For an administrator to continue to be successful in the FOF space they need to have the ability to evolve as the market changes. Remaining competitive is all about partnering with both your investors and investment managers, offering customised solutions that are flexible and highly automated whilst maintaining a high touch service model with the right staff in place. This is what we do well at UBS.”

“THE FOF SPACE CONTINUES TO CHANGE AND AS A RESULT BOTH INVESTORS AND INVESTMENT MANAGERS CONTINUE TO HAVE DIFFERENT REQUIREMENTS AND DEMANDS FROM THEIR SERVICE PROVIDERS”
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edge fund governance has been a hot topic for several years now; a reliable fall back for industry pundits exhausted by endless discussions of onshore regulatory initiatives. The focus on governance is an understandable product of the high profile hedge fund collapses that preceded and accompanied the global financial crisis combined with the notorious failure of board oversight exposed by the Weavering case in 2011. In Cayman this led to an industry consultation by the Cayman Islands Monetary Authority (CIMA) in 2013 on the need for rules to regulate hedge fund governance and ultimately to a new CIMA Statement of Guidance for Regulated Mutual Funds - Corporate Governance (SOG-MF) and a new regime for the registration of hedge fund directors under The Directors Registration and Licensing Law, 2014 (DLL).

A peculiar feature of this governance debate has been the apparent disconnect between the reported dissatisfaction of investors and the continued growth of the market for independent directors. In 2011, perhaps influenced by the widely reported facts of the Weavering case, industry surveys reported that only 45% of investors thought that hedge fund boards were effective and 70% of investors had concerns about director independence and expertise. In November 2011 a Financial Times article raised concerns about so-called ‘jumbo’ directors highlighting four individuals in the Cayman Islands holding over 100 directorships each and, in 2013, the Foundation for Fund Governance took up the baton on that issue with a report pointing out that 100 individuals (70 resident in the Cayman Islands) held over 50% of seats on the 4,500 boards in their survey. Despite all this, around 70% of the boards of Cayman hedge funds formed in 2014 contain independent directors who represent a majority on around 80% of those boards.

THE SHIFT TOWARDS INSTITUTIONS

Behind this apparent contradiction is a pronounced shift in the hedge fund investor base away from high-net-worth investors towards institutions; a recent survey found most fund managers expect pension funds to be their primary
source of capital by 2020. Institutional investors tend to be more demanding in their due diligence and their expectations of ongoing transparency and risk management, than high-net-worth individuals or even family offices and endowments. They are used to investing in listed public companies where they have traditionally exerted collective pressure to improve standards of corporate governance. It is hardly surprising that bringing this mindset to the notoriously opaque world of hedge funds would create a drive for change.

Despite the prolonged debate and public consultations, the regulatory outcome in Cayman at least suggests that industry players are largely satisfied with the status quo. The SOG-MF lists the well-established fiduciary and industry players are largely satisfied with the status quo. The regulatory outcome in Cayman at least suggests that for change.

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The academics conclude that the value of independent directors is in their reputational capital, which acts as a certification of the fund’s reputation to investors, with the corollary that their departure will be viewed as an early warning sign by investors, based on the self-interest of independent directors to preserve their own reputational capital from the fund’s performance and financial position. The academics conclude that the value of independent directors is in their reputational capital, which acts as a certification of the fund’s reputation to investors, with the corollary that their departure will be viewed as an early warning sign by investors, based on the self-interest of independent directors to preserve their own reputational capital from the fund’s performance and financial position.

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THE FUNCTIONS OF A HEDGE FUND BOARD

The functions of a hedge fund board are summarised in the SOG-MF, which states that the board has ultimate responsibility for effectively overseeing and supervising the activities and affairs of the fund, which essentially involves: monitoring legal and regulatory compliance, conflicts of interest, functions delegated to service providers, the fund’s performance and financial position, valuation policies and net asset value calculations; communicating with CIMA and investors; and ensuring the fund’s risks are appropriately managed and mitigated. Since the fund’s day-to-day activities and management are delegated to service providers, the board’s primary function is to act as intermediary between the investors and the service providers (particularly the investment manager) whose activities they monitor. The directors are the investors’ eyes on the ground and, even if they don’t owe duties to the investors directly, an investor will inevitably prefer an independent board to a board comprised of the manager’s employees.

The demand for independent directors is therefore understandable but it has been customary to doubt the effectiveness of such appointments because the independent directors are generally appointed by the manager and have very little practical ability to influence or terminate the manager. However, two recent academic studies have overturned this view and demonstrated that funds obtain clear benefits from an independent board even though appointed by the manager. The first study found that board independence has considerable positive impact on fund performance and that having independent directors with experience in risk management significantly reduces fund risk without affecting performance. The second study found that funds with an independent board attract more investor capital and that the independent directors with experience in risk management significantly reduces fund risk without affecting performance. The academics conclude that the value of independent directors is in their reputational capital, which acts as a certification of the fund’s reputation to investors, with the corollary that their departure will be viewed as an early warning sign by investors, based on the self-interest of independent directors to preserve their own reputational capital from the fund’s performance and financial position.

As ever, it appears that the market knows best. Independent hedge fund directors with the most experience do bring something extra to the table. The very fact that they hold so many directorships gives them greater familiarity with the issues specific to hedge funds, making them more efficient while lowering their reliance on any single manager.

THE MARKET KNOWS BEST

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The academics conclude that the value of independent directors is in their reputational capital, which acts as a certification of the fund’s reputation to investors, with the corollary that their departure will be viewed as an early warning sign by investors, based on the self-interest of independent directors to preserve their own reputational capital from association with unsuccessful funds. This may well be true but, more generously, we might also conclude that experienced independent directors acquire reputational capital not merely by avoiding association with unsuccessful funds but by promoting the success of funds through beneficial governance practices, such as regular board meetings, standardised and regular reporting from service providers and a solid understanding of fund-specific risks.
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**INDEPENDENT DIRECTORS AND THE SPLIT BOARD SAGA**

**GEOFF RUDDICK, HEAD OF FUNDS FOR IMS FUND SERVICES, SHEDS LIGHT ON ‘SPLIT BOARDS’ – ENGAGING INDEPENDENT DIRECTORS FROM DIFFERENT FIDUCIARY FIRMS**

There has been an extraordinary focus on and trend towards ‘split boards’ in the last few years. For most people the accepted definition of a split board is having independent directors from different fiduciary firms and it is considered by some to be the best way to construct a board. In reality this is an overly simplistic definition and assessment of how to recruit and construct an effective and diverse board. So how did this readily accepted definition come to be? In some respects there is merit and in other respects it is simply a sales pitch.

Governance is not a game. Unfortunately, in the past few years fundamental governance issues, such as board composition (split boards), capacity (numbers) and substance over form, (form over substance) have been used as marketing pitches. These are fundamental issues yet the sales side is increasingly the focus of attention. Just as numbers were once perceived to be the key component in assessing a director’s ‘capacity’ the industry has now come to understand that numbers are only one factor. Furthermore, the concept of split boards, whereby engaging independent directors from different fiduciary firms, is often a material consideration and sometimes the key focus in assessing board composition. This narrow focus, for the most part, misses the fundamental objective of establishing an effective and diverse board.

The directors are individually and collectively responsible for leading and directing the fund’s affairs. Effective corporate governance is imperative and recent issues, scenarios and outright collapses highlight this point. As regulators and investors continuously increase their focus on corporate governance the requirement for the appointment of independent directors is essential. Investors in particular have recently become increasingly interested in board composition and appointing directors with complementary skill sets.

There is a trend to recruit some combination of an accountant, lawyer, ex-regulator, investment or risk expert from different shops to attain complementary skill sets. In response, there has been an influx of individuals into the industry whereby self-promotion of these skill sets, to make up an effective board composition, has become the latest marketing pitch. One important skill set that is often overlooked is corporate governance in itself. Possessing one of the aforementioned technical attributes in isolation does not necessarily make someone a good director. Perhaps even more important than having a director with a specific skill set, expertise, or being from a different fiduciary firm is to select directors who have a broad range of experience, have the innate ability to ask intelligent and probing questions, and know when and where to find expert advice when needed. It is often more effective to engage someone with specialised expertise when needed rather than recruit it onto the board. Ultimately, the aim is to have a board composition that is sufficiently diverse to have the necessary knowledge to provide effective leadership and direction.

There is certainly a greater depth of high-quality directors in the space to choose from than there was a few years ago. The flood of new entrants into the fiduciary space can be partially attributed to a supply shortage as long standing individuals are reaching capacity. Some newcomers are simply being opportunistic as they are looking for a career transition. Most are senior people who have excellent experience, qualifications, pedigree etc., and are able to seamlessly make the transition from being an administrator, lawyer, auditor, regulator, risk or investment professional etc., to being a director. Others, however, have difficulty making the transition, as although they have impressive technical skills, they are unable to transition into a leadership and oversight role that goes beyond their area of expertise. Individual personalities can come into play as well. For example, some are too passive, lack the intellectual curiosity, or gravitas to effectively and appropriately challenge management or their fellow directors, while others have domineering and controlling personalities or...
simply lack the aptitude to participate in a collective approach.

As it is for many things in life, the right balance of individualism and collectivity is also paramount to an effectively functioning board. Additionally, the ability to put issues into the appropriate context is imperative – sometimes the board has to provide high-level oversight and other times a more detailed approach is required, but without becoming a micro-manager. Effective and experienced directors will be able to maintain perspective and context in such situations, regardless of their specific skill set.

The focus in constructing an effective and diverse board must go beyond just looking at attaining a split board and consider each potential director’s attributes as mentioned above. It is disingenuous to suggest that real independence and diversity cannot be obtained via having multiple directors from the same provider. This really depends on how each fiduciary provider is structured, in combination with the individual’s own attributes, and perhaps more importantly how they perceive their role and conduct themselves as an independent director. That said, there is an argument that retaining individuals from different providers eliminates the risk of potential ‘groupthink’. If this is indeed the case it is good reason for a change. However, groupthink or deferring to a more dominant director can still happen in split board scenarios as well. Therefore, split boards may be more perception than reality as many fiduciary firms have engaged professionals, with complementary skill sets, and have the freedom to make independent decisions. As such, there may already be an effective board in place.

Serving as a director is a personal appointment and there is corresponding personal liability. In today’s post-Waverly environment passive directors are, for the most part, a thing of the past regardless of whether they serve alongside a colleague or someone from a different fiduciary firm. An effective and diverse board requires competent individuals with complementary skill sets who can work collectively irrespective of whether they come from the same shop or not. The collaborative aspect is equally as important as the individual expertise. There should ultimately be synergies gained so that the board’s collective value equates to more than the sum of its individual members.

HOW DO YOU SELECT AN IDEAL BOARD?

As mentioned earlier, independent directors come with varying backgrounds, experience, qualifications, styles, interpersonal skills and corporate support – check around to compare and contrast. Investors, legal counsel, administrators, auditors and other professional service providers are a good starting point and will have a shortlist of individuals with whom they are familiar and would recommend. Once recommendations have been received make some additional enquiries to find the individuals who are right for the fund.

SOME SUGGESTIONS FOR CONSIDERATION:

Independence - the ‘Holy Grail’ of effective corporate governance. If a director, or the organisation for which they work, is not independent, conflicts of interest will inevitably arise and could interfere with the director’s ability to act in the best interests of the fund.

Experience - a director’s bio should provide a detailed summary. In addition, ask specifically if they have served on boards with similar strategies. Independent directors do not need to be experts; however, a general understanding of the fundamentals of the underlying strategy is essential.

Qualifications - a legal, accounting, compliance, investment, risk, corporate governance or other relevant qualification, combined with experience, will provide a good indication of where their specific expertise lies and how they will add value.

Support infrastructure – although most consideration should be given to the capabilities of the prospective director, there may be times when the individual may not be available. People take vacations, encounter emergencies, come and go from an organisation or jurisdiction, and start-up businesses often fail. Confirm that the individual has a sufficient support infrastructure to cover these contingencies, and whether they have colleagues who can be appointed in their place should the need arise.

Capacity - it’s a function of time and ability, not simply numbers. The number of directorships will provide some insight, but it is only one of the many important questions to ask as numbers in isolation can be misleading. Drill down and look at the composition of the clients the director serves; their role within their company; what other responsibilities they have beyond serving in a personal capacity on fund boards; their company’s model, support infrastructure, back-up and coverage; and their capacity constraints. Other considerations include whether the director has excess capacity for times of stress; and perhaps most importantly determining how they personally view their role as a fiduciary.

References - any thorough ‘interview’ will end with the question of references and therefore it would be prudent to receive some positive feedback from clients who utilise the candidate’s services or other directors who serve on a board with the individual.

Looking for an independent director and constructing an effective and diverse board does not have to be an arduous, time-consuming process, however, the decision should not be taken lightly. Remember, the directors are accountable for leading and directing the fund’s affairs. Effective corporate governance is critical and therefore the appointment of experienced and qualified independent directors who collectively provide a diverse and complementary board composition is essential. The influx of individuals with varying skill sets into the fiduciary space is a positive development, however, the industry needs to ensure the focus remains on the underlying fundamentals of good governance. So go beyond the split board sales pitch – have a thoughtful, measured approach and give all aspects due consideration.
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For more information, please contact:

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As the principle offshore jurisdiction for hedge funds and mutual funds, the Cayman Islands has sought to retain its status by implementing an innovative legislative and regulatory regime and by continuing to have an absence of taxation. Given the historic success of the Cayman Islands as a fund domicile, it also boasts the presence of sophisticated and professional service providers who are well-versed in the nuances of the fund industry.

Some of the core benefits to a fund being domiciled in the Cayman Islands are:

1. A quick and efficient regime for the registration of funds.
2. An effective and comprehensive regulatory environment which is both robust enough to give investors’ confidence yet flexible enough to be appropriate for different types/sizes of funds.
3. Legal, administrative and accounting service providers with a wealth of experience in the fund industry are readily available.
4. All of a fund’s directors or officers, managers, administrators or custodians are required to be situated in the Cayman Islands.
5. A fund’s investment objectives, trading strategies, leverage or trading limits are its own to manage and the Cayman Islands government does not seek to impose restrictions on commercial matters.

The principal legislation concerning the regulation of investment funds in the Cayman Islands is the Mutual Funds Law (2013 Revision). The Mutual Funds Law creates four types of mutual funds that are subject to regulation and supervision under the Mutual Funds Law by the Cayman Islands Monetary Authority (CIMA):

1. Registered mutual funds - A simplified registration procedure is available for mutual funds in circumstances where:
   (i) The initial minimum equity interest purchasable by an investor is US$100,000; or
   (ii) Equity interests are listed on an approved stock exchange such as the CSX.
   In order to register, the appropriate forms must be filed with CIMA together with a copy of the current offering document, consent letters from the auditors and the administrators and payment of the applicable registration fee.
   Where the fund is not a registered mutual fund and is not otherwise excluded from regulation, it must either apply to CIMA for a mutual fund licence or apply to be regulated as an administered mutual fund.

2. Licensed mutual funds - A mutual funds licence is suitable for retail funds with a large and reputable promoter who does not intend to appoint a Cayman Islands administrator. In order to obtain a mutual fund licence, the fund is required to:
   (i) File and maintain on file with CIMA a current copy of the fund’s offering document;
   (ii) Maintain a registered office in the Cayman Islands (or if a trust, a licensed trust company acting as trustee);
   (iii) Appoint a reputable administrator which may or may not be an administrator based in the Cayman Islands; and
   (iv) Provide such information to CIMA as is necessary to evidence the soundness of the promoter, the expertise of the administrator and that the directors are fit and proper persons.

3. Administered mutual funds - To be regulated as an administered mutual fund, the fund must appoint a Cayman Islands licensed mutual fund administrator to provide its principal office in the Cayman Islands. Although a majority of the supervisory functions which are performed by CIMA for licensed mutual funds (such as verifying the reputation and suitability of the promoter and the administrator and ensuring compliance with the Mutual Funds Law) is carried out by the Cayman Islands administrator, CIMA maintains a general supervisory and enforcement role with respect to administered mutual funds.

4. Non-Cayman Islands funds – Funds that are established or incorporated outside of the Cayman Islands
but whose management or administration is provided in the Cayman Islands may be required to be registered with CIMA in the Cayman Islands. If a corporate mutual fund is subject to regulation under the Mutual Funds Law it must first register as a foreign company under the Companies Law (as Revised) to be licensed or registered as a mutual fund.

In addition, the Mutual Funds Law provides a number of exceptions where funds are not subject to any specific regulation in the Cayman Islands. These include:

• Funds with only one investor (as there is no pooling of investor funds);
• Funds issuing debt rather than an equity interest;
• Closed-ended funds or private equity vehicles which do not permit redemption or repurchase of interests at the option of the investor; and
• Investment funds with no more than 15 investors, the majority of whom have the power to appoint or remove the operators of the investment fund (i.e. the directors, the general partner or the trustee, as the case may be) other than Cayman Islands regulated master funds.

There are more than 10,000 registered funds and master funds in the Cayman Islands. These regulated funds are generally designed for more sophisticated investors such as those investing US$100,000 or more and who are therefore assumed to be better able to afford professional advice in the management of their affairs.

STRUCTURES AVAILABLE
The most common form of mutual fund vehicle is an exempted company (incorporated with limited liability), and is usually established in one of two ways, namely, by granting or not granting the investors voting rights in respect of their shares (other than in respect of an alteration of the rights attaching to their shares which they will always have a right to vote upon).

Given the historic success of the Cayman Islands as a fund domicile, it also boasts the presence of sophisticated and professional service providers who are well-versed in the nuances of the fund industry.
PROVIDING EXCELLENCE ON A GLOBAL SCALE

NEWLY APPOINTED CEO OF CAYMAN FINANCE JUDE SCOTT SETS OUT HIS PLANS FOR EXPANDING THE MARKET LEADING REPUTATION OF THE CAYMAN ISLANDS AS AN INTERNATIONAL FUND Domicile

Jude Scott, now CEO of Cayman Finance, is a former Partner of Ernst & Young and former Global CEO of Maples and Calder. He retired as an Audit Partner in 2008 after spending over 23 years with Ernst & Young where he specialised in the audits of investment funds, banks and insurance companies.

HFMWeek (HFM): Since taking the helm at Cayman Finance what is your core strategy to maintaining market growth and attracting new business?

Jude Scott (JS): Firstly I am extremely honoured to have been appointed in this position. Cayman Finance has represented Cayman’s financial services industry for more than 10 years and through cooperation and engagement with domestic and international political leaders, regulators, organisations and media, we serve to promote the integrity and transparency of the industry. Over this time, the Cayman Islands has cemented its reputation as one of the world’s leading international financial centres and the hedge fund domicile of choice.

I see my role as one of facilitating the continued development and growth of the Cayman Islands financial services industry and making sure that we continue to meet the changing needs of our clients and industry business partners. While doing this we will continue to focus on our strengths and what has made us successful, in terms of our balanced regulatory framework and an innovative approach to developing products and services. I also strongly believe that it is my job to ensure that all clients experience only excellence in all their dealings with the Cayman Islands. We are fortunate that we have the full support of our government and our regulator to continuously work with the industry to ensure that we maintain the balance between effective regulation and providing service value.

HFM: What experience do you bring to the role and what areas of Cayman Finance’s offering will you be developing in the near future to become more competitive?

JS: My career in the Cayman Islands financial services arena has spanned over 25 years, much of that time working as an audit partner with Ernst & Young, specialising in auditing for investment funds, banks and insurance companies. I also spent a period of time as global chief executive officer of one of the major Cayman Islands law firms so I do have a good understanding of what our clients are looking for from their business partners here.

However, to remain at the cutting edge of this industry and to continue to be relevant to our clients, we must do everything we can to better understand their needs and requirements, particularly in this global environment of cost and regulatory creep. One example in practice was our recent successful New York roadshow, where Cayman Finance and the Ministry for Financial Services co-hosted a breakfast briefing seminar to over 160 key business contacts and partners. We spent a week meeting with leading firms and institutions in New York, collecting valuable input and insights on how we can improve as a jurisdiction, as we aim to continue to provide the products and services our clients need to be successful.

HFM: Which regions and markets will you be primarily targeting going forward? Why?

JS: Although many of our clients are based in North America due to its proximity, investors in Cayman funds and clients of this jurisdiction come from all over the world, attracted by our stable legal system and flexible and efficient corporate environment. Most of the world’s most prominent and successful asset managers, financial institutions and sovereign wealth funds utilise Cayman structures to achieve their investment objectives. In addition to the US and Canada, Asia remains an important source of business, with Cayman funds popular in centres like Hong Kong, Japan and Singapore. Latin America continues to offer significant considerable growth potential on the funds side and is an area of great attention for Cayman.

HFM: What can Cayman offer investors from emerging markets that other offshore domiciles can’t?

JS: The stable and robust legal system in the Cayman Islands, based on UK common law, makes this jurisdiction a very attractive option for structuring funds for international investors looking to invest in emerging markets. The legal certainty that Cayman provides helps to mitigate the risks of doing business across borders and the increased efficiency with which capital moves helps direct foreign investment back into the emerging markets, resulting in greater economic development.

For Cayman in particular, the strength and depth of our service providers is another important factor, as well as the familiarity that international investors have with Cayman.
In Asia for example, Cayman is seen as the default option for structuring investment funds, so there is an important role for us to play facilitating both inbound and outbound investment into the region.

HFM: How is Cayman as a domicile maintaining its status as a premier domicile? What new innovations should we expect?

JS: There will always be jurisdictions that try to challenge the Cayman Islands’ leading position, however the strengths that make the Cayman Islands the premier international financial centre are not easily replicated. Our high-quality and experienced service providers operate in a legal and regulatory framework with just the right balance, with a government committed to the financial services industry, and an innovative approach to developing products and services that benefit the global economy.

Product innovation is an area in sharp focus and Cayman’s reputation for being able to respond quickly with legislation and new products to meet perceived client needs is an important distinguishing element in our success. For example, in 2014, the government introduced a completely revamped Exempted Limited Partnership Law, which has been well received by the market as it provides more certainty, is easier to use, and is more cost-effective. The funds industry will also be aware that our government is committed to introducing LLC legislation this year, with a vehicle that is expected to be called an ‘ELLC’ - Exempted Limited Liability Company. We know that the market is eagerly anticipating this development because it will have many possible uses at the fund level for holding investments, and even as general partner entities.

We are also making it easier to negotiate the challenging global regulatory climate, as our service providers have taken the lead in guiding clients through this period of unprecedented change, alongside technological enhancements for more efficient dealings with the Cayman Islands Monetary Authority and the Registrar of Companies. We know that fund managers around the world are just getting to grips with their responsibilities under Fatca and the Alternative Investment Fund Managers Directive. Now on the horizon we have the implementation of global Fatca or Common Reporting Standards for automatic exchange of information, which the Cayman Islands was one of the first jurisdictions to sign up to and will mean even greater volume in terms of the information reported by 2017. Our best in class service providers will continue to keep clients ahead of the regulatory curve.
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Despite all the talk of institutionalisation, the alternative investment industry is still fundamentally a relationship based business; emphasis is placed on trust, reputation and track record by independent financial advisors, asset allocators and the investment managers themselves.

As restructuring and insolvency professionals we have dealt with the fall-out from numerous frauds and fund failures over the years, and they all tend to have a consistent theme, the managers of failed funds always had stellar reputations and a long history of solid performance, principally based on the valuation of hard-to-price assets.

So how can overstretched asset allocators gauge the risk more effectively?

Of course professional investors don’t rely solely on reputation or track record. The best (and the least overstretched) will conduct due diligence and analytics on strategy, performance and market until they know the target investment almost as well as its managers. But a more common reality is pro-forma due diligence questionnaires. Once a decision to invest has been made, the completion of DD questionnaires all too often becomes an administrative process, likely to identify only the most glaringly obvious red flags.

Hindsight is always 20/20, so I have set out below some of the more common valuation features of the failed funds and speculative schemes we come across, which are always painfully obvious in retrospect.

SERVICE PROVIDERS

As the industry has matured, independent administration has become commonplace, with investors rightly taking comfort from independent oversight. However, we have to consider the small print in these arrangements. If an offering circular makes it clear that the investment manager, rather than the administrator, is responsible for valuation, then you can be certain that the administrator will be doing little to no work in verifying hard-to-value illiquid positions.

It is often only when something goes wrong that investors realise just how little responsibility has been taken on by independent service providers.

PRE-IPO STOCKS

Investment in private stocks shortly prior to an initial public offering has clearly been a highly successful strategy for those funds that have the connections to access high quality stocks, with US tech stocks in particular being recent examples.

However, this strategy can be equally associated with the kind of frenzied speculation one sees in markets which are a bubble close to bursting.

These types of positions throw up a number of potential valuation issues for an open-ended fund. The most obvious valuation principle may be that the stocks are held at cost (or cost less any impairment) until after an IPO has enabled true price discovery. However, this creates potential pricing issues where new subscribers are able to buy-in to the fund without paying any premium for an improvement in the expected potential of the IPO stocks as the listing approaches (or as market conditions improve).

Some investment managers might cite this as a justification for putting a subjective value on the pre-IPO stock, perhaps referencing multiples for similar transactions. In my view, that’s a slippery slope toward examples we’ve seen of hugely inflated pre-IPO stocks that become exposed when the stock market moves into a bear phase, with late investors being hit hardest.

In many cases, there is effectively no ‘fair’ way of valuing such positions in open-ended funds and, as a result, the only truly equitable way of approaching this is to avoid the need for valuation at all, by locking-in the investment in these positions until the IPO liquidity event (through the creation of side-pockets). A common feature in the offering circulars of failed funds is an inappropriate struc-
ture. In particular, funds with illiquid / long-term investment strategies structured with monthly redemptions and performance fees. Not only does this create obvious liquidity risk, but also an inherent incentive to inflate valuations.

THINLY TRADED PUBLIC STOCKS
Penny stocks and boiler room scams have been around for as long as stock trading itself, and most sophisticated investors would no doubt feel confident they can identify such schemes without too much trouble. However, the incidences of asset management fraud and fund failures involving investments in low volume stocks are still surprisingly regular. One reason for this is the sophistication of the schemes. PIPE funds (or Private Investment in Public Equity) can be a legitimate means of seeding growth companies through convertible instruments. However, as we’ve seen in one of our high profile US cases, PIPE funds can also be used to massively inflate asset values, and fees, ultimately leaving investors with a series of listed shells with no value.

Investors cannot necessarily rely on service providers, such as administrators, to identify issues where listed instruments do not have an active market for pricing purposes. Where a fund invests in speculative growth stocks, there is no adequate substitute for conducting your own due diligence on the larger invested stocks in the portfolio, particularly where the listing is on the less regulated SME (small & medium enterprise) focused markets.

COUNTER-PARTY RISK AND UNREALISED GAINS
The concentration of over-the-counter investments with one counterparty will generally be identified in even the most basic due diligence process. However, as we’ve seen in one of our major cases involving a $600m fraud, such concentrations can be explained away as necessary for effective market making and bulk pricing. Similarly, related counterparties can be portrayed as independent financial intermediaries.

A simple, but effective, way to gauge this risk is to track the cash development of the position. Has the counterparty position accumulated over time? Has it generated unrealised gains which offset realised losses elsewhere in the portfolio? On a portfolio-wide basis are realised cash losses on traded investments being offset by the total of unrealised gains on illiquid positions?

In such scenarios there is, at the very least, a heightened liquidity and valuation risk.

STRUCTURAL SUBORDINATION IN EMERGING MARKETS
Structural subordination has always been a nascent issue for cross border investments, where securities in holding companies do not have the benefit of guarantees against the assets of underlying subsidiaries. This is becoming particularly common in emerging market investment, such as the People’s Republic of China, where onshore assets can be overwhelmed by local borrowing with the result that holding company positions potentially become worthless.

With the flood of US dollar lending into emerging markets in recent years the focus has been on yield, with very little attention paid to the downside case. As these investment flows begin to reverse with likely US dollar rate rises, the risk is that the valuation of these positions has not properly addressed the considerable downside of being structurally subordinated in a default scenario.

In summary, while there is clearly no one-size-fits-all approach to due diligence and valuation risk, there are some common themes that are worth investigating for each new investment, and indeed in an existing portfolio. PwC offers the full breadth of restructuring, valuation and exit management services to the funds industry and we pride ourselves on finding solutions for investors.
EXEMPTED LIMITED PARTNERSHIP LAW 2014: ONE YEAR ON

SUSAN LOCK AND RICHARD SPENCER OF CAMPBELLS REFLECT ON THE SUCCESS OF THE CAYMAN ISLANDS’ NEW EXEMPTED LIMITED PARTNERSHIP LEGISLATION ONE YEAR AFTER IT CAME INTO FORCE

The Exempted Limited Partnership Law, 2014 (the ELP Law) came into force on 2 July 2014, completely repealing its predecessor. The new legislation offers an enhanced regime for the establishment and operation of Cayman Islands exempted limited partnerships (ELPs).

One year on, it is clear that the ELP Law has been a great success. While the ELP Law did not fundamentally alter the nature or operation of ELPs, it has clarified and simplified issues around them for investors, general partners and managers alike. Here we describe the aspects of the new legislation that have proved particularly appealing to our clients and which we also believe have contributed to a shift away from other jurisdictions in favour of Cayman Islands ELPs.

IMPROVEMENT FOR INVESTORS

The ELP Law addressed several concerns in respect of the prior ELP regime that had been raised at the investor level and which still cause issues in certain other offshore jurisdictions. Such that in the year following the enactment of the ELP Law, we have seen the following investor-friendly aspects of the new law become key drivers for implementing a Cayman ELP structure rather than a partnership structure in another offshore jurisdiction.

FIDUCIARY DUTIES

While there are circumstances where duties and obligations may arise through contract or conduct, the ELP Law confirms that, subject to any express provision of the partnership agreement (the LPA), neither a limited partner nor a member of a board or committee owes a fiduciary duty simply by virtue of exercising its rights or performing obligations under the LPA or as a member of the board or advisory committee of the ELP (as the case may be).

LIMITED LIABILITY

Limited partners may lose their limited liability status by taking part in the management of the ELP, but the ELP regime has always including a so-called ‘safe harbour’ of activities which will not constitute taking part in the ELP operations or management. This express limited liability safe harbour guaranteeing limited liability status for limited partners was extended to those serving on any board or advisory committee, or those being an officer, director, shareholder, partner, member, manager, trustee, agent or employee of, or a fiduciary or contractor for, any person in which the ELP has an interest, or any counterparty to the ELP or a general partner. Additionally, the ELP Law clarifies that the limited liability of limited partners is not lost simply by reason of the partnership ceasing to have a qualifying general partner.

ADVISORY BOARDS

The benefit of the terms relating to advisory boards under the LPA may be enforced by the members of the boards notwithstanding that they may not be parties to such LPA.

ADMISSION OF PARTNERS AND TRANSFER OF PARTNERSHIP INTERESTS

The ELP Law simplifies and clarifies the formalities associated with the admission of partners and the transfer of partnership interests by providing that admission is effective as long as it is in compliance with the LPA's prescribed protocol, regardless as to whether formalities otherwise required have not been complied with. These provisions have retrospective effect. It also provides that a transferee shall not assume any liability of the transferor and that a transferee is not relieved of any liability unless otherwise agreed.

STATUTORY CLAWBACKS ON INSOLVENCY

The time period that applies to statutory clawbacks in the event of the insolvency of an ELP has been clarified. If a limited partner receives a payment representing a return of any part of its contribution (or is released from any outstanding obligation in respect of its commitment) at a time when the ELP is insolvent and the limited partner has actual knowledge of such insolvency, such limited partner shall be liable to repay such amount for a period of six months commencing on the date of that the payment was made.

OPERATIONAL IMPROVEMENTS

In addition to the various improvements in favour of investors, the ELP Law also incorporated various provisions aimed at improving the establishment and operation of ELPs, including providing additional flexibility and clarification where required, and by providing clearer, more streamlined procedures. Of these, we highlight below...
those provisions that have been particularly well received in the first year of the revised ELP Law.

DUAL NAMES
Additional flexibility is available by allowing ELPs to have a dual name in another language (in line with Cayman Islands exempted companies) and such dual name need not be an exact translation of the English name of the partnership.

GENERAL PARTNER’S DUTIES
There is a requirement for a general partner of an ELP to act at all times in good faith. The ELP Law now allows parties the freedom to contract, by giving them the ability to contractually vary such statutory duty of a general partner duty to act in good faith at all times in the interest of the ELP and to allow the LPA to specify as to whom the general partner is required to act in any given circumstance. This flexibility will allow the ELP and general partner/manager to deal practically with particular issues of competing and conflicting interests.

DEFAULT SANCTIONS
The benefits of freedom to contract are further enhanced by now allowing the ELP parties wide discretion to specifying the consequences of a breach of an LPA (for example default sanctions) by specifically providing that such provisions are not to be unenforceable solely because they are penal in nature.

EXECUTION OF LPA BY THIRD PARTIES
A third party is now given the express ability to execute the LPA in order to allow such person to take the benefit of a provision or obligation thereunder without being deemed a partner in such ELP.

EXECUTION FORMALITIES
The ELP Law simplifies the formalities associated with the execution of LPAs, and documents executed on behalf of a partnership, by providing that such provisions are not to be unenforceable solely because they are penal in nature.

THE CAYMAN ISLANDS FINANCIAL SERVICES LEGISLATIVE COMMITTEE IS CURRENTLY CONSIDERING A DRAFT LAW WHICH WOULD PROVIDE FOR THE FORMATION OF AN ‘EXEMPTED LIMITED LIABILITY COMPANY’

required under Cayman law for the execution of a power of attorney have not been followed. This provision has retrospective effect.

SEPARATE REGISTER OF CONTRIBUTIONS
The ELP Law allows for the preservation of confidentiality by providing that the register of limited partners need now only contain the name and address of each person who is a limited partner, the date on which such person became a limited partner and the date it ceased to be a limited partner. Details of contributions may now be kept in a separate register which may only be inspected with the consent of the general partner.

FOREIGN LIMITED PARTNERSHIPS AS GENERAL PARTNER
The enabling of a foreign limited partnership to be registered in the Cayman Islands in order that it may act as the general partner of a Cayman Islands ELP has been a particularly welcome enhancement. Previously, only Cayman Islands persons or foreign companies registered in the Cayman Islands under Part IX of the Companies Law could act as a general partner of a Cayman Islands ELP.

ANTICIPATED LEGISLATION
Finally, as noted above, the ELP Law has not altered the fundamental formation or nature of an ELP which does not have a separate legal personality and must therefore still be operated by a general partner which has unlimited liability and acts on behalf of partners and holds such assets on behalf of the ELP. However, in a move to continue to enhance the Cayman Islands reputation as the preeminent offshore jurisdiction in which to establish an international investment fund, the Cayman Islands Financial Services Legislative Committee is currently considering a draft law which would provide for the formation of an ‘exempted limited liability company’ (LLC). Such an entity would have the features of a Cayman Islands ELP (in the sense that such a company would not be constrained by requirements to maintain share capital or be limited by shares or by guarantee) but would be an entity having separate legal personality (like a Cayman Islands exempted company). We would expect that the Cayman LLC would be very attractive as an alternative vehicle to promoters of investment funds.
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CIMA has recently proposed changes to outsourcing arrangements for funds service providers. What are these changes and what is the implementation process like?

Marco Martins (MM): The changes are still under review, so it’s not possible to give a final opinion on this. However, from the early drafts it was a lot about ensuring best practices are followed. Nothing Earth shattering, nothing that would prohibit outsourcing or fundamentally change the way businesses run. More about what type of data recording and record-keeping should be maintained, as well as reinforcing the supervisory and oversight obligation of certain parties. So long as it is about ensuring best practice rather than changing how businesses operate, we should be fine. We are monitoring it closely.

HFM: What was the thinking behind this proposal? How will it benefit Cayman’s financial sector?

MM: My feeling is that the driver for it was to ensure best practice in an area where the regulator may have felt less in control. I don’t see it as a fundamental change in the way our businesses are structured, I think the regulator just wants to ensure that there are no gaps in the risk management of key products. A lot of it is based on common sense and established best practice so if done right it could improve Cayman’s profile as a high-quality jurisdiction.

HFM: What is Harneys’ reaction to these changes? Will you be submitting feedback or suggested amendments?

MM: We are cautiously positive about it. Yes we have given feedback and are participating in the process. As long as it is fair and balanced, and shines a light on best practices we don’t have a problem with it. It must refrain from attempting to change the commercial dynamic of outsourcing structures as that could make Cayman less competitive, but as long as it is about promoting good and healthy best practices, and keeping the flexibility and freedom clients like about Cayman, I don’t have a problem with it.

HFM: What features of Cayman’s regulatory and service infrastructure does Harneys find most attractive about the domicile?

MM: The quality and size of Cayman’s service provider industry – the number of high-quality lawyers, accountants, directors, administrators, who are based here, understand what Cayman can offer, and have decades of combined know-how and expertise that add up to centuries of work-hours and makes the offering miles away the most sophisticated in the global market. The regulator is also extremely sophisticated, focused, and accessible. It understands the fine balance between proper and adequate regulation and the need to deliver a service to demanding global clients.

The political and social makeup of Cayman also contributes – it is an open, inclusive society. Cayman is diverse, modern and ahead of the curve when it comes to its relationship with a mobile and talented workforce. At the end of the day we all have choices, and if we can contribute to a society that welcomes us, that is a huge plus. That comes with local responsibility and I think this is an area that the financial industry needs to focus on, but we must thank our lucky stars that we have regulators and politicians who understand a global audience and will do what is required to create an environment that is productive and welcoming. That stretches to the legislation, of course, which is modern and dynamic.

Cayman is constantly reviewing its legal framework and has constantly taken the lead in offering its clients a sophisticated offering, be it a dedicated financial division within its court system or constantly evolving investment funds, banking and related regulations.

HFM: What aspects of Cayman’s offering do you feel still need to be developed to stay competitive and do you feel these issues are being addressed?

MM: Cayman offers a unique combination that is still far and away the most attractive in key markets, in particular the investment funds, complex banking, captive insurance and sophisticated financing structures. This attraction is based on a combination of world-leading service providers, including all the leading international offshore law firms, accountancies, many of the leading banks, administrators and directors. Working together this industry is able to deliver expertise and quality that is difficult for any other off-
shore jurisdiction to match. And this is an asset that takes decades to build up, so no matter what new initiatives they may come up with, that lead remains significant.

However, that doesn’t mean we can be complacent. In fact, I think Cayman’s biggest threat is complacency and seeming impervious to emerging needs or competition. Take cost, for example. Although I believe Cayman delivers value for money, it cannot avoid looking at the cost of certain of its products in the face of increasing competition from other jurisdictions, and figuring out if it has the right portfolio of products, priced at the appropriate level, to target the markets.

Looking at funds specifically, while Cayman’s products have been more than adequate for a certain developed market, now that we are seeing increasing appetite for fund structures from emerging markets and a new type of client, Cayman should be alive to the fact that there are opportunities in launching new types of structures to target such clients and markets. It may be, for example, a lower cost fund structure for new managers with under X amount of AuM. It may be a simpler, less costly investment management structure, it may mean more flexibility in relation to certain ancillary requirements.

So I always recommend that we stay alert to what other jurisdictions are doing, and I notice that a lot of what they are doing targets these emerging markets and new client profiles. Cayman must stay alert and take action when it is appropriate.

**HFM:** For Harneys’ Cayman office specifically, what is your strategy regarding marketing your services to emerging and developed markets? Which will be your primary focus over the coming year?

**MM:** We have built a team of highly skilled professionals in key emerging markets, as well as in parts of North America. These individuals are unique in their skills and abilities to develop and service a demanding and underserved client base. We rely on their local know-how, which combined with their knowledge and expertise of offshore structures, makes them not only good ‘marketing’ assets, but key business and relationship developers. We intend to continue to rely on this approach to the market which is fundamentally about delivering more to our clients – better service, local relationships, easy and responsive access and more rounded expertise that combines understanding of the onshore drivers and needs, and the offshore possibilities.

Our primary focus in the coming year will be to continue to build out this capability and to grow the Cayman legal team to target and support business growth in North America in particular. Given the progress we have made over the past couple of years, we believe that we are now in a better position to recruit the type of candidate who can help us achieve our growth objectives and offer clients the kind of comprehensive and excellent service they need from a full service Cayman Islands practice. We hope to make a further announcement on this soon.
THE DIRECTOR REPORT CARD

HARBOUR TRUST’S LEANNE GOLDING AND MICHELLE MORGAN SPEAK TO HFMWEEK ABOUT THE IMPORTANCE OF HOLDING FUND DIRECTORS TO ACCOUNT

Leanne Golding

is a senior vice-president of Harbour and is responsible for providing fiduciary services to Harbour’s fund clients, including serving as an independent director for such funds. Golding is a CFA Charterholder and an accredited director (Chartered Secretaries of Canada).

Michelle Morgan

is a senior vice-president of Harbour and is responsible for providing fiduciary services to Harbour’s fund clients, including serving as an independent director for such funds. She is a Chartered Accountant and has worked in the fund industry for over 15 years.

The fund industry is demanding. Investment managers are constantly judged based on their performance. Administrators are pressured to provide SSAE 16 reports. And, as would be expected given the ever-changing fund governance landscape, fiduciary providers are now being scrutinised.

How do your current directors measure up? The below ‘report card’ covers essential discussion points designed to help you assess the effectiveness of your current board. Of course, every situation has its own nuances so this overview should be used only as a guide while keeping in mind what best suits the needs of your fund structure.

MEASURING PERFORMANCE

Frequency – How often does your board meet? At a minimum they should be meeting twice per year, but for more active or complex structures or strategies, more may be required. Best practice is to hold quarterly update meetings as well as dealing with any matters that arise in the interim.

Agenda – When your board convenes, what do they discuss? Board meetings should include a robust agenda that discusses all aspects of the fund and includes reports from the investment manager, the administrator, and (at least once a year from) the auditor. Directors should leave the meeting with a good understanding of the status of the fund’s operations.

In-person – Have you seen your directors in person this year? Ideally, you should see them at least once a year, either at board meetings or operational on-site visits.

Responsiveness – Your time is valuable and you shouldn’t have to chase down board members for their attention. Directors should respond promptly and with meaningful comments.

Willingness to engage – Will your directors roll up their sleeves when there is a valuation issue, document update, or change in service providers? The answer had better be ‘yes’. Are they in touch with your auditor and administrator? Directors should also be willing to participate in your investors’ due diligence. Engaging in this process is of great value to them and indirectly helps you with your capital raising.

Knowledge – Does your director understand your fund, business and plans for the future such that they can help you efficiently and effectively? Or are you slowed down by having to re-explain things they should already know? Are they current on industry matters such that they can discuss these intelligently with you and contribute to the conversation?

Added value – You should be able to reflect upon the past year and feel that each director has added value. If not, consider whether that director gets a failing grade.

ASSESSING EXPERIENCE & QUALIFICATIONS

You should evaluate your directors’ experience and education in the context of your fund. Below are some additional points you may also want to consider when grading your board members.

Succession – If your fund will be around for another 20 years but your board members will retire in five, consider whether this mismatch will eventually cause problems.

Commitment – Are your directors engaged in the industry on a full-time basis, and are they likely to remain so? Fiduciaries who are full-time keep their knowledge current and are usually more accessible.

Board composition – Do your directors have similar backgrounds and personalities, or do they have differences that complement each other and bring different perspectives?

Independence – Is the majority of your board independent of your firm and your service providers? Is your firm a material revenue source for any of your directors? Fiduciaries should be able to act in an objective manner on all matters.

Industry involvement – Do your directors attend seminars and conferences to keep abreast of recent developments? Are they actively involved in relevant associations...
EVALUATING ORGANISATIONAL STRUCTURE AND CULTURE

It is a good exercise to look beyond your individual directors and evaluate the culture and structure of their firms or the manner in which they have organised themselves. These characteristics can be an important differentiator when assessing how robust your fund governance is as well as when grading your board on how easy they are to work with.

Infrastructure – Are your directors’ business models consistent with your own? If you want institutional investment, allocators will want to see that your board is also institutional. Consider whether your directors’ firms have established standard business practices in areas such as business continuity and cyber-security. Depending on your needs, larger firms may also be able to provide complementary service lines including registered office, company secretarial services, liquidation and trustee services.

Support structure – Does your director have other staff involved in your relationship and what form does that take? Support staff can range from primarily administrative in nature, to experienced professionals providing robust added value and helping manage the relationship. It is important to note, however, that support staff should be present to enhance the level of service provided by the directors and not replace them.

Collaboration – Do your directors work with colleagues they can collaborate with, increasing your access to industry knowledge? A fiduciary firm that works with many large investment managers will see first-hand what is happening in the industry and be able to convey that knowledge across their clients.

Fees – You get what you pay for. Directors offering low fees need to accumulate more relationships to earn the same level of income. Not only may this affect their ability to provide quality service, they may also be less discerning when deciding whether to accept risky clients. This is detrimental to the fund should there be any negative press on your director.

Capacity – Does your director place an upper limit on their number of client relationships? If you are happy with both their maximum figure and their commitment to it, the next step in assessing capacity is to look beyond the numbers to behaviour. For example, are you able to get your director on the phone and do they recognise who you are when you call? Are they prepared for meetings and able to contribute in a meaningful way? Are transactions turned around on a timely basis?

MAKING THE HONOUR ROLL

Every fund is different. Evaluate your needs and talk to your investors to get an idea of what their expectations are and what’s important to them. Your needs will also naturally evolve over time, and it is a good exercise to step back and evaluate your board as your fund matures. Be forward-thinking. The needs of a group of investors in the start-up phase of a fund may be different than the demands of institutional investors so figure out what your end goal is.

If your directors are receiving failing grades, the prospect of making a change can be daunting. You can’t (and wouldn’t want to!) interview every director out there. Decide what you want from your board based on the above. Then communicate this to your peers, investors, service providers and other trusted advisors to see if they have any recommendations. From there you can narrow down the list and interview a select few to determine who will be the best fit.

Corporate governance is increasingly in the spotlight so ensure your directors are making the grade.
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The Cayman Islands Monetary Authority (CIMA) issued its ‘Statement of Guidance for Regulated Mutual Funds - Corporate Governance’ in December 2013 (the CIMA Statement). The CIMA Statement was the culmination of an extensive analysis of the existing practices and procedures affecting governance within regulated mutual fund structures. It also resulted from responses to a private sector survey commissioned by CIMA to gauge market opinion as to the desirability for change and improvement of the core legal and regulatory requirements applicable to directors of regulated funds established in the Cayman Islands.

On 29 April, 2015, the Alternative Investment Management Association (AIMA) published the third edition of its Fund Director’s Guide; the previous edition was released in 2008. It represents a timely update of the treatment of the practices and procedures, role and responsibilities of directors of funds who, since the financial crisis, have been operating under an increased level of scrutiny and with a much increased workload as a result of, for example, the implementation of the Alternative Investment Fund Managers Directive (AIFMD) and the Foreign Account Tax Compliance Act (Fatca).

In what follows, we have highlighted some key areas of common approach between the CIMA Statement and the AIMA Guide. For directors of funds, in trying to achieve compliance but also implement best market practice, it should be borne in mind that the CIMA Statement has been issued by the Cayman Islands Monetary Authority under Section 34 of the Monetary Authority Law (Revised) and although a breach of any such guidance does not of itself constitute an offence, it is generally the expectation that directors will seek to comply with any such CIMA statements. CIMA however also makes it clear that the content of the CIMA Statement is to be regarded as setting out its minimum expectations for the sound and prudent governance of a regulated fund. Therefore, in addition to the CIMA Statement, directors will doubtless look to the AIMA Guide for a more specific, detailed and practical treatment of the subject.

CONFLICTS OF INTEREST

(i) CIMA

The CIMA Statement is concise and clear on the requirements applicable to conflicts of interest, which are that directors are obliged to identify, disclose, monitor and manage all conflicts of interest and any such disclosed conflicts of interest must be documented. It is common practice for the board of directors of a fund to disclose any known or potential conflicts of interest which may arise in the conduct of their business. Typically, a director may also have a connection to one of the other service providers to the

which best market practice for those who provide directorship services can be developed and the industry better regulated. The AIMA Guide is a comprehensive treatment of the subject and offers expert practical and operational support to directors. Being the product of a working group made up from the membership of AIMA, it is a highly representative view of what is taking place in the industry at the moment.

Jonathan Law
specialises in alternative investment funds, corporate law, advising fund sponsors/managers, administrators, brokers and custodians and advising institutional investors on establishment, operation, re-structuring of participation in Cayman domiciled alternative fund structures, Cayman company, commercial and regulatory laws and trade and acquisition finance transactions.
fund and will disclose the nature of that interest to his/her fellow board members at the first opportunity. The Articles of Association of the fund will also typically contain specific requirements regarding the timing and nature of that disclosure and its effect on the ability of the conflicted director to participate in relevant board decisions.

(ii) AIMA

The AIMA Guide also requires identification, disclosure and documentation of conflicts. It does go further than the CIMA Statement, reminding directors that the text of any such disclosure should be specific to the conflict, actual or potential, rather than a broad narration that all relevant disclosures have been made. In addition, it indicates that the practical step of disclosing all recent past and existing business and family connections should be considered as a precautionary measure and, of course, any holding of shares in the fund by a director ought to be carefully treated.

BOARD MEETINGS

(i) CIMA

The board is recommended to meet at least twice a year, subject to the particular circumstances of the fund and any need to meet more frequently in order to adequately fulfill responsibilities. The board should, where necessary, request the participation of any of its service providers at these meetings.

(ii) AIMA

Frequency of meetings is driven by considerations of operational effectiveness together with any tax considerations. A commentary on the UK tax consequences of governance would indicate that quarterly meetings, in person, are a base requirement; that telephonic participation by directors should be avoided and that a majority of the board

and any chairperson should not be resident onshore. The meeting agenda should be circulated in advance of each meeting and each topic fully discussed and explored during the course of the meeting – ‘rubber-stamp’ meetings are particularly problematic. Each of the directors should be properly informed as to the content of the topics being discussed and should express an opinion in the exercise of his/her own independent judgment.

RISK MANAGEMENT

(i) CIMA

Under the CIMA Statement the directors are given a direct and specific duty of oversight, mitigation and management of all risks affecting the business and operations of the fund. Any and all risks should be the subject of specific and detailed discussion at board meetings.

(ii) AIMA

Considered by the AIMA Guide to be, arguably, the two most important functions of the board are review of investment performance and review of the asset manager’s approach to risk management. As a result, the board should be intimately familiar with the operations of the asset manager, the performance statistics as contained in regular reports submitted to the board together with a market review and peer group analysis prepared by the asset manager. The directors should also typically be reviewing the risk report prepared by the asset manager and assessing whether the risk metrics reported are in line with the overall investment strategy of the fund.

OFFERING MATERIALS / CONSTITUTIONAL DOCUMENTS

(i) CIMA

The directors must ensure that the offering documents of the fund are properly prepared in line with market standard expectations together with the legal requirement that the shares in the fund being offered are adequately described in all material particulars so as to enable a potential investor to make an informed investment decision. Specifically, the fund’s investment program and associated risks should be clearly and fully stated and the fund’s policy on conflicts of interest should be separately treated in specific detail.

(ii) AIMA

As a part of their overall management obligations, the directors bear collective and individual responsibility for the content of the fund prospectus, the constitutional documents and the subscription agreement(s). The directors should review these carefully both before and during any offering, to ensure accuracy and proper disclosure and also to identify weaknesses in the documents which may be creating an unfavourable reaction with certain investors, for example the use of standardised terms. Variation of the prospectus and constitutional documents may trigger certain consent requirements from the investors as a whole, or a certain percentage of them, which should be carefully considered.
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here is no doubt that the regulatory environment surrounding the alternative investment fund industry is becoming increasingly complex as well as increasingly time consuming and expensive to monitor and comply with. As a result, the barriers to entry for new managers can appear daunting while existing managers are forced to continually revisit their internal management reporting and control structure, as well as their external service provision to ensure that they remain in good standing.

There has, for some time, been a sense that managers and investors have resorted to dealing with the most immediate regulatory challenge rather than being able to step back and plan ahead. The fact is that those challenges have been many and varied: increased client due diligence and anti-money laundering requirements, form PF reporting, Fatca registration and reporting, audit reporting changes and AIFMD, to name but a few. The cost of compliance, whether viewed purely as a financial issue or with the time and resource requirement also factored in, is a drag in performance and with relatively limited capital-raising opportunities, performance is often the key differentiator, particularly for institutional investors.

REGULATORY HURDLES
While the march of international regulatory initiatives has been relentless, the Cayman regulatory environment has also been undergoing various changes which have had an impact on individual funds and managers. That second layer of regulatory impact is often viewed as little more than an irritation but a closer examination would suggest that the Cayman regulations have often been constructed with the aim of minimising the impact in practical terms.

Beginning with Cayman’s anti-money laundering regime nearly 15 years ago, Cayman’s legislators and the Cayman Islands Monetary Authority demonstrated a desire to marry regulations with practicality. By introducing detailed guidance specifically aimed at the investment fund industry, concepts such as verification through the flow of funds from approved jurisdictions and delegation to regulated entities in those same approved jurisdictions created a strong regulatory framework without imposing unduly burdensome cost or inconvenience. With the exception of relatively minor amendments, the legislative and regulatory framework imposed then remains largely intact today, having stood the test of time and served as a template for many other jurisdictions to imitate.

THE MUTUAL FUNDS LAW
If we turn to the Mutual Funds Law itself, the legislative foundation of the Cayman industry and a pillar of Cayman’s broader financial services sector, it is interesting to note that a number of competitor jurisdictions have taken to duplicating the registration and oversight mechanism which have been enshrined within it since the early 1990s. A registration methodology that provides clarity on the initial registration requirements and ensures immediate access to markets as a regulated entity is now being replicated by competitor jurisdictions on the pretext that it represents innovation.

The key to the relative success which progressive legislation and regulation in Cayman has delivered over the best part of 30 years has often been publicised as the strength of the public-private partnership. There is no doubt that the active dialogue which has always existed among government, regulator and industry has ensured that new regulation has been implemented with the benefit of a very practical perspective.

The recent legislative initiatives have also benefited from that dialogue. The manner in which Cayman embraced the need for a Model 1 IGA to implement Fatca, the responsibilities devolved to the tax information authority and the use of technology to provide a modern means of registration and, in due course, reporting has allowed the industry to get in front of the practicalities of the US legislation and its international application. By delivering regulatory updates and guidance early on, the industries supporting Cayman-domiciled funds have been able to assess the regulatory requirements and adjust accordingly. With respect to Fatca, the administration industry has been required to assume the greater part of the responsibilities under Fatca given the administrator’s possession of fund, financial and investor data. By providing clarity and guidance at an early stage in the implementation process, the Cayman authorities have allowed the practicalities of internal data collection, verification and the data processing to be considered and addressed. Implementation has not been without its difficulties and it would be inaccurate to pretend otherwise.

The multiple extension of the time permitted for registration ahead of the reporting deadline was unfortunate but the desire to create certainty around timings was, at least, offset against the practicality of having a significant population of Cayman entities complete the registration via the portal. Once gain, other jurisdictions have followed Cayman’s lead and have provided the same flexibility around deadlines for registration.

For some time, issues of governance, capacity and transparency have been viewed as of significance to investors and, by proxy, managers. It has been well publicised that the Cayman Islands Monetary Authority embarked upon an industry wide survey on the topic, as well as undertaking detailed local consultation around what a proportionate response to the debate would look like from a Cayman legislative and regulatory perspective. The commentary around the interpretation and scope of the Directors Registration and Licensing Law has been extensive but, in keeping with the theme of regulation implemented with practical consideration, it is important to recognise that...
the legislation has not introduced material obligation or compliance complexity.

Certainly, the new legislation requires that, for the first time, individual directors of Cayman-domiciled and registered funds must be registered with the Cayman Islands Monetary Authority. However, the registration requirements are relatively straightforward. The personal details required to be filed by each individual director are not controversial and are no more onerous than is the case for an average SEC filing. In our experience, the greatest complexity of the process is the need to render payment by credit card but even there, the regulator has recognised the modern reality of paying online. Meanwhile, the other aspects of the new law and registration regime clearly create a foundation for future development, whether through the implementation of a qualitative test for suitable directors – the fit and proper person test – a disqualification regime, transparency to the regulator of appointments held, etc. The Cayman Islands Monetary Authority has already gone on record as saying that it will review the regime over the next two years to assess what enhancements can and should be made to make the regulation more effective in practice.

It is vital that the debate on future legislation and regulation is an informed one, which includes perspectives gathered from across the industry. While the Cayman industry is of the highest calibre and diversity, particularly in terms of the legal, administration, audit, governance, corporate and banking services, the input of the perspectives of managers and investors is necessary to ensure the correct balance.

It is often overlooked that there is a domestic window on the investment management world in the shape of independent directors. The common board constitution of independent directors sitting alongside a representative of the investment manager – not universally adopted but it remains the favoured board model – allows for direct communication between the investment manager and Cayman-based independent directors. From personal experience, those direct discussions are both illuminating and challenging, but the exchange of views is always advantageous in terms of better informing the debate which then takes place around changes required in Cayman.

MINIMAL IMPACT ON PERFORMANCE

Ultimately, no new regulation is going to be viewed as a good thing. However, while the perception may be that Cayman regulatory change is simply a cost of doing business in the jurisdiction, the reality is that there is a high level of sensitivity to regulation being both practical and progressive. Much of the regulatory framework plays off that which most managers are already subject to in the US or EU. Provided that element of rationalisation is maintained, the Cayman overlay will not be a significant cost or operational hurdle for new or existing investors. Crucial to this is that the Cayman regulatory environment has a minimal impact on performance because, as investors will affirm, performance is the key driver in asset allocation and is the only metric which really matters in assessing investment opportunity.
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CAIA OPENS CAYMAN BRANCH

HFMWEEK SPEAKS TO WILLIAM KELLY, CEO OF THE CHARTERED ALTERNATIVE INVESTMENT ANALYST (CAIA) ASSOCIATION AND DANIEL SANTIAGO, DIRECTOR OF HARMONIC FUND SERVICES AND CHAPTER HEAD AT CAIA CAYMAN ISLANDS TO LEARN MORE ABOUT THE CAIA’S NEWEST CAYMAN CHAPTER

Although they are home to just under 60,000 people, the Cayman Islands occupy an outsized position in the global financial sector. Recently, the Chartered Alternative Investment Analyst (CAIA) Association launched its newest global chapter there.

**HFMWeek (HFM):** What drew the CAIA to the Cayman Islands?

**William Kelly (WK):** First and foremost, it was our members. As the alternative investment industry has grown in the Cayman Islands, so too has a thriving community of talented, experienced industry professionals, and we wanted to bring all of the benefits of a global chapter right to their front door.

The Cayman Islands is a tremendous market for alternatives, and as the leader in alternative investment education, CAIA needs be at the centre of that industry growth.

**HFM:** What do you hope to accomplish within the chapter?

**Daniel Santiago (DS):** The launch of a chapter in the Cayman Islands is the culmination of several years of work and a very committed Chapter Executive Committee.

Our extraordinary concentration of leading industry practitioners provides the foundation for a dynamic, diverse, and robust membership.

Our goal is to provide access to exceptional educational events, support a vital public and private sector collaboration, and to play an active role in the community.

**HFM:** Tell us about the CAIA membership in the Cayman Islands.

**DS:** Our chapter’s membership is as varied as that of CAIA itself. There is a deep pool of experienced professionals, directly and indirectly, supporting the alternative investment industry, including fund administrators, operations professionals, accountants, independent directors, lawyers, analysts, consultants, and asset managers, and we’re eager to see our membership ranks grow.

The main ingredient to Cayman’s success as a financial services jurisdiction has been its ability to attract highly-educated and experienced industry professionals. For industry practitioners, the CAIA designation is a powerful differentiator that provides enormous credibility and demonstrates a commitment to self-education.

**HFM:** What’s next for CAIA Cayman Islands as well as CAIA globally?

**WK:** In just the past six months, CAIA has launched chapters in the Cayman Islands, China, Australia and Texas, and we’ve also launched our Virtual Chapter, which includes those members in 60+ countries where we don’t yet have a physical chapter ‘on the ground’.

We’ve also embarked on several new partnerships in academia and marked the one year anniversary of our Fundamentals of Alternative Investments Certificate Program, which has been extremely well received in the asset and wealth management industries.

An organisation with members as dynamic as ours needs to be dynamic itself. Safe to say, we don’t plan on slowing down anytime soon.

**DS:** At CAIA Cayman Islands, our focus will be on providing quality educational events and networking opportunities both for our current members and for those who might be interested in earning their CAIA Charter.

At the same time, we will be active in establishing key partnerships with local firms and industry groups.
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KEY CONSIDERATIONS FOR FUND MANAGERS

MARGARET THOMPSON AND MICHAEL PARTON, OF KB ASSOCIATES, DISCUSS FUND DIRECTORS’ FEES, CAPACITY AND THE BOARD OF DIRECTORS’ SELECTION PROCESS

How much should fund directors get remunerated and how do you set the fee level? A fund board typically comprises of at least one member from the fund manager, who is often not remunerated, as well as a majority of independent professional directors who would be expected to be paid professional fees. AIMA, in their fund director’s guide (updated April 2015) recommends that directors have the power to set their own compensation once the fund has been launched (to avoid potential conflicts of interest with the fund manager). Typically however, it is the fund manager who sets the initial remuneration level after undertaking their own selection process and obtaining fee quotes from several sources.

When a director quotes a fee, primary factors usually considered include the size and complexity of the fund, the investments the fund makes, and the time commitment required for meetings and other duties, along with the individual director’s skill and experience. According to AIMA, remuneration ranges from $15,000-25,000 per annum or more. Cayman directors in particular, are mindful of Justice Jones’ comments in the Weavering case confirming that directors’ fees should be in line with their duties and responsibilities, the scope of which does not vary in accordance with the level of the fees charged.

THE CAPACITY QUESTION
Capacity continues to be a hotly debated question. Transparency is important but it is acknowledged by directors and CIMA alike, that capacity is much more than just looking at numbers and it is difficult to create a limit that takes into consideration the nature, size and complexity of different funds. It is clear that the time requirement to serve on the boards of 25 funds with similar investment strategies, the same fund manager, administrator, custodian and auditor is not comparable to the time required for 25 funds with several fund managers, different strategies and service providers. One popular approach is that if a number needs to be quoted, it should be based on the number of ‘relationships’ rather than the number of funds. Perhaps even more fundamental is to gain a clear understanding of the time commitment required for an individual to participate effectively on their slate of fund directorships.

Following the introduction of the Cayman Islands Directors Registration and Licensing Law in 2014, it is possible, in the not too distant future, that the capacity question will be addressed by the regulators. Although CIMA have made it clear that they will first seek private and public sector feedback, it is already anticipated and provided for in the legislation that monitoring capacity constraints in some form will be part of the regulatory process in the foreseeable future. Whatever model CIMA proposes, the real test of capacity is most likely to be in times of market stress when funds require additional attention and time devoted to them by directors.

CHANGES IN BOARD COMPOSITION
Increasingly investors are demanding more accountability focusing particularly on fund governance and the role of the board of directors. Investor involvement in the selection of directors however is rare and the composition of the board is normally determined by the fund manager. While independence, skills, experience, age, diversity and capacity are important to consider in the selection process, there are other factors that fund managers are now paying attention to when assessing potential directors.

The need for a majority of independent directors is already accepted by most fund managers, however, managers are also focusing on whether independent board members are really independent of each other as well as the service providers. The selection of no more than one director from a single provider is becoming more usual. Furthermore, fund managers are giving value to an active board comprised of directors that provide their own perspectives and judgements and offer advice and recommendations that may enhance, or even differ, from those of management. Constructive dissent, when appropriate, is increasingly being encouraged and is considered necessary for the proper functioning of a fund board.

The heightened awareness to find the right composition for the board has seen fund managers becoming more diligent in their selection of board members, often engaging in formal interviews and conducting their own due diligence. Diversity, not only of backgrounds, qualifications and experience, but also of gender, is becoming more important. In fact, there is hard evidence to suggest (for instance, as pointed out by the Canadian ICSA) that mixed gender boards are in general, measurably more effective than all male boards. Given the growing evidence of a positive correlation between gender diversity on corporate boards and financial performance, it is likely, in line with global trends, that there will be more fund boards with a gender mix in the future.
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FATCA – TAXING ISSUES FOR SELF-ADMINISTERED FUNDS

Tim Frawley is a partner in the Cayman office of Maples and Calder. He has extensive experience in the use of offshore finance vehicles and specialises in alternative investment funds and structured products such as CLOs. His general corporate work includes captives, insurance linked securities and fund sponsored reinsurance vehicles.

Michelle Bailey is responsible for the management of Fatca-related services for fund clients at MaplesFS, including coordinating the implementation of process change in relation to the opening of new investor accounts under Fatca, the remediation of existing accounts to new Fatca standards and coordinating reporting by fund clients.

The implementation of the US Foreign Account Tax Compliance Act (US Fatca) and the less well-known but equally applicable UK equivalent (UK Fatca) have been a topical and core focus for Cayman Islands’ regulators within the past 12 months. US and UK Fatca directly apply to the vast majority of Cayman Islands-domiciled funds vehicles, notably notwithstanding they have no assets or investors in either the US or the UK.

Pursuant to commitments given in the Fatca inter-governmental agreements signed with the US and the UK, the Cayman Islands’ government has enacted laws to give effect to US and UK Fatca.

The Cayman Islands has also committed, along with 57 other ‘early adopt’ countries, to the implementation of the OECD Standard for Automatic Exchange of Financial Account Information – Common Reporting Standard (the CRS). It is anticipated that the Cayman Islands will pass legislation in late 2015 to give effect to the CRS with first reports due in early 2017.

As with US and UK Fatca, financial institutions will be required to have procedures in place to identify, and report information in respect of specified persons in the jurisdictions which sign and implement the CRS. A further 35 countries have committed to implement the CRS but with first reports due in 2018.

The initial deadline for US and UK Fatca registration with the Cayman Islands Tax Information Authority (the TIA) has passed. There have been, and remain, a number of challenges and misperceptions that have confronted fund managers with respect to the classification, registration and reporting obligations of vehicles within a fund structure.

In many instances, the operational solution being pursued for a fund vehicle is the delegation of these functions to a service provider, typically either an administrator or other compliance professionals, who will report back on a regular basis as to its procedures and processes. In doing so, they gain access to a team of experts who have the depth of experience necessary to cope with the distinct nature of the vehicle and grapple with the complex and often laborious nature of the current regulatory environment.

These obligations, however, can be particularly acute for self-administered funds, including traditional private equity or other closed-ended vehicles which pursue less liquid strategies and need to actively manage verification procedures for new and existing accounts. Based on early trends and evolving regulations, there are several potential issues of which fund sponsors and operators need to be aware.

OPERATORS’ RESPONSIBILITIES

Under the Cayman regulations, there is no statutory requirement to appoint a responsible officer or otherwise to delegate responsibility to a third-party service provider. A Cayman Islands financial institution and its operators (primarily being directors of a company or the general partner of a limited partnership and their respective officers) will be held accountable for ensuring compliance with Fatca-related obligations. Non-compliance is a criminal offence and while in most cases there is a requirement for fraud, intention or neglect, there is no such prerequisite for failing to implement the relevant arrangements and procedures. Operators attract vicarious liability where the offence is shown to have occurred with their consent or connivance, or is otherwise attributable to their neglect.

The operators must be satisfied that the entity has been properly classified, registered (where applicable) and has undertaken, and continues to undertake, appropriate due diligence on its investor base to ensure that reportable accounts are identified. The Cayman regime does not impose an obligation to withhold proceeds from recalcitrant investors.

INVESTOR AWARENESS

Financial institutions are reliant on investors being cooperative and timely with respect to completing self-certifications. Many investors, however, do not fully comprehend the need for funds to obtain from them positive assertions as to their tax status, whether as a US person or UK tax resident. It is a common misconception that the US Fatca self-certification requirements do not apply to non-US investors or fund structures, whereas the focus of US Fatca is in fact on non-US entities.

UK Fatca does not have the same global recognition and has some subtle differences from the more familiar US regime. As a result, Cayman funds often experience greater pushback with respect to UK Fatca formalities given inves-
tors are acclimatised to submitting applicable US tax forms (either W-8 or W-9 forms) with a subscription, which contain sufficient information for US Fatca purposes. The UK regime, however, requires a positive self-certification as to a person’s UK tax residency status and the US tax forms are therefore inadequate for this purpose.

It is anticipated that this approach will also be more broadly applied once CRS is implemented (into which regime UK Fatca is expected to be ultimately subsumed) as investors will need to confirm their tax residency status by reference to the CRS signatory countries.

CLASSIFICATION ISSUES AND DIFFERING REGIMES

Nuanced and divergent definitions can lead to the same entity having a different classification under the existing US and UK Fatca regimes. While US and UK versions use identical definitions of ‘investment entity’, the non-reporting exemptions available in each case differ slightly, so while an entity might be non-reporting for one regime it may not be such for the other.

Operators also need to reconcile and take account of certain types of investors who are taking varying positions on their own classification. Custodians may not, for example, necessarily consider themselves to be an investor whereas for Cayman legal purposes, as investors of record, they will be regarded as the account holders.

Additionally, entity classification and reporting obligations may vary for vehicles within a fund structure. A general partner or special purpose vehicle company may either fall outside the definition of a financial institution, being a non-financial foreign entity, and if otherwise caught as an investment entity may also be able to avail of an exemption from reporting. These matters are fact-specific and advice should be sought early in the structuring process especially as Fatca status confirmations often need to be given as part of any account opening process.

REGISTRATION, REPORTING AND NIL REPORTS

Cayman Islands financial institutions are subject to two registration requirements: first, to register with the IRS for a global intermediary identification number and, second, to register with the TIA through an online portal maintained by the Department of International Tax Cooperation (DITC). The registration requirements exist irrespective of whether a financial institution anticipates having any reportable accounts.

Under US Fatca, the first account reports are due by 26 June 2015. The Cayman reporting format is consistent with that published by the IRS and will either need to be individually entered manually on the portal or via submission by uploading an XML format report to the Portal.

Filing of a nil report with the DITC is not mandatory. It is however expected that many reporting entities will want to take positive steps to file a nil report as an industry best practice approach as evidence that positive steps have been taken to monitor and identify reportable accounts.

TIA APPROACH

In light of tight timeframes and anticipated reporting volumes (approximately 30,000 Cayman vehicles have already registered with the IRS) the TIA has advised that it will take a soft approach to enforcement during the first year of Fatca to work with, and allow, industry to meet compliance requirements by specified due dates.

FUTURE CHALLENGES

Fund sponsors and fund operators of self-administered funds face a number of legal and operational challenges in complying with both the US and UK Fatca regimes as enacted in Cayman Islands law, especially as this is a developing area of law with the CRS anticipated to become law also later in the year.

While many self-administered funds may have operational compliance infrastructure to be able to deal with these challenges, many other funds for reasons of scale, complexity and cost will be looking to third-party service providers to provide compliance solutions.
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CALIFORNIA DREAMING: OF AN INSTITUTIONAL EXIT FROM HEDGE FUNDS?

ASHLEY GUNNING AND ED PEARSON OF WALKERS EXAMINE THE EVOLUTION OF HEDGE FUNDS AND THEIR INVESTORS IN RECENT YEARS AND WHAT’S DRIVING CHANGE

Once a product primarily marketed at family offices and other wealthy individuals, hedge funds’ investor base has grown to encompass educational endowments, sovereign wealth funds, insurers and public and private pension funds. With hedge funds attracting a broader range of investors than ever before, trying to construct an ‘average hedge fund investor’ or talk of hedge fund investors as a coherent group invites generalisations that lose too much of the detail to be instructive.

At the same time, we now have more data on the hedge fund industry than ever before, and it is clear from this data that institutions now dominate the capital flows. As the variety of investors in hedge funds becomes more institutional, hedge funds themselves have institutionalised – Deutsche Bank’s annual Alternative Investment Survey (released in March 2015) suggests that today, fewer than 200 hedge funds manage more than two thirds of industry assets, and since 2008, assets managed by funds with more than $5bn under management have grown 141%, compared with growth of 53% for funds with fewer assets under management.

At Walkers, our longstanding relationships with the leading asset managers have given us a unique dataset to work from, and our analysis of this data supports these observations too. While we have supported managers of all sizes during the recent period of fundraising activity, 80% of the new hedge funds we helped to launch in 2014 were for established managers, and many of them launched by major institutions.

Against this background, when the California Public Employees’ Retirement System (CalPERS) announced in September 2014 that it was closing its hedge fund program, the industry paid attention. CalPERS cited complexity and cost as the key drivers of their decision. In January 2015, PFZW, Europe’s second largest public pension fund, also confirmed it had “all but eradicated” its use of hedge funds by the end of 2014. When explaining the decision, PFZW also referred to complexity and cost, but referred also to policy concerns, “given the high remuneration in the hedge fund sector and the often limited concern for society and the environment”.

The data does not support this suggestion. On 30 December 2014, eVestment, a hedge fund consulting and analytics group, which has been tracking hedge fund flows since 2000, released their 2015 Hedge Fund Industry Outlook. This report noted that 2014 had seen the largest inflows into the industry on an absolute basis since 2007, with total hedge fund assets now over $3trn. eVestment expect flows into hedge funds in 2015 to be even greater, between $90bn and $110bn.

CAN THESE VIEWS BE RECONCILED?

Why are institutional investors still allocating to hedge funds notwithstanding the concerns raised by CalPERS and others?

One explanation is that the flows reflect concerns among institutions that the markets of the last few years, flooded with central bank liquidity and regularly hitting new highs, will not last forever. The financial crisis, and the recession that followed, remain a recent memory for institutional portfolio managers, who are keen to secure the protection that hedge funds offer against a similar reversal in the future. In this context, the recent performance of hedge funds as an asset class is of only moderate concern to institutional investment officers – it is protection from volatility that matters.

For another explanation, we return to the difficulties inherent in constructing any sort of average in the hedge fund context. An average hedge fund is just as hard to describe as an average hedge fund investor. With a wide variety of strategies designed to hedge an ever wider variety of risks, it is to be expected that in any given market, some perform poorly while others perform well. Nor is it surprising that an aggregation of the returns of those strategies will generally look lacklustre. This suggests a second explanation for continued inflows: the role of hedge funds within an institutional portfolio is better understood. Institutions seek alternative exposures that they cannot create themselves, or to hedge a risk they cannot conventionally address in their existing portfolio.

This more nuanced understanding of hedge funds’ role in an institutional portfolio has led to some further trends which may indicate new opportunities for both managers and investors.

One example of this is the emergence of co-investment rights as a key focus of larger institutional hedge fund investors. If investing in hedge funds requires faith in the manager’s ability to identify market opportunities, then
it follows that an anchor investor will want access to the best of these opportunities beyond simple participation in the flagship fund. Managers willing to be flexible with their fund structures to meet their investors’ demands can derive benefits too: activist funds can pool co-investment capital to secure board seats they might not otherwise attain, or funds with strict position limits can pursue larger investments. The Cayman Islands’ legal framework has always been accommodating of such innovative structures, and Walkers has advised institutional managers and investors already familiar with co-investment from their private equity, real estate and infrastructure funds.

Figures released by JP Morgan in 2014 suggested that 74% of endowment and foundation investors, and 60% of pension fund investors were willing to participate in co-investment opportunities. More recent data further supports the emergence of this trend, with 40% of the respondents to Deutsche Bank’s survey indicating that they already co-invest with managers, and 72% of those respondents indicating that they planned to increase their allocation in 2015. Across the entire spectrum of institutional investors there will always be a small number of organisations who may decide the hedge fund component of their portfolio is no longer appropriate. Institutions have their own sets of competing internal and external pressures, which (as has been seen) can lead them to abandon hedge funds altogether. The financial crisis and subsequent response has exacerbated some of these considerations, and shaped a new regulatory environment in which hedge funds and their investors now operate. For the very largest institutions, perhaps the size of the programme is insufficient to secure any meaningful hedging of volatility relative to the cost of running the programme (CalPERS’ hedge fund programme comprised a little over 1% of its assets). When these decisions are made by super-sized funds, they understandably capture the headlines. However, the data suggests that they are the exception rather than the rule, and much of the related commentary served to highlight the problems in aggregating a specific set of concerns across such a diverse asset class and investor base. Walkers’ experience advising the industry over the last 50 years has shown that no two funds are the same, and nor are any two investors.

“INSTITUTIONS SEEK ALTERNATIVE EXPOSURES THAT THEY CANNOT CREATE THEMSELVES, OR TO HEDGE A RISK THEY CANNOT CONVENTIONALLY ADDRESS IN THEIR EXISTING PORTFOLIO.”
PROFESSIONAL DIRECTORS –
HOW DO WE RAISE
THE STANDARD?

WILLIAM JONES OF MANAGEMENTPLUS GROUP HIGHLIGHTS KEY AREAS WHERE THE SELECTION AND MANAGEMENT OF FUND DIRECTORS CAN AND
SHOULD BE REVIEWED

In early 2007, I was referred to as a “professional director” by a well-known London hedge fund lawyer – the reference was not complimentary. The lawyer advised a client not to hire only professional directors on the board and to use “real directors” instead. The fund manager selected two professional directors including me, and a friend of his who was a specialist in a specific industry in which the manager invested. The end result was that the real director attended only the launch meeting and another meeting over the course of the four-year life of the fund, which had quarterly meetings, and contributed close to nothing during the life of the fund.

Today the world is very different – the term ‘professional director’ carries positive connotations. Professional directors in the investment fund industry should have relevant experience in the fund industry (whether in traditional or alternative investment funds or both), be specialists in corporate governance and have a deep understanding of the legal, regulatory and tax environment in which the fund operates. Ideally they should have actual experience and at a minimum knowledge of operational matters affecting the fund (fund administration, settlement etc.), and ultimately be able to demonstrate value-added to the fund and its manager through engagement, advice and willingness to take action as necessary in any given circumstances.

In addition, professional directors are usually independent – from the investment manager, as well as other service providers to the fund. Such independence is assumed to be a cornerstone of the director’s ability to exercise his/her judgment freely and act in a manner that can be demonstrated to be in the best interests of the fund and by extension its investors.

However, the reality remains that many professional directors in the investment fund industry still do not have the requisite background, experience or knowledge to add value to a fund or the willingness to take appropriate action when challenging the fund manager or sponsor. What can be done to address this? In my view, investors, fund managers and directors themselves have a collective responsibility to raise the standards.

INVESTORS’ INFLUENCE
Investors can be very persuasive when it comes to corporate governance. While a small number of large investors are very vocal about implementing best practices, usually asset allocators or trustees who themselves have fiduciary obligations to their constituents, unfortunately the majority of investors do not actively engage fund managers on the topic of corporate governance. Investors can help improve standards by adding corporate governance to their due diligence efforts. Simply asking about the background of the directors and the mechanics of the board will signal to managers that corporate governance matters. More sophisticated investors conduct due diligence on directors, normally through an interview by phone or in person or by written questionnaire, and many commission background checks. The key contribution from investors is to make it clear to fund managers that a corporate governance process has to be in place that is commensurate to the complexity of the fund. Delivering such a message to managers is ultimately a form of self-protection, so I have always been curious as to why this does not happen more frequently.

EXPANDING YOUR PORTFOLIO
Whilst legally the incorporator of a fund appoints its directors, the reality is that the fund manager or sponsor identifies and selects the directors. In my view fund managers should have the obligation, even a fiduciary duty, to select competent directors. At a minimum they should represent in the fund’s disclosure document that they have carried out a rigorous selection process and appropriate due diligence to identify and select directors with the requisite experience and skill set for the relevant fund. This proposal...
IT IS UP TO INVESTORS, FUND MANAGERS AND DIRECTORS TO WORK TOGETHER TO ENSURE THAT THE CORPORATE GOVERNANCE PROCESS IS FIT FOR PURPOSE AND WORKS AS INTENDED

not just a pro forma license, but a substantive one. I would not allow a doctor without a medical license to treat me, so why would I hire a director who is not professionally qualified or licensed? This suggestion raises many questions about who licenses, under what standards etc., but these would be details to be discussed and implemented. The point remains that professional directors should in fact be ‘professional.’

Directors should also avail themselves of the many sources of information and experience available to them. Too many directors have never met the managers of their fund clients in person. I realise that geographical dispersion can make this difficult but it can be done. If not possible, directors should engage with the fund managers regularly outside the cycle of board meetings. Directors should also ask the other service providers of the fund – administrators, custodians, prime brokers, auditors, lawyers, consultants, IT and other technicians, tax advisors, etc – to discuss what they do for the fund and how oversight works. I have always found service providers to be very willing to share information and to coordinate how to best service a fund as a collective of service providers. Finally, directors should access the experience of other directors. Many director associations exist at national and local levels which provide educational content as well as access to the knowledge and experience of other directors.

CONCLUSION

In short, the fund director industry has come very far since the old days but we can do more. You may have noted that I have omitted any reference to regulators so far in this article. I believe that corporate governance is not within the scope of a regulator’s remit – local companies’ law has proven adequate over centuries, going back to Roman times, to govern directors. When issues have arisen, they tend to be related to lack of enforcement by investors through legal action against directors. Having said this, it is clear already that politicians and regulators will step in to correct perceived or actual corporate governance failures. It is up to investors, fund managers and directors to work together to ensure that the corporate governance process is fit for purpose and works as intended, which will hopefully have the side benefit of preventing further regulation on corporate governance.
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