HEDGE FUNDS – a Cayman Islands success story

INTRODUCTION

The Cayman Islands have become the leading offshore jurisdiction in the funds industry and are currently home to more than 6,500 registered open-ended funds and many unregulated closed-ended or exempted funds. The majority of such registered funds are hedge funds intended for experienced investors and it has recently been reported that an estimated 80 per cent of the world's hedge funds are registered in the Cayman Islands. This article briefly highlights some of the reasons for this success.

WHAT ARE HEDGE FUNDS?

The term "hedge fund" was originally coined to describe a type of collective investment vehicle that employed sophisticated hedging techniques to trade in the corporate equity markets. Over time the activities of hedge funds have expanded so that today the term refers generally to investment funds that follow one or more alternative investment strategies and utilise return enhancing tools such as leverage and arbitrage.

Hedge funds are typically intended for sophisticated institutional and high-net-worth investors who are not only capable of understanding the risks and rewards associated with alternative investment strategies involving complex derivative instruments but are able to withstand any adverse financial consequences.

WHY THE CAYMAN ISLANDS?

Hedge funds are constantly evolving and investment managers favour jurisdictions with a regulatory environment that is consistent with the desire to develop and market innovative investment strategies to sophisticated investors within the framework of a sound and reputable legal system. Key features that have made the Cayman Islands attractive to hedge fund managers include:

- A regulatory regime that focuses on full and transparent disclosure in the offering document of all information necessary to enable a prospective investor to make an informed decision as to whether or not to invest in the fund and on an annual audit of the financial statements by an independent auditor approved by the Cayman Islands Monetary Authority ("CIMA").

- No regulatory restriction on investment policies or strategies, commercial terms (including performance and other fee arrangements) or the choice of service providers (including managers, administrators, custodians and brokers).

- No requirement to appoint local directors or service providers (except for an approved auditor and, in the case of funds for which the minimum investment is less than US$50,000, an administrator to provide the principal office).

- Speed of formation together with an efficient and simple registration system with CIMA.

- Tax neutral environment with no direct corporation, capital gains, income, profits or withholding taxes applicable to funds

- Availability of experienced professional service providers including administrators, trust companies, accountants and lawyers.

- A recognised and respected legal system derived from English common law as supplemented by modern local legislation together with a well developed court system and experienced judiciary.

REGULATORY REGIME

Open-ended funds where equity interests (i.e. shares, units or limited partnership interests, as the case may be) are redeemable at the option of the investor are generally registered with and regulated by CIMA in accordance with the provisions of the Mutual Funds Law (as amended). There are three forms of registration under the Mutual Funds Law of which the one most commonly used for hedge funds is a Section 4(3) registration applicable where the minimum investment per investor is not less than US$50,000 or where the equity interests are listed on a recognised stock exchange, including the Cayman Islands Stock Exchange.

Closed-ended vehicles where investors are locked in until the fund is liquidated are not subject to regulation under the Mutual Funds Law and open-ended funds with fifteen or less investors are exempted from registration (provided the majority of investors have power to remove the operator of the fund).

HEDGE FUND STRUCTURES

Funds may be established in the Cayman Islands as companies, trusts or partnerships with the chosen form generally being dictated by the tax requirements of investors. The relevant laws and regulations of the Cayman Islands are designed to provide flexibility in the creation of investment vehicles and, as a result, the constitutional documents of a fund can normally be drafted to accommodate the requirements of a particular fund. Common structures include:

- Single class “vanilla” funds which are generally set up with a single class of shares giving investors the opportunity to participate in a single investment portfolio.

- Multi-class funds (sometimes referred to as umbrella funds) which issue equity interests in classes to enable investors to participate in a separate investment portfolios. The objective is normally to achieve cost efficiency but, since the portfolios are only segregated for accounting purposes, a conventional company is subject to the inherent risk of cross class liability. To deal with this issue multi-class funds are now commonly established as segregated portfolio companies under which the assets attributable to a particular portfolio are segregated by statute and not available to the creditors attributable to any other portfolio.

- Master-feeder funds which are structured to enable subscriptions made in separate feeder vehicles to be pooled into and managed as a single master fund portfolio. A typical example would involve US domiciled taxable investors investing directly in an onshore vehicle (often a limited partnership) and US tax exempt or offshore investors investing in an offshore vehicle (normally a company). Each “feeder” fund then invests all its assets in an offshore “master” fund. The objective is to enable investors that are subject to differing tax or other regulations to participate together in the same investment portfolio.

SIDE LETTERS

Attracting significant subscriptions from institutional investors is increasingly critical to the success of a fund, particularly in the early stages, and finding a stable, reputable jurisdiction such as the Cayman Islands is a key a factor in any investment decision. Such investors also are aware of their strategic and economic importance to investment managers and are often in a position to negotiate terms that may not be available to other investors, including reduced management fees, improved liquidity and access to information in relation to underlying investments. Some such terms, such as the rebate of fees, can be dealt with through side letters between the investor and the investment manager. However, side letters are not always appropriate and the constitutional documents of a fund should be carefully drafted to allow the operator discretion to agree arrangements with key investors without prejudicing the interests of other investors.

CONCLUSION

Finding the right balance between commercial flexibility and appropriate regulation is a challenge; the success of the Cayman Islands in attracting hedge funds demonstrates that the right balance has been found.

This article is intended to provide a limited overview of the subject matter and is not a substitute for proper legal advice in relation to a particular transaction or proposal.

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