



Funds in the Cayman Islands

Investment Fund Regulation

The law is simple and straightforward. Not all investment funds are regulated under the law. Not required to be registered are close-ended funds (i.e. those with no redemption or repurchase rights for the investors), debt issues, and funds with shares held by no more than 15 investors who by majority are capable of appointing or removing the operators of the fund (i.e. directors, trustees and general partners). There are no prohibitive licensing and regulatory provisions or stringent measures calling for local custodians, managers or directors. Rather, the legislation recognises that most of those engaged in the industry are already strictly regulated or controlled within or outside the Cayman Islands. Thus, reliance to a large extent on self regulation within the industry is seen as reasonable.

There are also no restrictions placed on investment objectives, risks, rates of return, leveraging or other commercial matters given the institutional and sophisticated nature of the investors in Cayman funds.

The law requires that the offering memorandum describes comprehensively the equity interests and contains sufficient information (on objectives, risks, service providers, conflicts of interest etc.) to enable the investor to make an informed decision.

A regulated investment fund must qualify under the law before starting business. To do so it may either obtain its own licence, appoint a licensed mutual fund administrator in the Cayman Islands to provide its principal office, or be automatically registered if it is for a sophisticated investor, i.e. the minimum investment per investor is US\$100,000. Funds established before 14th November 2006 are permitted to retain the previous minimum investment requirement of US\$50,000.

Categories of funds regulated under the Law

There are therefore three categories of funds regulated under the law:

- **the licensed fund**
- **the administered fund**
- **the registered fund**

Types Of Investment Fund Structures

The Cayman Islands has company, trust, partnership and related laws which allow a high degree of flexibility for establishing investment funds. The three vehicles commonly used for operating investment funds are the exempted company, the unit trust and the exempted limited partnership.

- The exempted company may redeem or purchase its own shares and may therefore operate as an open-ended corporate fund. Close-ended corporate funds can also be established using the exempted company, and it is a relatively straightforward procedure to convert from one to the other. The Companies Law also allows re-domiciling of companies and corporate reconstruction so that fund mergers are easily facilitated.
- The unit trust is usually established under a trust deed with the investors interests held as trust units.
- The exempted limited partnership provides a second unincorporated vehicle and it can be formed as easily as the exempted company or the unit trust.

The Cayman Islands Mutual Funds Law provides for the regulation of mutual funds by the Cayman Islands Monetary Authority. In this Law, a mutual fund is defined as “any company, trust or partnership either incorporated or established in the Cayman Islands, or outside the Cayman Islands, which issues equity interest redeemable or repurchased at the option of the investor, the purpose of which is the pooling of investors funds with the aim of spreading investment risk and enabling investors to receive profits or gains from investments.”

We are able to assist with all fund structures but have a particular expertise in master/feeder, fund of funds, Shariah compliant funds and segregated portfolio companies.

REGULATION OF INVESTMENT FUNDS IN THE CAYMAN ISLANDS

The regulation of investment funds (such as mutual funds and hedge funds) established under Cayman Islands law, or which are administered or managed in the Cayman Islands, is largely governed by the provisions of the Mutual Funds Law (Revised) (the “Law”). Whilst the term “mutual fund” has a clear definition in the Law, the terms “investment fund” and “hedge fund” are not separately defined under Cayman Islands law. Nevertheless, this distinction will quickly fall away once the process of modernizing the Law is complete; following which, the new version of the Law will be referred to as the “Investment Funds Law” of the Cayman Islands. Thus, for the purpose of this briefing note, the terms “mutual fund”, “investment fund”, and “hedge fund”, will be used interchangeably.

Regulatory oversight of mutual funds is vested in the Cayman Islands Monetary Authority (the “Monetary Authority”); a corporate body established under the Monetary Authority Law (Revised) and charged with the supervision and regulation of mutual funds and mutual fund administrators (along with the administration of various Cayman Islands regulatory statutes).

The Law defines a mutual fund as a company, unit trust or partnership:-

1. which issues shares, trust units or partnership interests respectively;
2. that carry an entitlement to participate in the profits or gains of the issuer and are redeemable or re-purchasable at the option of the investor before the commencement of winding up or dissolution of the issuer; and
3. with the purpose or effect of pooling investor funds with the aim of spreading investment risks and enabling investors to receive profits or gains from investments. The definition specifically excludes any person who is licensed under the Banks and Trust Companies Law (Revised) or the Insurance Law (Revised) or who is registered under the Building Societies Law (Revised) or the Friendly Societies Law (Revised). Closed-ended investment vehicles, whose equity interests are not redeemable or re-purchasable at the option of the investor before their winding up or dissolution, fall outside of the definition of a mutual fund and, accordingly, are not regulated under the Law in any way.

The scheme of the Law is to apply an appropriate level of regulation to each mutual fund carrying on (or attempting to carry on) business in or from the Cayman Islands, depending on its circumstances and ultimate investor market. The Law does not introduce any investment restrictions or statutory compensation provision. It should be noted that, pursuant to section 4(5) of the Law, a mutual fund will be carrying on business in or from the Cayman Islands if (a) it is incorporated or established in the Cayman Islands or (b) it is managed or administered in the Cayman Islands, regardless of its place of incorporation or establishment.

In ascending order of degree of regulation, open-ended mutual funds may be exempted under subsection 4(4) (“Exempted Funds”), administered under sub-section 4(1)(b) (“Administered Funds”), registered under sub-section 4(3) (“Registered Funds”), or licensed under sub-section 5(1) of the Law (“Licensed Funds”).

Exempted Funds

The Law permits one category of funds to carry on or attempt to carry on business in or from the Cayman Islands without any filing whatsoever with the Monetary Authority. This exempt status is available only to those funds in which the equity interests are held by not more than 15 investors, the majority in number of whom are capable of appointing or removing the trustees of a unit trust mutual fund, the general partners of a limited partnership mutual fund or the directors of a corporate mutual fund, as the case may be. Note that, in order to meet this requirement, the power to appoint and remove directors etc. must be vested in a majority *in number* of the investors, rather than a majority in terms of the value of equity interests. Funds which are structured so that the investors are issued with a class of shares which carry participation rights but which do not carry voting rights will not qualify as Exempted Funds.

In considering whether or not a particular fund qualifies as an Exempted Fund, it should be borne in mind that the Law defines “investor” to mean the legal holder of the equity interest in a fund and does not “look through” to the beneficial or indirect owners.

Despite the exempt status of such funds under the Law, all law firms, banks, trust companies, fund administrators and other service providers in the Cayman Islands have a responsibility under the Proceeds of Criminal Conduct Law (Revised) (the “PCCL”) to make suitable inquiries before providing services to any client in order to prevent their services being used in connection with the proceeds of criminal conduct. The PCCL contains provisions for such service providers to report any suspicious activity to the relevant authority.

Administered Funds

A mutual fund having more than fifteen investors and not being a licensed or registered mutual fund will be an administered mutual fund (an “Administered Fund”) if its principal office in the Cayman Islands is provided by a licensed mutual funds administrator.

In accepting an engagement to provide the principal office of an Administered, Registered or Licensed Fund (a fund of any such category, a “Regulated Fund”), an Administrator is required to satisfy itself, and make a declaration to the Monetary Authority, that (a) each promoter of the Regulated Fund is of sound reputation, (b) the administration of the Regulated Fund will be undertaken by persons who are of sound reputation and have sufficient expertise to administer the Regulated Fund, and (c) the Regulated Fund’s business and any offer of equity interests in it will be carried out in a proper way. This declaration must be filed with the Monetary Authority (on Forms MF2 and MF2A) as soon as the Administrator starts to provide its principal office, along with the following documentation:

1. the fund’s current offering document or the latest draft;
2. a letter of consent from an approved Cayman Islands auditor indicating the name of the fund, the date of the financial statements, and the accounting principles to be used, and including a statement that the auditor is aware of and agrees to fulfil his obligations pursuant to section 34 of the Law (the “section 34 statement”);
3. a letter of consent from its administrator indicating the name of the fund and giving a summary of the services to be provided. Please note however, that if the fund decides to appoint a separate net asset value calculation agent (other than the administrator) the Monetary Authority will require a similar consent letter to be prepared and filed by such

entity on behalf of the fund;

4. where applicable, a certified copy of the certificate of incorporation or registration issued by the Registrar of Companies or evidence of registration or establishment of a partnership or a unit trust; and

5. the first annual Administered Fund's fee of US \$3,048.78 (CI \$2,500.00).

Administered Funds are therefore to be contrasted with Licensed Funds in that the Administrator has a statutory duty to conduct suitable inquiries to satisfy itself of the probity of the promoters, administration and business of the Administered Fund whereas, in the case of a Licensed Fund, this responsibility is vested directly in the Monetary Authority. To this extent, the regulatory regime is characterized by the principle of private sector self-regulation although, as described below, the Monetary Authority retains comprehensive powers to intervene where appropriate.

The principle of private sector self-regulation is further expressed in the duty of the Administrator to notify the Monetary Authority immediately if it should become aware, or have reason to believe, that an Administered Fund (or a promoter, trustee, general partner or director of such an Administered Fund) is or is likely to become insolvent, or is carrying on business unlawfully or in any manner that is or is likely to be prejudicial to its investors or creditors. There is every reason to believe the legislature's apparent faith in the ability of the mutual fund administration industry in the Cayman Islands to assist in the regulation of mutual funds is well founded.

Registered Funds

As a further alternative to obtaining a mutual fund license or appointing an Administrator to provide its principal office in the Cayman Islands, section 4(3) of the Law provides that a mutual fund may carry on or attempt to carry on business in or from the Cayman Islands if the minimum equity interest purchasable by a prospective investor in that mutual fund is US \$100,000 or its equivalent in any other currency, or if its equity interests are listed on a stock exchange recognised by the Monetary Authority (including an over-the-counter market). A recognised exchange for this purpose is one that is either:

1. a US licensed exchange; or
2. an EU licensed exchange; or
3. a Canadian licensed exchange; or
4. a full member of the World Federation of Exchanges that is located in a Schedule 3 country; or
5. the Cayman Islands Stock Exchange.

Such a fund may apply for a certificate of registration from the Monetary Authority by filing the prescribed details (on Form MF1) in respect of its current offering document or the latest draft which should be accompanied by:-

1. a letter of consent from an approved Cayman Islands auditor, indicating the name of the fund, the date of financial statements and the accounting principles to be used, and containing the Section 34 statement;
2. letter(s) of consent from its administrator (and net asset value calculation agent, if applicable) indicating the name of the fund and giving a summary of the services to be

provided;

3. where applicable, a certified copy of the certificate of its incorporation or registration issued by the Registrar of Companies or evidence of registration or establishment of a partnership or a unit trust; and

4. the first annual Registered Fund's fee of US \$3,048.78 (CI \$2,500.00).

The lighter regulatory touch which is applied to Registered Funds is premised on the assumption that investors who are in a position to invest the minimum subscription amount of US\$100,000 are likely to be sophisticated investors who can assess for themselves or afford professional advice on the risks associated with an investment in the fund or, alternatively, that listed funds will be subject to effective regulation by the relevant stock exchange. Registered Funds are the most common category of mutual fund regulated under the Law.

Licensed Funds

Section 5(1) of the Law provides that, unless a mutual fund is an Administered, Registered or Exempted Fund, it shall not carry on or attempt to carry on business in or from the Cayman Islands unless it has a mutual fund license and has either a registered office in the Cayman Islands or, in the case of a unit trust, has as its trustee a trust company licensed under the Banks and Trust Companies Law (Revised).

The grant of a mutual fund license is within the discretion of the Monetary Authority. In considering an application for a mutual fund license, the Monetary Authority may require such information as it may deem necessary to satisfy itself that each promoter of the applicant fund is of sound reputation, that its administration will be undertaken by persons who are of sound reputation and have sufficient expertise to administer the applicant fund, and that its business and any offer of equity interests in it will be carried out in a proper way. Such an application is to be made in the prescribed form (Form MF3) and must be accompanied by:-

1. a copy of the current offering document or latest draft;
2. a copy of the most recent annual audited accounts (if the applicant is an existing fund);
3. where applicable, a certified copy of the certificate of incorporation or registration issued by the Registrar of Companies or evidence of registration or establishment of a partnership or a unit trust;
4. completed personal questionnaires, three references and police clearance certificates for:-
 - (a) all directors of a corporate mutual fund; or
 - (b) all directors of a corporate trustee of a unit trust mutual fund; or
 - (c) all directors of any corporate general partner of a limited partnership mutual fund;
5. a letter of consent from an approved Cayman Islands auditor accepting an appointment as auditor, indicating the name of the fund, the date of the financial statements, and the accounting principles to be used, together with completed Section 34 statement;
6. letter(s) of consent from its administrator (and net asset value calculation agent, if applicable) indicating the name of the fund and giving a summary of the services to be provided; and
7. the application fee of US \$3, 048.78 (CI \$2,500.00). (The annual license fee is also US \$3, 048.78 (CI \$2,500.00)).

A mutual fund license may be granted on terms that it will take effect upon the incorporation of a corporate mutual fund or, in the case of a foreign company, upon its registration as a foreign company under Part IX of the Companies Law (Revised), or on the establishment of any unit trust. A mutual fund license may also be granted subject to such conditions as the Monetary Authority may consider appropriate and the Monetary Authority may, upon application, waive, vary or revoke any such condition

Continuing Obligations

Under the Law, the requirement that Licensed Funds and Administered Funds have their current offering documents filed with the Monetary Authority, and that Registered Funds have prescribed details in respect of their current offering documents filed with the Monetary Authority, is not satisfied unless:-

a. each such offering document describes the equity interests in all material respects, and contains such other information as is necessary to enable a prospective investor to make an informed decision as to whether or not to subscribe for or purchase the equity interests; and

b. (where there is a continuing offering of equity interests and any promoter, director, trustee, or general partner of the fund becomes aware of any change that materially affects any information in the offering document (or the prescribed details) filed with the Monetary Authority), the fund files an amended offering document (or amended prescribed details) incorporating that change within twenty-one days of the promoter or operator becoming so aware. In addition, every Regulated Fund is required to file accounts audited by an approved auditor within six months of the end of each financial year. Further, every Regulated Fund must pay its annual fee of US\$3,048.78 (CI \$2,500.00) to the Monetary Authority on or before 15th January in each year. The Law is expected to be amended in December 2006 or January 2007 to require the operators (i.e.; a director if the fund is a company, the trustee if a trust, or a general partner if a partnership) of Regulated Funds (with fiscal years ending on or after December 31, 2006), to complete a return referred to as the Key Data Elements ("KDE") Form (which sets out general, operational and financial information on each fund). The Regulated Fund will be required to submit on an annual basis, both its audited accounts and the KDE to the Monetary Authority through the fund's approved audit firm in the Cayman Islands.

Although the Regulated Fund may wish to appoint another service provider (e.g.; a registered office or its administrator) to complete the form on the fund's behalf, ultimate responsibility for the timely and accurate filing of the KDE Form will remain with the operator.

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