



Regulation of Investment Funds in the Cayman Islands

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Preface

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:-

- which issues shares, trust units or partnership interests respectively;
- that carry an entitlement to participate in the profits or gains of the issuer and are redeemable or repurchasable at the option of the investor before the commencement of winding up or dissolution of the issuer; and
- 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 repurchasable 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 sub-sections 4(4)(a) and 4(4)(b) (“Exempted Funds”), administered under sub-section 4(1)(b) (“Administered Funds”), registered under sub-section 4(3) (“Registered Funds”), or licensed under sub-section 4(1)(a) of the Law (“Licensed Funds”).

EXEMPTED FUNDS

The Law permits two categories 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. First, under section 4(4)(a) of the Law 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.

Second, under section 4(4)(b) of the Law a foreign (non-Cayman) domiciled mutual fund would be exempt from registering with the Monetary Authority as long as it is not offering its shares to members of the public in the Cayman Islands (which does not include Cayman Islands exempted or ordinary non-resident companies).

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:'

- the fund's current offering document or the latest draft;
- 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 fulfill his obligations pursuant to section 34 of the Law (the "section 34 statement");
- 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;
- 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
- 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. There are now over 150 mutual fund administrators licensed under the Law and these include branches or affiliates of most, if not all, of the leading fund administrators worldwide, such as UBS Fund Services (Cayman) Ltd.; BISYS Hedge Fund Services (Cayman) Limited; Goldman Sachs (Cayman) Trust, Limited; Cayman National Trust Company Ltd.; Butterfield Fund Services (Cayman) Limited; CIBC Bank and Trust Company (Cayman) Limited; CITCO Fund Services (Cayman Islands) Limited; and Fortis Prime Fund Solutions (Cayman) Limited. Most of the larger administrators are members of the Cayman Fund Administrators Association, which has developed its own code of conduct for its members in consultation with the Monetary Authority. This depth and strength in the fund administration industry is founded on the enormous success of Cayman's banking industry - the Cayman Islands is the world's fifth largest banking centre (after London, New York, Tokyo and Hong Kong) with nearly 400 bank and trust licensees, including 45 of the world's top 50 banks, with dollar deposits in excess of US \$1.2 trillion.

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:

- a US licensed exchange; or
- an EU licensed exchange; or
- a Canadian licensed exchange; or
- a full member of the World Federation of Exchanges that is located in a Schedule 3 country; or
- 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:-

- 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;

- 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;
- 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
- 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 4(1)(a) 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:-

- a copy of the current offering document or latest draft;
- a copy of the most recent annual audited accounts (if the applicant is an existing fund);

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- 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;
- 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;
- 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;
- 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
- 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:-

- 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
- (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 docu-

ment (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 was amended in 2006 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).

Accordingly, each Regulated Fund is 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.

REGULATORY POWERS

The Monetary Authority may at any time instruct a Regulated Fund to have its accounts audited and submitted to the Monetary Authority. The Monetary Authority may also request such information or explanation in respect of any Regulated Fund as it may reasonably require to enable it to carry out its duties under the Law.

If requested to do so, each promoter, director, trustee or general partner of a Regulated Fund is required to give the Monetary Authority access to or provide at any reasonable time all records relating to the fund and the Monetary Authority may copy or take an extract of any record to which it is given access.

If it is satisfied that (a) a Regulated Fund is or is likely to become insolvent; (b) a Regulated Fund is carrying on or attempting to carry on business or is voluntarily winding up its business in any manner that is prejudicial to its investors or creditors; (c) a Regulated Fund in the case of a Licensed Fund, is carrying on or attempting to carry on business without complying with any conditions of its Mutual Fund License contrary to section 5(5) of the Law; (d) the direction and management of a Regulated Fund has not

been conducted in a fit and proper manner or (e) a person holding a position as a director, manager or officer of a Regulated Fund is not a fit and proper person to hold the respective position, the Monetary Authority may, *inter alia*:

- cancel any mutual fund license, or any registration under section 4(1)(b) or 4(3), in force in respect of the mutual fund;
- revoke or impose conditions on any mutual fund license;
- require the substitution of any promoter, director, trustee or general partner of a fund;
- appoint a person at the expense of the fund to advise the fund on the proper conduct of its affairs or to assume control of and administer its affairs (including the power to terminate its business); and
- require the fund to reorganize its affairs, or apply to the court for its compulsory liquidation.

The Monetary Authority also has power to apply to the Grand Court of the Cayman Islands for such orders as it thinks fit to preserve the assets of the investors of any fund which may be carrying on or attempting to carry on business in or from the Cayman Islands without being either Licensed, Administered, Registered or Exempted including an order for the winding up of any such fund.

The Monetary Authority may also apply for a warrant to search any premises where it reasonably believes that an offence has been, is being or is about to be committed, or where records to which it ought to have been given access are to be found and may take from such premises the original or copies of any record which may indicate that an offence has been committed.

The Monetary Authority is prohibited from disclosing any information relating to the affairs of any fund except where disclosure is required for effective regulation of the fund or when required by law or the Courts of the Cayman Islands.

Following legislative amendments which took effect in November 2006, the powers of the Monetary Authority set forth in the Law have been slightly expanded. Specifically, the Monetary Authority:

- is authorized to maintain a general review of mutual fund business in the Cayman Islands, and to submit an annual report to the Governor;
- is responsible for supervision and enforcement in respect of persons to whom the Law applies, and for the investigation of persons where the Monetary Authority reasonably believes that they are or have been in breach of sections 4(2), 7, 10 or 19 of the Law;

- may exercise its discretion to examine, by way of scrutiny of prescribed regular returns, on-site inspections or auditors' reports, the affairs or business of any Regulated Fund for the purpose of a general review under the Law or for the purpose of satisfying itself that the provisions of the Law (including statutory regulations) or the Proceeds of Criminal Conduct Law (Revised) are being complied with;
- may disqualify any person from being an auditor of a regulated mutual fund or a licensed mutual fund administrator if it is determined that such person has failed to comply with certain statutory obligations set forth in section 34 of the Law; and
- may authorise any other person to assist it in the exercise and performance of its powers and functions under the Law.

REGULATION OF MUTUAL FUND ADMINISTRATORS

Prior to the introduction of the Mutual Funds Law in 1993, service providers to mutual funds were generally licensed under either the Banks and Trust Companies Law or the Companies Management Law. However, the Mutual Funds Law (Revised) (the "Law"), provides *inter alia* that a company formed in the Cayman Islands is prohibited from acting or carrying on the business of mutual fund administration in or from the Cayman Islands unless it is authorized to do so by a mutual fund administrator's license or otherwise exempted by the Monetary Authority in accordance with the Law. Mutual fund administration is defined as the management (including control of all or substantially all of the assets of a mutual fund), or the administration of a mutual fund (including funds incorporated abroad and registered as foreign companies pursuant to Part IX of the Companies Law (Revised) - see section 2 below), or the provision of a principal office to that mutual fund in the Cayman Islands. The provision of a registered office at which statutory and legal records are kept or company secretarial work is undertaken and the maintenance of any register of equity interests or the filing and payment of fees in relation to a mutual fund are excluded from the definition of mutual fund administration, as are the activities of the general partner of a partnership which is a mutual fund.

There are two types of mutual fund administrator's license:- the unrestricted mutual fund administrator's license and the restricted mutual fund administrator's license. An applicant for a license in either category must meet the following statutory tests: (a) that he has sufficient expertise to administer regulated mutual funds, and (b) that his business as a mutual fund administrator will be administered by persons who are fit and proper persons to be directors or, as the case may be, managers or officers in their respective positions. An applicant for an unre-

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stricted license is required to have a net worth of at least US\$488,000. There is no statutory net worth requirement for an applicant for a restricted license but, in practice, the Cayman Islands Monetary Authority will not entertain an application for such a license unless the applicant has a net worth of at least US\$50,000. In cases where the administered fund is a foreign company (i.e., not incorporated or established in the Cayman Islands), the Monetary Authority will require that such fund be incorporated or established in an approved jurisdiction.

An applicant for an unrestricted license must itself have a principal office in the Cayman Islands with two individuals or a body corporate resident or incorporated in the Cayman Islands to act as its agent. An unrestricted licensee may act for an unlimited number of Regulated Funds.

A restricted licensee may act in relation to up to ten Regulated Funds, each of which must be specified in the license, but is required only to have a registered office in the Cayman Islands. A restricted mutual fund administrator's license permits the promoter which incorporates a fund manager in the Cayman Islands to manage a related family of funds and, in those exceptional cases in which the approval of the Cayman Islands Monetary Authority is granted, unrelated funds may also be managed by a restricted licensee. Since 2004, there has been an increasing number of restricted licensees (who are engaged in the management of Regulated Funds), applying to terminate their respective license with the Monetary Authority, so that they can pursue the potentially cheaper alternative of being regulated under the Securities Investment Business Law (Revised) of the Cayman Islands.

By way of background, no company incorporated in the Cayman Islands may carry on or purport to carry on securities investment business unless that company holds a license granted under the Securities Investment Business Law (Revised) (the "SIB Law") or is exempt from holding a license. Typically, former holders of restricted mutual fund administrator's licenses, and investment managers of Regulated Funds will try to fall within an available exemption from the SIB Law. In this case, if the Regulated Fund is to be the applicant's only client, an exemption will be available. Notwithstanding, the applicant will need to file with the Monetary Authority, before beginning its SIB-regulated activities, and in January of each year, file a Declaration of Exemption and pay an annual fee (currently US\$1,220).

The application fee for a restricted mutual fund administrator's license is CI \$7,000.00 (approximately US \$8,536.00), and the application fee for an unrestricted mutual fund administrator's license ranges between CI\$20,000.00 to CI\$25,000.00 (approximately US\$24,400.00 to US\$30,488.00). The annual fees payable

in respect of restricted and unrestricted mutual fund administrator's licenses are in like amounts, respectively.

These license fees do not include the fees payable to the Government under the Companies Law.

The costs of incorporating an exempted Cayman Islands company (with standard memorandum and articles) are as follows:

Initial (One-Time) Registration Fees to Government:-

- Authorized share capital not exceeding US \$50,000

US\$574.00
- Authorized share capital exceeding US \$50,000 but not exceeding US \$1,000,000

US\$805.00
- Authorized share capital exceeding US \$1,000,000 but not exceeding US \$2,000,000

US\$1,688.00
- Authorized share capital exceeding US \$2,000,000

US\$2,400.00

The annual government fee is the same as indicated above.

Other costs include legal fees for incorporation of a Cayman Islands exempted company, first and subsequent annual registered office fees, first and subsequent annual secretarial fees (optional) and disbursement costs.

Apart from net worth requirements and fees, the main difference between an unrestricted mutual fund administrator's license and a restricted mutual fund administrator's license is that, by accepting an appointment to provide the principal office of a mutual fund in the Cayman Islands, an unrestricted licensee assists that mutual fund to obtain the requisite regulatory approval to carry on business in or from the Cayman Islands.

Since a restricted licensee is not itself required to maintain a principal office in the Cayman Islands, such licensees generally do not have a substantial physical presence in the Cayman Islands although they must maintain a registered office here. Except in those rare instances in which a restricted licensee has established a sufficient physical presence to enable it to provide the principal office of a mutual fund in the Cayman Islands, the Cayman Islands Monetary Authority does not treat the appointment of a restricted licensee as the administrator of a mutual fund as a sufficient basis on which to grant regulatory approval for that fund to carry on business in or from the Cayman Islands. As a result (subject to the rare "physical presence" exception) every mutual fund for which a restricted licensee provides administration (and which is either established under Cayman Islands law or carrying on business from the Cayman Islands) must be administered by an unrestricted licensee under sub-section 4(1)(b), registered under sub-section 4(3), exempted under sub-sections 4(4)(a) and 4(4)(b) or licensed under sub-section 4(1)(a) of the Law.

A licensee of either category has a statutory duty to provide administration services only to acceptable mutual funds and to notify the Cayman Islands Monetary Authority immediately if it should become aware, or have reason to believe, that a fund of which it provides the principal office (or a promoter, trustee, general partner or director of such a 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.

If you wish to receive further information on establishing a new investment vehicle, or restructuring an existing Cayman Islands fund, please e-mail cayman@higgsjohnson.com.