

Investment funds in Cayman Islands: regulatory overview

Jarrod Farley
Carey Olsen

global.practicallaw.com/3-501-3562

RETAIL FUNDS

1. What is the structure of the retail funds market? What have been the main trends over the last year?

Open-ended retail funds

The Cayman Islands are not primarily known as a retail fund jurisdiction. Its laws and regulations applicable to investment funds are geared mainly towards attracting institutional investors.

Open-ended funds established in or marketed to the public in the Cayman Islands (that is, funds where investors can voluntarily redeem their interests) are considered "mutual funds" under the Mutual Funds Law (2013 Revision) (MF Law) and therefore must be regulated by the Cayman Islands Monetary Authority (CIMA), unless they fall within a limited exception.

Three types of CIMA-regulated funds (Regulated Funds) can admit retail investors (that is, investors who invest less than US\$100,000):

- Funds licensed under section 4(1)(a) of the MF Law (Licensed Funds).
- Funds licensed under section 4(1)(b) of the MF Law (Administered Funds), that is, funds for which a CIMA-licensed mutual fund administrator provides the principal office and has delegated regulatory responsibilities.
- Funds registered under section 4(3) of the MF Law (Registered Funds) by virtue of being listed on an approved stock exchange.

In theory, retail investors can also invest in unregulated mutual funds (Unregulated MFs). These are funds exempted from registration with CIMA under section 4(4) of the MF Law due to having 15 or fewer investors, a majority of whom can appoint and remove the operator of the fund (the directors, general partner or trustee, as applicable). It is impossible to be certain, but it can be inferred that being limited to 15 investors makes them generally unsuitable for marketing to retail investors and therefore statistically insignificant as retail funds.

Although investment fund regulation in the Cayman Islands is generally geared towards institutional investors, there is one exception to this. The Retail Mutual Funds (Japan) Regulations (2007 Revision), as amended (Retail Japan Regulations) provide a compliance framework for Licensed Funds that will market to retail investors in Japan, enabling them to automatically comply with the applicable Japanese securities laws. However, these funds are merely a sub-set of Licensed Funds, which themselves only comprise 1% of Regulated Funds.

According to CIMA's latest statistical digest (for 2012) only 8% of Regulated Funds have a minimum required investment of less than US\$50,000 and only 7% require a minimum investment between US\$50,000 and US\$100,000.

Between 30 September 2013 and 30 September 2014, the number of Licensed Funds declined by seven (from 113 to 106) and the number of Administered Funds also declined by seven (from 404 to 397).

Closed-ended retail funds

Closed-ended funds (that is, funds whose equity interests cannot be redeemed at the option of the investor), whether retail or non-retail, are currently not regulated by CIMA under the MF Law.

As unregulated vehicles, it is difficult to know how many closed-ended funds exist, and harder still to guess the number admitting retail investors. However, based on the author's experience and the fact that, as unregulated funds, they would presumably find it even more difficult to comply with retail marketing restrictions in other jurisdictions, the author believes the number of closed-ended funds admitting retail investors is statistically insignificant.

Regulatory framework and bodies

2. What are the key statutes, regulations and rules that govern retail funds? Which regulatory bodies regulate retail funds?

Open-ended retail funds

Regulatory framework. Open-ended funds are regulated by the Mutual Funds Law (MF Law) (see *Question 1*). The Retail Japan Regulations also apply to Licensed Funds that market to retail investors in Japan (see *Question 1*).

Directors of corporate Regulated Funds are regulated by The Directors Registration and Licensing Law 2014 (Director Licensing Law) as supplemented by The Directors Registration and Licensing (Registration and Licensing) Regulations 2014.

The Securities Investment Business Law (2011 Revision) (SIB Law) provides that the Cayman Islands Monetary Authority (CIMA) is responsible for the licensing and control of persons carrying on "securities investment business" in or from within the Cayman Islands (see *Question 4*).

Regulatory bodies. CIMA is the regulatory body for open-ended retail funds (see *Question 1*).

Closed-ended retail funds

Regulatory framework. There is no regulatory framework for closed-ended retail funds in the Cayman Islands (see *Question 1*).

Regulatory bodies. There is no regulatory body for closed-ended retail funds in the Cayman Islands (see *Question 1*).



3. Do retail funds themselves have to be authorised or licensed?

Open-ended retail funds

There following types of open-ended fund can admit retail investors (see *Question 1*):

- Licensed Funds.
- Administered Funds.
- Registered Funds listed on an approved stock exchange.
- Unregulated Mutual Funds (MFs).

Of the four types, only Unregulated MFs are not required to be regulated by CIMA. The licensing and registration requirements for Regulated Funds are set out below.

Any proposed director of a corporate fund regulated by CIMA must register with CIMA (via CIMA's online registration portal) before he can be appointed.

Licensed Funds. A Licensed Fund must have either:

- For companies or limited partnerships: a registered office in the Cayman Islands.
- For unit trusts: a trustee that is a trust company licensed under the Banks and Trust Company Law (2013 Revision) (BTC Law).

To apply to be licensed as a Licensed Fund, the following must be submitted to CIMA:

- An offering document (or the latest draft) describing the offered interests in all material respects and containing any other information necessary for an investor to make an informed investment decision (CIMA prescribes certain information that must be included).
- A completed application (Form MF3).
- A certified copy of the certificate of incorporation or registration.
- Completed personal questionnaires, three references and police clearance certificates (or affidavit of no convictions for certain individuals) for:
 - directors of the fund (for a company);
 - directors of the fund's trustee (for a unit trust); or
 - the fund's general partner or the general partner's directors, as applicable (for a limited partnership).
- Background details on the fund's service providers, if not included in the offering document.
- For an existing fund, a copy of the most recent annual audited accounts.
- A consent letter from an approved local auditor.
- A consent letter from an administrator.
- The prescribed licence fee (US\$4,268.29) and application fee (US\$365.85).
- Details of who will be responsible for dealing with queries from CIMA and the payment of fees (such as the registered office provider or local administrator).

CIMA must be satisfied that:

- Each promoter of the fund is of sound reputation (a promoter is any person responsible for preparation and distribution of the fund's offering document other than its professional advisers).
- The fund's administration will be undertaken by persons:

- with sufficient expertise;
- of sound reputation; and
- who are fit and proper to be in their respective positions.

- The fund's business and any offering of its interests will be carried out in a proper way.

CIMA may grant a licence subject to any conditions that it considers appropriate.

Administered Funds. An Administered Fund must have a principal office in the Cayman Islands provided by a CIMA-licensed mutual fund administrator.

To register as an Administered Fund, the following must be submitted to CIMA:

- An offering document (or the latest draft) describing the offered interests in all material respects and containing any other information necessary for an investor to make an informed investment decision.
- Completed application (Forms MF2 and MF2A).
- A certified copy of the certificate of incorporation (or equivalent).
- A consent letter from an approved local auditor.
- The prescribed registration fee (US\$4,268.29) and application fee (US\$365.85).

The administrator providing the fund's principal office must be satisfied that:

- Each promoter of the fund is of sound reputation.
- The fund's administration will be undertaken by persons with sufficient expertise and who are of sound reputation.
- The fund's business and any offering of its interests will be carried out in a proper way.

Registered Funds. To admit retail investors, a Registered Fund must be listed on an approved stock exchange.

To register as a Registered Fund, the following must be submitted to CIMA:

- An offering document (or the latest draft) describing the offered interests in all material respects and containing any other information necessary for an investor to make an informed investment decision.
- A completed application Form MF1.
- A certified copy of the certificate of incorporation or registration.
- A consent letter from an approved local auditor.
- A consent letter from an administrator.
- The prescribed registration fee (US\$4,268.29) and application fee (US\$365.85).
- Details of who will be responsible for dealing with queries from CIMA and the payment of fees (such as the registered office provider or local administrator).

Closed-ended retail funds

There are no regulatory requirements for closed-ended funds (see *Question 1, Closed-ended retail funds*).

Marketing

4. Who can market retail funds?

Open-ended retail funds

The Securities Investment Business Law (SIB Law) provides for the licensing and control of persons carrying on "securities investment business" in or from within the Cayman Islands by the Cayman Islands Monetary Authority (CIMA). Securities investment business includes dealing in, arranging deals in and advising on securities. Accordingly, the marketing of interests in funds will generally constitute securities investment business.

With limited exceptions for public authorities and so on, the SIB Law applies to:

- Any entity formed or registered in the Cayman Islands carrying on securities investment business.
- Any person that establishes a place of business in the Cayman Islands from which securities investment business is carried out.

Any of the foregoing will require a licence under the SIB Law to carry on securities investment business, unless the entity or person:

- Qualifies as an "excluded person".
- Files the relevant annual declaration and fee (US\$6,097.56) with CIMA before commencing securities investment business (and by 31 January each year thereafter).

An entity or person will qualify as an excluded person if it only carries on securities investment business with:

- Group companies (that is, other companies within the same group of companies).
- Sophisticated persons, meaning persons who:
 - are regulated by CIMA;
 - are regulated by a recognised overseas regulatory authority;
 - have securities listed on a recognised security exchange; or
 - have the knowledge and experience and are capable of evaluating the merits of a proposed transaction with a value of at least US\$100,000.
- High net worth persons, meaning individuals with a net worth of at least US\$1 million or any person with total assets of at least US\$5 million.
- Entities in which the investors are all sophisticated or high net worth persons.
- Persons regulated in relation to securities investment business by a recognised overseas regulatory authority.

Closed-ended retail funds

The position is the same as for open-ended retail funds (*see above, Open-ended retail funds*).

5. To whom can retail funds be marketed?

Open-ended retail funds

If incorporated as an exempted company, a fund's securities cannot be offered to the public in the Cayman Islands unless listed on the Cayman Islands Stock Exchange.

Any other type of Regulated Fund or an Unregulated MF can market its interests to the public in the Cayman Islands through a person appropriately licensed under the Securities Investment Business Law (SIB Law).

Overseas open-ended funds that do not register with the Cayman Islands Monetary Authority (CIMA) as a Regulated Fund, can only market their interests to the public in the Cayman Islands through a person appropriately licensed under the SIB Law, and provided that either:

- The interests are listed on a stock exchange approved by CIMA.
- The fund is regulated in a category and by an overseas regulator approved by CIMA.

However, for this purpose, "public in the Cayman Islands" does not include the following categories of person (meaning an overseas fund will not be restricted in marketing to them from outside the Cayman Islands):

- Sophisticated persons (as defined in the SIB Law) (*see Question 4*).
- High net worth persons (as defined in the SIB Law) (*see Question 4*).
- Entities in which all the investors are sophisticated or high net worth persons.
- Exempted or ordinary non-resident Cayman Islands companies, or any director or officer of the same acting in such capacity.
- Overseas companies registered as foreign companies in the Cayman Islands, or any director or officer of the same acting in such capacity.
- Any Cayman Islands exempted, ordinary non-resident or foreign company acting as general partner of a Cayman Islands exempted limited partnership, or any director or officer of the same acting in such capacity.
- The trustee of any Cayman Islands exempted trust.

Closed-ended retail funds

Closed-ended funds can market their interests to the public in the Cayman Islands through a person appropriately licensed under the SIB Law.

Overseas closed-ended funds can freely market their interests to the public in the Cayman Islands provided they do so from outside the Cayman Islands, and not from a place of business in the Cayman Islands.

Managers and operators

6. What are the key requirements that apply to managers or operators of retail funds?

Open-ended retail funds

The following key requirements apply to managers and operators of open-ended funds:

- A corporate Regulated Fund or the corporate general partner of a limited partnership Regulated Fund must have at least two directors.
- All the directors of a corporate Regulated Fund must be registered with the Cayman Islands Monetary Authority (CIMA) under the Directors Licensing Law.
- The trustee of a Licensed Fund must be licensed under the Banks and Trust Company Law (BTC Law).
- Investment managers incorporated or registered in the Cayman Islands must generally be regulated under the Securities Investment Business Law (SIB Law) (*see Question 4*).
- Any director, manager or officer of a fund regulated by CIMA must be a "fit and proper person", as determined by reference to this person's:

- honesty, integrity and reputation;
- competence and capability; and
- financial soundness.

Closed-ended retail funds

Investment managers of closed-ended funds, if incorporated or registered in the Cayman Islands, will generally be carrying on securities investment business and require regulation under the SIB Law, unless the fund does not invest in "securities" (as defined in the SIB Law).

Assets portfolio

7. Who holds the portfolio of assets? What regulations are in place for its protection?

Open-ended retail funds

Licensed Funds to which the Retail Japan Regulations apply must appoint a custodian in an approved jurisdiction.

Apart from this exception, there are currently no rules requiring the appointment of a custodian or broker to hold a fund's portfolio assets.

Closed-ended retail funds

There are no restrictions applicable to closed-ended funds.

Legal fund vehicles

8. What are the main legal vehicles used to set up a retail fund and what are the key advantages and disadvantages of using these structures?

Open-ended retail funds

Legal vehicles. Open-ended funds can be formed as:

- **Companies.** The exempted company limited by shares is the most commonly used vehicle for regulated open-ended funds (accounting for 79% of Regulated Funds, based on the Cayman Islands Monetary Authority's (CIMA's) statistical digest for 2012). Most of these are standard exempted companies, but about 16% of such companies are segregated portfolio companies (in which separate portfolios can be created with assets and liabilities that are legally ring-fenced).
- **Exempted companies and their shares** are widely understood and in addition to a body of Cayman Islands jurisprudence, the Cayman Islands courts can draw on a long tradition of relevant case law from England and the rest of the Commonwealth. A company has legal personality separate from its shareholders and can issue shares in different classes and series. A shareholder's liability for the company's debts is limited by statute to the amount unpaid on its shares (which in an investment fund will usually be issued fully paid).
- **Limited partnerships.** These are registered under the Exempted Limited Partnership Law 2014. Cayman Islands exempted limited partnerships are underpinned by English partnership law, but are modified by statute to make them more suitable for use as investment funds. For example, exempted limited partnerships, while not having separate legal personality, can sue and be sued in their own name.
- **Unit trusts.** These are governed by the Trusts Law (2011 Revision). Unit trusts are underpinned by English trust law, but are modified by statute to make them more suitable for use as investment funds. For example, STAR trusts (Special Trusts - Alternative Regime) are not subject to any perpetuity period and can have purposes as their objects.

Advantages/disadvantages. The key advantages and disadvantages of the different types of vehicle are:

- **Flexibility.** Companies are generally governed by more rigid rules than those applicable to limited partnerships and unit trusts (for example, in relation to provisions regarding maintenance of capital, the method of changing their constitutional documents and so on).
- **Legal personality.** Companies have separate legal personality, while limited partnerships must operate through their general partner, and unit trusts through their trustee.
- **Additional vehicles.** Exempted limited partnerships require at least one general partner that is established or registered in the Cayman Islands and unit trusts require a trustee, who will usually insert a controlled subsidiary for liability protection.
- **Regulatory requirements.** A Licensed Fund that is a unit trust requires a trustee licensed under the Banks and Trust Company Law (BTC Law).
- **Overseas requirements.** The choice of vehicle will often depend on whether it can qualify for specific tax or regulatory treatment in an overseas jurisdiction (for example, unit trusts are generally used for the Japanese market and limited partnerships for the Israeli market).

Closed-ended retail funds

The position is the same as for open-ended funds (*see above, Open-ended retail funds*).

Investment and borrowing restrictions

9. What are the investment and borrowing restrictions on retail funds?

Open-ended retail funds

There are no statutory investment or borrowing restrictions on open-ended funds.

Closed-ended retail funds

The position is the same as for open-ended funds (*see above, Open-ended retail funds*).

10. Can the manager or operator place any restrictions on the issue and redemption of interests in retail funds?

Open-ended retail funds

Open-ended funds can agree any restrictions on the issue and redemption of interests with their investors at the time they subscribe for such interests. The introduction of additional restrictions in respect of an investor's existing interests can only be achieved in accordance with the consent mechanisms contained in the fund's constitutional documents.

Closed-ended retail funds

The position for closed-ended retail funds is the same as for open-ended funds (*see above, Open-ended retail funds*).

11. Are there any restrictions on the rights of participants in retail funds to transfer or assign their interests to third parties?

Open-ended retail funds

There are no statutory restrictions on the ability of participants in open-ended funds to transfer or assign their interests to third

parties. However, the constitutional documents of such funds usually contain restrictions, except where the interests are listed on a stock exchange.

Closed-ended retail funds

The position for closed-ended retail funds is the same as for open-ended funds (see above, *Open-ended retail funds*).

Reporting requirements

12. What are the general periodic reporting requirements for retail funds?

Open-ended retail funds

If the fund is regulated by the Cayman Islands Monetary Authority (CIMA), it must file the following with CIMA within six months of the end of each financial year:

- Audited financial statements (audited by an approved local auditor).
- Fund Annual Return.

Closed-ended retail funds

Closed-ended funds have no statutory reporting requirements.

Tax treatment

13. What is the tax treatment for retail funds?

Open-ended retail funds

There is no Cayman Islands tax applicable to payments made to or from an open-ended fund.

Closed-ended retail funds

There is no Cayman Islands tax applicable to payments made to or from a closed-ended fund.

Quasi-retail funds

14. Is there a market for quasi-retail funds in your jurisdiction?

The author is not aware of any significant market for quasi-retail funds.

Reform

15. What proposals (if any) are there for the reform of retail fund regulation?

The author is not aware of any proposals to reform retail fund regulation.

HEDGE FUNDS

16. What is the structure of the hedge funds market? What have been the main trends over the last year?

The regulatory regime in the Mutual Funds Law (MF Law) distinguishes between open-ended funds (which are mostly hedge funds) and closed-ended funds (which are generally not hedge funds).

Open-ended hedge funds will either be regulated by the Cayman Islands Monetary Authority (CIMA) as Licensed Funds, Administered Funds or Registered Fund, or will be Unregulated

MFs and therefore not subject to regulation by CIMA (see *Question 7*).

As at 30 September 2014, the total number of Regulated Funds was 11,292 (down from 11,343 a year earlier). The vast majority of these (96%) are Registered Funds (10,789, down from 10,827 a year earlier). Approximately 85% (about 9,500) of these Regulated Funds require an investment of at least US\$100,000 (see *Question 7*).

These figures reveal the predominance of the non-retail, institutional market. To register as a Registered Fund (rather than obtain a licence as a Licensed Fund or register as an Administered Fund), a fund must satisfy one of the following criteria:

- Require a minimum initial investment of at least US\$100,000.
- Have its interests listed on an approved stock exchange.
- Be a "master fund" (see below) that satisfies one of the two conditions above.

Based on the figures above, Registered Funds listed on an approved stock exchange generally still require an investment of at least US\$100,000 and are therefore listed for reasons other than the ability to admit retail investors.

The slight decrease in the number of Regulated Funds, after two years of increasing numbers, which were entirely due to the new requirement to register master funds, reflects a mature and relatively stable market. If master funds are excluded from these figures for the first three quarters of 2014, the underlying number of Registered Funds decreased in the first quarter, rallied in the second quarter, before falling back again in the third quarter.

A master fund must register with CIMA under the MF Law if it is an open-ended Cayman Islands vehicle trading in investments that has one or more "regulated feeder funds" (that is, a fund that is itself a Regulated Fund, and conducts more than 51% of its investing through the master fund).

Master funds will generally qualify for registration as Registered Funds under section 4(3) of the MF Law and require the:

- Filing of a Form MF4.
- Payment of the annual fee (US\$3,048.78) and application fee (US\$365.85).

Importantly, master funds can no longer rely on the Unregulated MF exemption in section 4(4) of the MF Law (see *Question 7*).

Regulatory framework and bodies

17. What are the key statutes and regulations that govern hedge funds in your jurisdiction? Which regulatory bodies regulate hedge funds?

Open-ended hedge funds are regulated by the Mutual Funds Law (MF Law) (see *Question 16*).

18. How are hedge funds regulated (if at all) to ensure compliance with general international standards of good practice?

The offering document of a Regulated Fund must:

- Describe the equity interests being offered in all material respects.
- Contain the information necessary to enable a prospective investor to make an informed decision whether or not to subscribe for or purchase the interests (the Cayman Islands Monetary Authority (CIMA) prescribes some information that

must be included in the offering documents of Licensed Funds, and will generally expect to see such information in the offering documents of all Regulated Funds).

All Regulated Funds must have their financial statements audited annually by an approved local auditor. The audited statements must be submitted to CIMA, together with a Fund Annual Return, within six months of the fund's financial year end.

CIMA has issued guidance on corporate governance that is applicable to all Regulated Funds, and takes non-compliance into account when determining if the fund is being managed in a fit and proper manner. CIMA can impose significant sanctions on funds and their operators if it determines that a regulated fund is not being managed in a fit and proper manner or is otherwise in breach of the Mutual Funds Law (MF Law).

The Cayman Islands operates a strong anti-money laundering and anti-terrorist financing regime. The Cayman Islands government and CIMA actively engage with regulators in other jurisdictions to ensure compliance with international standards of good practice. All hedge funds are subject to the:

- Proceeds of Crime Law (2014 Revision).
- Misuse of Drugs Law (2014 Revision).
- Terrorism Law (2011 Revision).

In addition, all Regulated Funds must comply with the detailed anti-money laundering compliance regime contained in the:

- Money Laundering Regulations (2013 Revision).
- Guidance Notes on those regulations issued by CIMA.

Marketing

19. Who can market hedge funds?

The position is the same as for retail funds (see *Question 4*).

20. To whom can hedge funds be marketed?

The position is the same as for retail funds (see *Question 5*).

Investment restrictions

21. Are there any restrictions on local investors investing in a hedge fund?

The position is the same as for retail funds (see *Question 5*).

Assets portfolio

22. Who holds the portfolio of assets? What regulations are in place for its protection?

The position is the same as for retail funds (see *Question 7*).

Requirements

23. What are the key disclosure or filing requirements (if any) that must be completed by the hedge fund?

For the filing requirements to register with the Cayman Islands Monetary Authority (CIMA) as a regulated fund, see *Question 3*.

For the filing requirements for Regulated Funds that are master funds, see *Question 16*.

For annual account filings requirements applicable to Regulated Funds, see *Question 18*.

Regulated Funds must also comply with the following ongoing requirements:

- If the fund is offering its interests to investors on an ongoing basis and becomes aware that something in its offering document is materially affected by any change, it must file an updated offering document with CIMA within 21 days (which can take the form of a supplement).
- Any additional director of a corporate fund must be registered with CIMA before he can be appointed.
- Annual fees must be paid to CIMA by 15 January each year.

24. What are the key requirements that apply to managers or operators of hedge funds?

The position is the same as for retail funds (see *Question 6*).

Legal fund vehicles and structures

25. What are the main legal vehicles used to set up a hedge fund and what are the key advantages and disadvantages of using these structures?

These are the same as for retail funds (see *Question 8*).

Tax treatment

26. What is the tax treatment for hedge funds?

There is no Cayman Islands tax applicable to payments made to or from a Cayman Islands fund.

Restrictions

27. Can participants redeem their interest? Are there any restrictions on the right of participants to transfer their interests to third parties?

The position is the same as for retail funds (see *Questions 10 and 11*).

Reform

28. What (if any) proposals are there for the reform of hedge fund regulation?

The author is not aware of any proposals to reform hedge fund regulation.

ONLINE RESOURCES

Cayman Islands Monetary Authority (CIMA)

W www.cimoney.com.ky

Description. This is the CIMA website. It provides useful information and has a feature that allows users to search for regulated entities.

Practical Law Contributor profile



Jarrod Farley, Partner

Carey Olsen

T +1 345 749 2004

F +44 1481 739081

E jarrod.farley@careyolsen.com

W www.careyolsen.com

Professional qualifications. England and Wales, Solicitor, 2000 (non-practising); Cayman Islands, Attorney-at-law, 2004

Areas of practice. Corporate and commercial; investment funds and private equity; mergers and acquisitions.

Non-professional qualifications. BA in Ancient and Modern History, Oxford University

Recent transactions

- Advising a leading Canadian fund manager on the launch of a Can\$600 million alternative credit fund.
- Advising leading Israeli and Chinese fund managers on the establishment of a jointly-managed venture capital fund to invest in Israeli and Israeli-related companies operating in China.
- Advising on multiple open-ended and closed-ended fund launches for existing and new manager clients.
- Advising on a Series A Preference Share financing.
- Advising on the re-domiciling of an existing foreign exchange broking business.
- Advising a major UK bank on a secured financing of a closed-ended Cayman Islands fund complex.