Loeb Smith & Brady

Cayman Domiciled Hedge Funds.

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Overview of Cayman Islands law governing hedge funds – Q&A

1. **What are the key statutes and regulations that govern hedge funds in the Cayman Islands? Which regulatory bodies regulate hedge funds?**

The primary legislation regulating hedge funds in the Cayman Islands is the Mutual Funds Law (2013 Revision) (the "**Funds Law**") and accompanying regulations, including the Retail Mutual Funds (Japan) Regulations (2007 Revision, as amended) which generally apply to investment funds licensed under the Funds Law (licensed funds) where the securities are marketed to the public in Japan.

What is a "mutual fund"?

The Funds Law defines a "mutual fund" as follows (emphasis added):
"*a company, unit trust or partnership that issues equity interests, the purpose or effect of which is the pooling of investor funds with the aim of spreading investment risks and enabling investors in the mutual fund to receive profits or gains from the acquisition, holding, management or disposal of investments but does not include a person licensed under the Banks and Trust Companies Law (2009 Revision) or the Insurance Law (2008 Revision), or a person registered under the Building Societies Law (2010 Revision) or the Friendly Societies Law (1998 Revision)*".

Accordingly investment funds which are established for a sole investor and do not involve the pooling of investor funds fall outside the regulatory framework of the Funds Law. Nonetheless, a single investor hedge fund can apply for voluntary registration to, among other things, benefit from the status of being a fund registered with and regulated by Cayman Islands Monetary Authority (the "**Monetary Authority**").

Will the mutual fund issue "equity interests"?

As can be seen from the definition of "mutual fund" above, the Funds Law applies only to investment funds which issue "*equity interests*". Equity interests are defined in the Funds Law as:

"*a share, trust unit or partnership interest that-*

(a) carries an entitlement to participate in the profits or gains of the company, unit trust or partnership; and

(b) is redeemable or repurchasable at the option of the investor….. before the commencement of winding-up or the dissolution of the company, unit trust or partnership, but does not include debt,…"

Accordingly, private equity funds and other closed-ended funds (e.g. real estate funds) which do not give investors the right to redeem their shares, units or interests from the fund at the investor's option do not fall within the scope of the provisions of the Funds Law.

The law as set out herein therefore applies only in respect of investment funds of any asset class which satisfies the definition of "*equity interests*" above. For present purposes we will refer to these funds as "**Open-ended Funds**".

Registration

Open-ended Funds are, subject to the exemption noted below, required to be registered with the Monetary Authority.

Exemption from Registration

Open-ended Funds in which the "*equity interests*" are held by not more than fifteen (15) investors, a majority of whom are capable of appointing or removing the "operator" of the fund are not required to be registered with the Monetary Authority. In the case of an investment fund structured as a company, the operator would be the fund's Directors. In the case of an investment fund structured as a limited partnership, the operator would be the fund's general partner(s). In the case of an investment fund structured as a unit trust, the operator would be the fund's trustee(s).

As noted above, private equity funds and other closed-ended funds (e.g. real estate funds) which do not give investors the right to redeem their shares, units or interests from the fund at the investor's option do not issue "equity interests" for the purposes of the Funds Law and therefore would not fall into the registration regime in any event.

Ancillary legislation affecting Cayman Islands Open-ended Funds include the:

- Companies Law (2013 Revision) ("**Companies Law**").
- Exempted Limited Partnership Law, 2014 ("**ELP Law**").
- Partnership Law (2002 Revision) ("**Partnership Law**").
- Trusts Law (2009 Revision) ("**Trusts Law**").
- Banks and Trust Companies Law (2009 Revision) ("**BTC Law**").
- Securities Investment Business Law (2011 Revision) ("**SIB Law**").
- Proceeds of Crime Law 2008 ("**PCL**").
- Money Laundering Regulations (2010 Revision) ("**ML Regulations**"), enacted pursuant to powers under the PCL.

The PCL, ML Regulations and the guidance notes prepared and issued by the Monetary Authority on the prevention and detection of money laundering in the Cayman Islands to provide guidance to service providers in complying with their obligations under the ML Regulations (Guidance Notes) are together referred to as the AML Laws.

Regulatory bodies. The Investment and Securities Division of the Monetary Authority is responsible for the ongoing supervision of Open-ended Funds and fund administrators. The Funds Law is administered by the Monetary Authority.

The Financial Reporting Authority (FRA) is the Cayman Islands' Financial Intelligence Unit with responsibility for receiving, analysing and disseminating disclosures of financial information concerning the proceeds of criminal conduct, money laundering and the financing of terrorism pursuant to the provisions of the PCL.

Suspicious activity or transaction reports (that is, reports on financial transactions in which there are reasonable grounds to suspect the transactions are related to the proceeds of criminal conduct (as defined in the PCL) must be submitted to the FRA.

2. 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?

Open-ended hedge funds

Legal vehicles. A hedge fund can be established as one of the following:

- **A company** (usually an exempted company incorporated with limited liability), which offers shares.
- **A limited partnership** (usually an exempted limited partnership), which offers limited partnership interests.
- **A unit trust** (typically an exempted unit trust), which offers units of beneficial interest to investors.

The choice of the structure is often dictated by some or all of the following factors:

- Market practice.
- Tax.
- The regulatory requirements of the investors in the fund.
- The investors' or investment manager's familiarity or preference of one structure over another.

The vehicle that is normally used to establish a fund in corporate form is the exempted company (including the exempted limited duration company and the segregated portfolio company), which is incorporated under the Companies Law.

The constitution of an exempted company is contained in both its:

- Memorandum of Association, which sets out the company's powers and objectives.

- Articles of Association, which regulates the administration of the company, including its shareholders' rights and its directors' powers and duties.

The share capital of an exempted company incorporated with limited liability can be denominated in any one or more currencies and fractional shares can be issued. The share capital can also be issued:

- In classes, or different series of the same class or classes.
- With different rights.
- To allow participation in the same or a separate portfolio of underlying assets.

Therefore, an exempted company structure is particularly appropriate for umbrella funds or multi-class funds. Shares are normally issued with a low par or nominal value (typically 1%) and at a high premium (that is, the amount by which the issue price exceeds the par value), to provide maximum flexibility on redemption. Monies paid in as share premium are available, under the Companies Law, for distribution by way of dividend or to satisfy any premium on redemption. In addition, subject to satisfying a solvency requirement, shares may be redeemed from capital.

An exempted limited partnership is registered under the ELP Law. There must be at least one:

- General partner who is liable for all debts and obligations of the partnership.
- Limited partner who, subject to certain exceptions, is liable for the debts and obligations of the partnership only to the extent provided in the partnership agreement.

In addition, at least one general partner must be one of the following:

- An individual, resident in the Cayman Islands.
- A company incorporated under the Companies Law or registered as a foreign company under the Companies Law.
- An exempted limited partnership.
- A foreign limited partnership registered as a foreign limited partnership under the ELP Law.

The partners' rights and duties in relation to one another are regulated by the ELP Law and the partnership agreement, which gives increased flexibility for fund managers and investors (in particular, seed investors or large institutional investors) to negotiate and tailor the partnership agreement as they see fit. Limited partnership interests offered to investors represent undivided interests in the partnership property. Limited partnership interests may, subject to satisfying a solvency requirement, be redeemed in accordance with the provisions of the partnership agreement.

The unit trust is established by declaration of trust and a trust deed (together, the Trust Deed), under which a trustee issues units of beneficial interest. The trustee holds legal title to the underlying assets on trust (for the benefit of unitholders) and each unit represents an undivided fractional interest in the trust property. The trust is subject to the provisions of the Trusts Law and case law. The Trust Deed sets out all powers and duties of the trustee and beneficiaries' rights, including provisions regarding the transfer and redemption of units. All dealings with the trust property are effected by the trustee or by its delegate.

Advantages. Of the three structures, only the company benefits from separate legal personality distinct from its investors and administrators. Additionally, investors' liabilities are limited to the amount unpaid on their shares, if any. The unit trust and limited partnership structures arguably offer more flexibility than the exempted company structure.

Disadvantages. The exempted company structure is subject to company law requirements (for example, capital maintenance restrictions) under the Companies Law and is arguably not as flexible as the limited partnership structure or the unit trust structure. Neither the limited partnership structure nor the unit trust structure has the benefit of separate corporate personality.

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

The following procedures apply to hedge fund registration (*MFL*):

- If the minimum aggregate equity interest purchasable by a prospective investor is at least US$100,000 (or its equivalent in another currency) or the equity interests are listed on a recognised stock exchange, including the Cayman Islands Stock Exchange, then the registration application requires filing of the following documents with the Monetary Authority:
    - a certified copy of the Certificate of Incorporation or Certificate of Registration (as applicable and depending on whether the fund is a company, limited partnership or trust);
    - Form MF1 (this form includes certain prescribed details of the fund, such as the identity of the operators and service providers and the key terms regarding subscriptions and redemptions);
    - a current offering document (for example, a private placement memorandum);
    - a consent letter from the fund's administrator and a consent letter from the Cayman Islands auditor, approved by the Monetary Authority;
    - a registration fee, which is currently US$4,269 (approximately).
- If a licensed investment fund's administrator provides the fund's principal office in the Cayman Islands (this may apply in the case of an investment fund that agrees to accept minimum initial investments below the US$100,000 threshold) then the registration is applied for by filing the following documents with the Monetary Authority:
    - Forms MF2 and MF2A, completed by the administrator and the investment fund (including similar particulars to the Form MF1) (*see above*);
    - the same documents (except the Form MF1) and registration fee as above.

These are filing registration requirements. The Monetary Authority will not perform a substantive review of the filing. Generally, the hedge fund can accept subscription monies once the filing is made.

A fund's offering document must (*section 4(6) MFL*):

- Describe the equity interests in all material respects.
- Contain such other information as is necessary to enable a prospective investor in the fund to make an informed decision about whether to subscribe for or purchase the equity interests.

The requirement to outline the risks involved in investing in the fund in the offering document is implicit in section 4(6) of the MFL. The fund is required under the MFL to file its current offering document with the Monetary Authority within 21 days of becoming aware of any change that materially affects any information in the offering document filed with the Monetary Authority or in the prescribed details of the offering document filed with the Monetary Authority.

Other than the section 4(6) MFL requirement set out above, there are currently no Cayman Islands specific disclosure or filing requirements for side letters. However, the offering documents typically disclose that the fund can enter into side letter arrangements with certain investors.

This Briefing Note is not intended to be a substitute for specific legal advice or a legal opinion. It deals in broad terms only and is intended to merely provide a brief overview and general guidance only. For more specific advice on the Cayman Islands companies, please refer to your usual Loeb Smith & Brady contact or:

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