



# Opalesque Round Table Series '10

# CAYMAN ISLANDS

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Opalesque 2010 Roundtable Series Sponsor:



# Editors' Note

Dear Reader,

There have been speculations in the international mainstream press like Cayman is going to fail because the EU is going to rise. The members of this Opalesque Cayman Roundtable do not see things that way: **Europe's success does not have to mean Cayman's failure**, as the products and regulations are seen as complimentary by the members of the Opalesque 2010 Cayman Roundtable.

In fact, a minimal number of funds have left Cayman for an European jurisdiction. As of September, only four funds move to Luxembourg and two to Malta, while Cayman continues to be the leading hedge fund jurisdiction and expects to register 1,200 new open-ended funds in 2010. This is the same figure as in 2009, bringing the total the number of Cayman hedge funds back to the pre-crash level of 9,589. Cayman Islands hedge funds are still the global benchmark and premium hedge fund products – if fund managers explore or set up European offerings, it is usually complimentary to their existing fund offerings rather than as a substitute for Cayman Islands funds.

Leading law firm Maples and Calder has shared the following statistics on Cayman hedge funds:

- **The vast majority of funds formed in 2010 have at least one independent director and over 60% have two independent directors**
- **80% have independent fund administrators**
- **About 25% have more than one prime broker at launch**
- **Downward fee trend: Less than half of funds still charge 2% management, but over three-quarters are in the range of 1% to 2%**
- **Incentive fees remain predominantly at 20%**
- **Very few funds have incentive fee clawback mechanisms**
- **About 50% of funds still have a fund level gate and only about 15% have an investor level gate**
- **About 25% of funds have a soft lock and about 15% a hard lock.**

## **OECD further strengthens Cayman's recognition**

Meanwhile, in a qualitative review following the initial quantitative review, the OECD recently recognized Cayman Islands' legal and regulatory regime complies with international standards for transparency and exchange of tax information. Cayman achieved this "white list" status fairly early on and now has 20 signed tax information exchange agreements and is awaiting signature on a further six agreements and currently negotiates with four more OECD member states. This recognition by the OECD adds to earlier recognition of Cayman's adherence to international standards by the International Monetary Fund (IMF), International Organization of Securities Commission (IOSCO) and the Caribbean Financial Action Task Force (CFATF).

The Roundtable was sponsored by Maples and Calder and Maples Finance and took place on Sept. 28th 2010 at their local Georgetown office with:

- Jon Fowler, [Head of Investment Funds Group, Maples and Calder Cayman](#)
- Karen Watson, [Senior Vice President, Maples Fund Services](#)
- Norm McGregor, [Partner, Deloitte](#)
- Don Seymour, [Managing Director, dms Management](#)

This Roundtable further includes details on:

- Historical review: How did Cayman manage to become the dominating offshore hedge fund jurisdiction?
- How important are the recent developments of jurisprudence in Cayman? Can international investors have confidence using the Cayman Island structure knowing that if something does go wrong, they can rely on a very robust court system here that will readdress the grievances?
- What should hedge fund managers and investors know about ASC 740 or FIN 48? Would the fund changing from US GAAP to IFRS help? Should, or can, the fund attempt to restate NAV's and/or adjust subscriptions/redemptions? Is there potential for clawback of redemption proceeds under Cayman Islands law once an investor has redeemed out? Does the fund pass the entire liability on to current investors?
- FATCA, the Foreign Account Tax Compliance Act, will be a massive undertaking from an operational standpoint for many stakeholders in the hedge fund industry due to the requirement to gather information on the ultimate investors. How can the industry prepare for FACTA?

Enjoy the read!

Matthias Knab  
Director Opalesque Ltd.  
Knab@opalesque.com



# Participant Profiles



(LEFT TO RIGHT)

Jon Fowler, Norm McGregor, Don Seymour, Karen Watson and Matthias Knab

# Introduction

**Don Seymour**  
dms Management

My name is Don Seymour, I am a Managing Director of dms Management. We are the largest company management firm in the Cayman Islands focused on providing fund governance services to hedge funds, primarily through our principals serving as independent Directors to the funds. We have offices in the Cayman Islands, Hong Kong, Ireland, and Brazil. The firm was established in 2000 and, today comprises 12 Directors and about 50 professional staff.

**Norm McGregor**  
Deloitte

My name is Norm McGregor and I am a Partner with Deloitte in the Cayman Islands. Our firm was established in 1973 and is comprised of 10 partners and approximately 170 staff providing audit, tax, financial advisory and consulting services primarily to the hedge fund industry. As part of the global Deloitte network, we work on a daily basis with our offices in Dublin, London, and New York which allows us draw on one another to proactively address industry issues.

**Karen Watson**  
Maples Fund Services

I am Karen Watson and serve as Senior Vice President with Maples Fund Services. We provide fund administration services and I head the fund admin team here in Cayman as well as our global Data Management and Client On-boarding teams, which service our six worldwide offices. We have offices in the Cayman Islands, Montreal, Dublin, Hong Kong, Dubai and Luxembourg. MaplesFS has approximately 170 staff globally providing fund administration services as well directorships and corporate services.

**Jon Fowler**  
Maples and Calder

My name is Jon Fowler and I am the head of the investment funds group of Maples and Calder in the Cayman Islands. Our global investment funds team of over 30 partners and 60 associates advise on approximately 40% of all funds registered in the Cayman Islands. This gives us not only an in depth knowledge of this jurisdiction, but, as Cayman is the leading domicile for investment funds, we also have a bird's eye view of the funds industry as a whole. Worldwide, we have approximately 200 lawyers advising on the laws of the Cayman Islands, Ireland and the British Virgin Islands from our offices based in those jurisdictions as well as in offices in London, Dubai, and Hong Kong. As Karen mentioned, our affiliate MaplesFS is a leading fund administration and fiduciary business.



# MAPLES

## Leading the way with Investment Funds...

Maples and Calder provides legal advice on the world's most sophisticated investment fund structures. And MaplesFS provides those investment funds with directors, fund administration, accounting and related services.

Our clients range from the largest institutional investment managers to boutique fund advisers, as well as many of the world's largest investment and commercial banks.

If you need advice from the best international legal team on the laws of the Cayman Islands, Ireland or the British Virgin Islands, please contact us.

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My last visit to the Cayman Islands was in April 2009. Coincidentally, it was that week when the European Commission published the first draft of its Alternative Investment Management Directive, which since then has stirred up things in the global hedge fund industry. Can you give us an update what has happened in Cayman since then?

Jon Fowler

Cayman continues to be the leading hedge fund jurisdiction. We are currently on course to register approximately 1,200 new open-ended funds during 2010. This is approximately the same number of funds as in 2009, so the number of overall fund formations is steady despite the global downturn. The total number of hedge funds in the jurisdiction at end of August stands at 9,589, which is roughly where we were pre-crash: workflows and fund numbers have held up very well.

On exempted limited partnerships, which are the customary vehicles used for private equity funds, Cayman is currently averaging 125 partnerships per month. 170 partnerships were registered in June 2010 alone. This means that for private equity funds we are seeing a solid up-tick, as immediately post-crisis this number was in the region of 75 partnerships registered per month.



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When the first draft of the EU AIFM Directive came out back in April 2009, a number of clients had questions as to how this was going to affect them, and what was this going to mean for the Cayman Islands. A lot of people thought the Directive would come into effect far more quickly, so many of us were raising the Directive with clients who are U.S. based managers, including those in New York, Boston, Chicago. Despite an initial flurry of questions, during 2009 the Directive and its possible effects were not solidly on the radar for US managers. It's worth remembering that at the time there was a lot going on within the U.S., with new U.S. regulation knocking at the door and most managers focused on keeping their funds and their business afloat during the post-crash environment. It was only in early 2010 that the U.S. hedge fund industry really started to focus on the Directive and its potential impact. Fast forward to 1.5 years from the first draft of the Directive; we are in Q4 2010 and still waiting for an agreed text.

There have been several drafts of the Directive: we have the original draft from the European Commission, followed by the compromise Parliament Draft and the Council Draft in May 2010. The latest is now the Belgian Presidency Draft from September 2010, which is intended as a compromise between the Parliament Draft and the Council Draft, which take very different approaches. In terms of the approach to third country managers and funds, the Parliament Draft contains rigorous but potentially unworkable proposals, whereas the Council Draft is more pragmatic in terms of the way it addresses the issues involved. The Belgian proposal includes 40 pages of very detailed third-country provisions by way of compromise.



At the moment, I would say that our clients are in a holding pattern on the Directive, continuing to wait and see what type of EU environment the final version will bring. At the moment, people are not changing the procedure or the basis on which they set up their funds. They are doing what they have always done. They are setting up hedge funds in the Cayman Islands, and in certain cases are using our Irish office to set up a complementary offering to access the European market via a UCITS product, a PIF or QIF. Despite reports to the contrary, no-one is looking to transfer everything out of Cayman into an onshore jurisdiction, or to structure in anticipation of what may be happening with the Directive; it's simply too uncertain where we will end up.

**The EU AIFM Directive itself includes significant detail on many aspects of how managers subject to it, and their funds, will operate. There is also significant scope for the EU Commission to add complexity through delegated legislation. There are a number of wrinkles to iron out and AIMA has been very active in pointing those out. We are talking about a raft of detail in the Directive that will need to be worked through for those third country managers and funds that plan to access EU investors in accordance with the Directive. There is a definite mismatch between the way the Directive is written and the way fund structures are typically set up.**



**I am confident that Cayman Islands hedge funds will be able to meet all currently proposed criteria for third country funds, even in the Parliament Draft, with relative ease; given the Cayman Islands' existing levels of international co-operation and compliance, issues of tax information exchange agreements, regulator exchange of information, cooperation agreements, MoUs, and reciprocal access to markets are not anticipated to present a problem.**

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Although there is uncertainty in relation to the outcome of the Directive, it is worth bearing in mind that both the new Belgian Presidency Draft and the previous Council Draft envisage continuations of the existing private placement regimes within the E.U.. Given that approach, it does not make sense for managers to significantly change what they have been doing for the past ten or fifteen years. Whether the passport provisions for third country managers and funds in the Directive will be attractive to clients as an alternative to existing country-by-country private placement regimes remains to be seen. All depends on the final text and how it is implemented in practice.

Another important point is that the Council Draft and the Belgian Presidency Draft permit passive marketing whereas the Parliament Draft does not. Passive marketing is when the manager does not market to the investors; rather the investors approach the manager to invest. European investors could, therefore, approach best of breed non-EU hedge funds managed outside of the EU and invest in them without making the manager subject to the AIFM Directive.

The Parliament position on the Directive seems deeply entrenched. Hopefully, the Belgian Presidency Draft will actually break the impasse and we will end up in a situation where we have something that works well for the industry while providing the desired regulatory framework for the EU and G20.

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That said, it would be good to see a workable compromise reached which then can be rolled out across the industry and put an end to the current uncertainty for managers with, or contemplating, EU investors.

[Note: since the date of the Roundtable discussion agreement in principle on the directive has been reached. A formal vote on the text is planned for 11 November 2010.]

#### **Karen Watson**

As fund administrators we are not seeing a lot of impact from the discussion around the European directive. Some clients have started European funds, but really all of them say they are staying with the status quo at the moment and do not change any legal base or set up of their hedge fund.

From the fund admin perspective, we are studying what could be some of the operational implications, which are mostly related to reporting capabilities: how we can assist providing the information that will need to be provided through the regulatory channels, what information will be required and how we can assist the funds gathering that information and help them to meet those requirements. But again, at this point in time there is just not enough information available.

#### **Matthias Knab**

**Before we continue, let us quickly step back and explain to our readers how did Cayman arrive to where it is now, being the global hub for hedge funds?**

#### **Don Seymour**

Since the late 1960s, Cayman has been developing as a financial center, mostly around the banking industry. The industry here started after a change in attitude from the Bahamian government, when international sponsors of banks looked increasingly to establish banking structures in Cayman because it offered a more stable environment. That really started the growth of Cayman as an offshore financial center.

Let's fast-forward to around 1993 when Cayman passed the first hedge fund legislation called "The Mutual Funds Law", which allowed for the authorisation, supervision and enforcement of regulated funds.

A few funds were formed after the legislation was passed in 1993, but other jurisdictions continued to be preferred over Cayman for fund formation since there was little regulatory focus on the fund sector since banking was still the dominant industry within the financial sector. In 1997, I was hired by the Cayman Islands Monetary Authority to establish the Investment and Securities Division and administer the law to regulate the hedge fund sector. I hired the staff, developed the policies and procedures and set the general policy direction for regulating hedge funds which was a light touch, principles based, market friendly and responsive framework.

After that, the single biggest factor was that excellent legal talent was being attracted to the Cayman Islands, as the importance of the country as an offshore financial center continued to grow. Around that time, some of those really talented lawyers developed the vision to actually build world class law firms in the Cayman Islands and they became very involved with formulating and implementing the legislation that would be necessary to achieve that. Of course, tax neutrality was another attraction and a regulatory framework that was less onerous, including innovations like a simple registration statement called MF1. In the Investment Services Division we focused our work around the speed of registering the fund, pragmatism and market responsiveness. Those were among the factors the industry was telling us that they needed in order to make the Cayman Islands more attractive than its competitors.

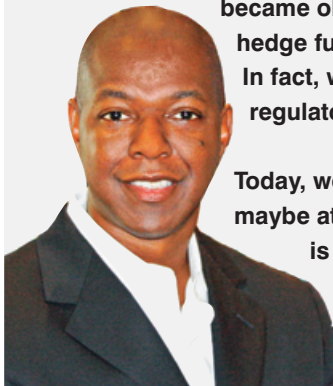
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Around 1998 Cayman hedge funds really started to build momentum - I think the market preferred Cayman, because it became obvious that Cayman had the best talent on top of a very robust, market friendly framework for hedge funds. The products and services were frankly better than what the other jurisdictions offered. In fact, what is happening today is that we see a harmonization from competitor jurisdictions to the regulatory framework that the Cayman Islands established back in 1997.



Today, we have a market dominance that is so strong that sponsors actually have to explain, or maybe at a disadvantage, if they choose not to use a Cayman product, because the Cayman product is the proven hedge fund product in the offshore sector with nothing else really close, this is not just anecdotal, but empirical as well. It is the industry standard by any measure.

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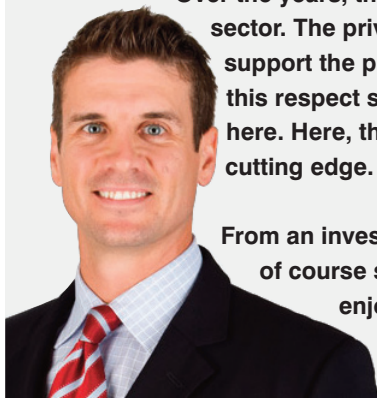
I agree. The Cayman Islands offers sensible regulation with investor protections which in turn inspires investor confidence in the jurisdiction and encourages new products. The jurisdiction has united a wealth of talent from across the world – not only lawyers but auditors, administrators and directors. This deep talent pool is one of the main reasons why people continue to choose to work with the Cayman Islands.

We should also mention how the public-private partnership has also contributed to move the Cayman Islands forward. Over the years, there has been a lot of exemplary interaction between the government and the private sector. The private sector identified industry needs and trends while the government would then support the private sector in bringing the related products to market. Cayman is a small place, and in this respect small is an advantage, as larger domiciles

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**From an investment point of view, another advantage is the tax neutrality we offer. While the end user of course still has to pay the taxes in their own country, the Cayman domiciled investment vehicle enjoys tax neutrality which enables the transaction to occur and encourages the flow of capital into larger jurisdictions.**

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**Jon Fowler**

Cayman is a common law jurisdiction, so legally speaking we have much in common with the US, Ireland, UK, Australia and the rest of the Commonwealth. This has certainly contributed to the growth of the jurisdiction.

From a legal perspective, Cayman has a light, but effective, regulatory regime which is based on the principle of disclosure. We are addressing the needs of a primarily institutional, not retail, investor base who can assess the risks clearly based on appropriate disclosure in an offer document.

**Don Seymour**

Jon, how important do you think is the jurisprudence that has developed in Cayman? Can international investors have confidence using the Cayman Island structure knowing that if something does go wrong, he can rely on a very robust court system here that will readdress the grievances? It is my view that particularly since 2009 there were a number of reported court cases that have certainly strengthened Cayman's position as a hedge fund jurisdiction.

**Jon Fowler**

This is correct. Cayman recently established a Financial Services Division (FSD) of the Grand Court with a bench of 6 Judges who are very experienced in commercial matters. Those Judges include one of Maples' retired senior partners, Andrew Jones QC, who has decades of experience in hedge fund related and other commercial work.

Fund related disputes are now automatically referred to the FSD and assigned to one of the specialist commercial Judges. One of the key features of the FSD's approach to case management has been the use of technology – including conducting hearings by telephone and

by video conference – to move cases forward quickly and pragmatically.

Our Court of Appeal is presided over by Sir John Chadwick, an eminent retired Judge of the English Court of Appeal. Our court of final appeal is the Privy Council in London. This very

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**It's also worth mentioning that there are now a number of law firms in Cayman who have capable litigation practices with significant funds experience. As a manager or stakeholder, you do not really want to be in a jurisdiction with only one or two specialist litigators. Litigation is quicker, cheaper and more effective when all parties have access to specialist advisers who understand the industry.**

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I agree that the jurisprudence that has developed from this framework is helping to enhance Cayman's position as the leading funds jurisdiction. Decisions of the Cayman Court are now receiving more coverage internationally and are focussing on issues that affect the funds industry globally.

The Strategic Turnaround case is a good recent example of that – the dispute about the fund's right to suspend redemptions or payment of redemption proceeds will be heard by the Privy Council in London in November. Also of importance is President Chadwick's recent judgment in Camulos Partners, which warns investors against the use of winding up petitions in circumstances where other remedies exist which it would unreasonable not to use. The soft wind down of funds by their managers is another topic that has come under the FSD's microscope recently – this is an issue on which we expect to see further judgments in the near future.

**Matthias Knab**

**What else is new and relevant in hedge fund land? Any updates and new developments around valuation issues?**

**Norm McGregor**

For the most part, for 2010 year ends, the standard setters seem to be taking a break in the



area of fair value and are allowing the industry to continue to digest the numerous reporting requirements that have been introduced over the past few years. As you know, this included the significant changes in fair value disclosures under ASC 820 (formerly FAS 157) which required the categorization of investments and enhanced liquidity information. In addition, ASC 815 (formerly FAS 161) mandated additional disclosure on the derivative activity of investment funds. IASB also made amendments to IFRS 7 to introduce a three level fair value hierarchy similar to those requirements under ASC 820.

These changes led to an education process with both manager and investors and resulted in the industry developing some consistencies in valuation practices and related financial statement disclosures. Still there are some further refinements in place this year under US GAAP that will lead to more robust disclosures around fair value.

It would be remiss of me if I didn't mention the other area that required a great deal of attention over the past year which was of course ASC 740 or more commonly referred to as FIN 48. This standard is essentially about evaluating uncertainties relating to income tax liabilities within the fund's books and records, which in the past may not necessarily have been recorded. Of particular concern to a fund is the trading of securities in countries that impose capital gains or other income taxes on non residents but do not automatically collect taxes through withholding or some other mechanism. Certain countries have legislation in place that, at least in theory, imposes capital gains taxes on transactions by non residents. In practice however many of these countries, for administrative or other practical reasons, have not historically sought to levy and collect such taxes. These countries include Australia, Brazil, Germany, Portugal, Poland and Spain.

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**As the industry continues to deal with this matter, many are hoping that the taxing authorities in the jurisdictions that give rise to the reporting issues will assert clear administrative positions so that reporting entities will gain more clarity. There is a basis for this because, unless addressed, these uncertain tax rules may stem the flow of capital into these jurisdictions as investors find similar opportunities without the uncertainty.**

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### **Jon Fowler**

From a legal perspective, FIN 48 has been a significant issue this year. Some managers found themselves a little blindsided by the fact that they had potential tax liabilities (per the FIN 48 test) which had been carried for years. There has been much discussion of how to deal from a legal and accounting perspective with the type of issues that Norm refers to.

There are many questions that managers and Directors have been asking. Would the Fund changing from US GAAP to IFRS help? Should, or can, the fund attempt to restate NAV's and/or adjust subscriptions/redemptions? Is there potential for clawback of redemption proceeds under Cayman Islands law once an investor has redeemed out? Does the fund pass the entire liability on to current investors? Can the fund live with a qualification to its audit? Does the fund make a provision in its accounts for the potential liability? If the fund puts in a

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provision which is later unwound as the tax does not get paid, is that then a windfall for the investors at the time of the unwind?

Managers have also looked at getting insurance against this type of risk. However the clients I spoke to had trouble finding insurers who were willing to take on the FIN 48 risk at all, let alone at an economically feasible premium rate. The capacity in the insurance market for FIN48 risk got taken-up quite quickly, and then it was virtually impossible to get meaningful insurance.

Today, people are far more aware of the issues around FIN 48, and going forward they are dealing with it in a number of different ways. Setting up trading subsidiaries in double tax treaty jurisdictions is one approach, and our Irish office has seen a number of clients set up Irish section 110 companies for this purpose. Other clients are using swaps in a number of different ways to ensure they do not fall foul of the relevant rules although this does introduce counterparty risk. Hopefully the relevant governments, including Australia and Spain, will provide greater clarity going forward as to their domestic tax rules.

**Norm McGregor**

Jon, you mentioned the double-tax treaty jurisdictions – did you find many people using Cayman pass through entities such as partnerships to enable the end investor take advantage of the benefits of the treaties in their own jurisdiction, rather than setting up a vehicle in different jurisdictions?

**Jon Fowler**

That is a good question – is it possible to put a flow through in-between to ensure you get the benefits of the double tax treaty between the investor and the actual place of investment?

Despite it being discussed a number of times, we have not see that approach adopted. Anecdotally I did speak to one lawyer whose client had tried to go that route, but then they found that the double-tax treaty between the U.S. and Australia actually excluded investments in land rich companies (which pretty much described that fund's Australian investments). As I said we have seen funds setting up Irish Section 110 companies, because they can then avail themselves of a slightly more beneficial double-tax treaty treatment there.

**Don Seymour**

Matthias, you recently reported in Opalesque an interesting case where one of our clients, a fairly large manager, had set-up a UCITS structure in Dublin, ran it for a couple of years, and then decided to re-domicile it back to the Cayman Islands.

Like many other firms, they tried to attract European investors because their marketing intelligence was telling them that those investors wanted to increasingly invest in a European product. So this manager was running the European products for almost two years, and then as their contracts were coming up for renewal they realized that the regulatory constraints plus the costs of actually running the structure did not really make it worthwhile to continue the structure in Dublin so they re-domiciled back from Dublin to Cayman.

From our experience and data points we are collecting, we cannot confirm what sometimes has been reported in the mainstream press about any type of trend to move a fund away from Cayman into the E.U. What we do see though is that when a manager reaches a certain size and he wants to continue to grow and attract European investors, it makes a lot of sense to set up a complimentary product within the EU.

Some press commentators put out claims like Cayman is going to fail because the EU is going to rise. I actually do not see things that way – we see that their success does not have to mean our failure. We are talking about really complimentary products, there is no conflict between the European and the Cayman product whatsoever and therefore it is not a zero sum game.

In fact, just in the last few weeks and also certainly before that, we have seen that large European pension plans still continue to invest massive sums of money into Cayman products. In the end, it really comes down to the strength of the product, the strength of the manager and how it performs. Ultimately, it is about delivering performance to be successful in this business.

Of course, we have seen significant changes in how managers have had to become more institutionalized so that they can serve their clients better. There is an increased focus on transparency, on having independent fund administration and on infrastructure. Managers need to demonstrate they have a robust infrastructure to mitigate not just portfolio risks, but the operational risk issues that can occur. But once they can do that and still perform, the Cayman fund structure is still the dominant product.

We had seen that Cayman and European products work very well side by side, after a manager has reached a certain size. At this time, we certainly don't see any startup manager setting up his first product as E.U. product because of the significant costs and constraints.

Of course, with the changed environment now, fund launches now have become a lot smaller and slower. That also means there is fee pressures on everyone involved with hedge funds. Just recently I was dealing with a quote from two big four audit firms, and the difference exceeded a hundred thousand dollars over two years. That is an enormous difference and, of course,

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**Don Seymour**

managers and also the sponsors are negotiating harder to get better fee arrangements. And don't forget, there is still a lot of capital sitting on the sidelines.

Such a market dynamic and the need for cost reduction does not suit the European environment well. Therefore, even if we would look say three or five years into the future, I still see that Cayman will be the place for start-up managers, because the jurisdiction provides the right kind of environment for them to grow in to a billion dollar manager. Then, as a more established manager if he decides he and wants to target Europe can more afford it, he can set up European products, run it on the same platform and grow his overall business.

**Jon Fowler**

I would agree with Don, in that we have not seen a trend in terms of funds switching jurisdiction. A minimal number of funds have left Cayman for European jurisdictions like Ireland, Luxembourg or Malta. Yolanda McCoy, the Head of CIMA's Investments and Securities Division commented last week that CIMA had only seen 6 funds redomicile so far - 4 to Luxembourg and 2 to Malta. We keep seeing press reports about funds fleeing the Cayman Island's as a jurisdiction, but the reality is that this is not happening; we are on course to register 1,200 new open-ended funds during 2010. The numbers just don't stack up; it is uninformed speculation.

When the first draft of the EU AIFM Directive first came out in 2009, some clients were asking if they could set up a fund in a way they could "push the button" to switch jurisdictions at a later date. Now people have calmed down and I haven't had that type of request for over a year.

As Don said, when clients who use Cayman Islands funds explore or set up Irish, Luxembourg



or other European offerings, it is usually complimentary to their existing fund offerings rather than as a substitute for Cayman Islands funds. UCITS are a different product, which can only be established in the EU and allow managers to diversify their investor base. Traditionally, the UCITS investor base is a radically different group from the typical Cayman Islands fund's institutional investor base. UCITS tended to attract more retail investors or conservative institutional investors, resulting in much larger numbers of investors with a smaller ticket size. Of course there are institutional investors in the European Union as well for whom UCITS is

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**From an investor perspective, the UCITS product is more regulated and comes with mandated liquidity of at least one redemption period every two weeks or more frequently. However, if you read the small print, most UCITS funds do have the ability to impose redemption gates. I've also seen commentary that so far, the majority of the new UCITS launches have been in strategies, such as long/short equities and long only absolute return, where there was significant liquidity even at the height of the crisis.**

**If a manager has run Cayman institutional funds for years, squeezing that strategy into a NewCITS format can be rather tricky and result in a alteration to style and execution, leading to performance drag. There is also an increased risk of mis-selling and/or volatility beyond investor expectations if certain more complex strategies are plugged into a UCITS framework**



**Investors have to look at the full picture, which can include higher fees for structuring, distribution and compliance.**

**We are at an interesting point in terms of hedge fund regulatory and structural development. The offshore and onshore products can really complement each other rather than be mutually exclusive; it is a "horses for courses" situation with the type of products a manager chooses being driven by a number of complex factors, and no one size fitting all.**

**Jon Fowler**

attractive or necessary and the growth in alternative UCITS or "NewCITS" has seen further expansion into the hedge fund investor space.

The two products also differ from a marketing perspective in that UCITS are usually not distributed by managers approaching investors directly; rather investors are reached through established distributors as UCITS can be registered in EU (and some global jurisdictions) for public distribution. This contrasts with the traditional institutional Cayman Islands fund model of direct negotiations between the manager and investor, which will often result in a side letter

relating to the fund investment.

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We have a number of clients who have both Cayman structures and EU based UCITS or other regulated funds, mainly in Ireland.

**Karen Watson**

We see the same happening. Clients set-up a Cayman structure to start their fund, build their track record and grow their assets, and at the same time they ask for capabilities to create a UCITS structure through one of our of our Dublin or Luxemburg offices. We are going into this direction, but the starting point has been the Cayman structure still and the UCITS is to extend this structure rather than replace it.

**Jon Fowler**

Some estimates put the size of the NewCITS market at around \$100 billion by the end of 2010 with 400 funds. The global hedge fund industry is now in the region of \$1.5 trillion with 9,600 funds in Cayman alone. NewCITS is a toddler in hedge fund developmental terms and is getting an awful lot of press attention, but it is worth keeping relative sizes in perspective.

**Matthias Knab**

**Just to compliment that, if you look at the actual flows within hedge funds, those 400 UCITS funds did actually attract a significant stake compared to the rest of the universe.**

**On the other hand, just recently in Zurich I was moderating a panel with Swiss institutional hedge fund investors – all Chief Investment Officers of insurance companies and large pension funds, and none of them is interested in UCITS. They are too large and too sophisticated, they stick to the traditional ways of investing into alternatives.**

**Another thing to keep in mind is that UCITS are not only attractive to European investors, but have become a global and trusted investment franchise. UCITS are very popular in Asia and Latin America. I see that UCITS basically strengthen the hedge fund industry, but as we say this is about horses for courses. Onshore and offshore can go nicely together and not necessarily in competition with each other.**

**Jon Fowler**

Correct, I was just talking to Peter Stapleton, who is one of the partners in our Irish funds group, and he was telling me that the global sales trends for UCITS has expanded beyond the EU with strong growth in Asia and Latin America (e.g. Chile and Peru) are these regions are

strong investor source jurisdictions for Irish UCITS funds that they are setting up at the moment. In total, he identified 60 different jurisdictions as the investor hot spots for UCITS setting up in Ireland.

**Karen Watson**

That is right, Latin American funds primarily are asking about the UCITS as a compliment to a Cayman fund. We have seen the most interest from Columbia, Peru, Chile and Brazil.

**Don Seymour**

We have an office in Brazil and probably due to the legacy of Brazilian banks in Cayman, virtually all sponsors we talk to prefer to set up Cayman structures, we found zero interest for UCITS from the plan sponsor side. Cayman enjoys a very favorable reputation in Brazil and was always the natural offshore jurisdiction to Brazilians – not BVI, not Guernsey or anywhere else.

In Hong Kong too, every fund that we met is Cayman focused. Other than for the SPV work, where BVI has a cost advantage for basic holding companies as SPVs, the Cayman Islands are still the vastly predominant jurisdiction for hedge fund work, while the UCITS did not factor at all.

**Jon Fowler**

Our discussion here really emphasizes that geographical splits exist in terms of which investors prefer which kind of product and from where.

Even if you look at the options within E.U., you have the primary choice as where to set up the UCITS fund, with Ireland and Luxembourg as the leading contenders. If you look at the current Irish domiciled fund statistics, 46% of Irish funds are set up for UK promoters and 39% for US promoters. Investors from countries such as France, Germany and Italy have historically tended towards Luxembourg fund vehicles. Different markets prefer different geographic locations and different types of products, and these preferences evolve over time.

**Matthias Knab**

**What is new on the fund governance side? This was obviously a big concern during the crisis. Where do we stand now?**

**Don Seymour**

The state of fund governance in the Cayman Island it is very good, I would say. Post crisis, fund governance has become more important than ever. Even pre crisis, we faced here many questions about what do the fund directors really do, how many funds do they work with, do they have the ability to deal with all the issues that arise in the funds? What the crisis really did was to stress-test the fund governance industry in the Cayman Islands, and I think the industry as a whole has passed with flying colors.

One major trend we see is the emphasis that corporate governance firms are putting on their infrastructure and how that translates into transparency opportunities and security for investors and fund structures. As investors engage in on-site due diligence of independent directors, the firms that are thriving are the ones that can demonstrate a similar level of

**As investors continue to focus on issues of governance, it has become almost the rigor now to have independent directors on a fund board. And independent obviously means not affiliated with the manager, so that he is not not able to control the governance structures. This is the concern that most investors have.**



**Looking into the future, there two significant issues developing in the United States that will affect the global hedge fund industry. One is FACTA, the Foreign Account Tax Compliance Act. Here on Cayman we are starting to analyze and think about how we deal with the issues arising from that. And secondly there is the Dodd-Frank Bill where we are also gauging the impacts and if and how essentially the long-arm of the SEC may be extending into how we run hedge funds offshore funds.**

**Don Seymour**

commitment to their operation and institutional knowledge that a law firm, audit firm, or administration firm would be expected to.

Since you were here last, Matthias, the new Cayman Islands Director's Association (CIDA) has become the fastest growing professional organization in Cayman and now has over 180 members. This really speaks well as to the rapid and significant professional development of the industry and the depth of the talent pool available on the island. The industry has attracted really top talent to the island. I think Cayman Island as a whole probably has the most robust fund governance industry when you look at the quality of the professionals, and I say that with no disrespect to our friends in Ireland who also have a lot of talent there. However if you look into other offshore jurisdictions, things tends to be a bit smaller and maybe not as well organized or proven.

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**Karen Watson**

That's right, Don, these are probably the two primary pieces of regulation that affect hedge funds from an operational perspective, and there will be some major impacts.

Though a number of changes will come through in interpretation by the relevant regulators, the HIRE Act was signed in March of last year and from all accounts and information that we can gather, the FATCA provisions are not going to be watered down heavily. There are significant operational impacts from a fund perspective in regards to the withholding tax and logistically how that is going to work and who is going to collect it in cases where it has to be applied. For example, how do Cayman fund administrators manage the collection and reporting to the IRS.

Another key area of operational concern is how does this legislation potentially impact the due diligence that is required by hedge funds and other offshore investment vehicles when for the first time there will be piercing of the corporate veil. Not being able to rely on the corporate identity and the new requirement to dig down to the ultimate underlying beneficial owner will entail a significant change to the operational processes of offshore funds where currently there is heavy reliance on what is known as a "Reg 8" exemption which allows funds to look at incoming monies into a fund and if it is in the legal name of the holder and it is coming in from a bank in a Schedule III country then that is the end of the due diligence process.

With FATCA in place, potentially that is not going to suffice and you have to look all the way down, pierce the corporate veil, and go through every level of ownership to find out if a US person is holding a position in the fund. So, it is a huge implication operationally and funds will need to be prepared for it when it comes into effect in 2013. That is something that we are certainly starting to look at and to assess operational requirements to be able to manage that due diligence process and also to assess how this will impact the cost of administration to funds.

The Dodd-Frank Act that you mentioned is another regulatory reform from which we expect to see, and already are seeing, a lot of operational impact in several areas.

With the registration requirements arising from the elimination of private advisers, we are going to see a lot more reporting requirements on hedge funds. This is something that many fund administrators' have in place, in particular those with global presence that also work with



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Karen Watson



UCITS and Newcits, which have regulatory requirements that are certainly much stricter than for hedge funds. The capacity to meet these reporting requirements is in place, so I don't see that posing much of a problem for funds that use third party administrators.

The Volcker Rule is another part of the Dodd-Frank Act that we are seeing a lot of impact from - a lot of opportunities really, I think, in that with the restrictions on proprietary trading we are anticipating a surge in start-up funds. Though in the short term there is some impact of funds closing down as banks react to the legislation, in the long-term I think we will be seeing investment professionals who have spent their career trading at institutional desks at these banks moving out on their own and starting their own funds.

Outsourcing of middle office services is a trend we are seeing take hold industry wide. With these start-up funds in particular there will be an increased need for a middle office service as they have had the in-house infrastructure in place working for a large institution. They have the expertise, they have the trading knowledge, they have these core competencies, but they do not necessarily have the infrastructure or the capital to put in place sophisticated systems required for some of the trading platforms and to manage the flow of daily information that is required. Outsourcing allows conversion of this fixed cost into a variable basis point cost and allows the managers to focus on their core competency of trading.

One of the more complex elements of the Act is the move to achieve greater transparency and reduce systemic risk in OTC-derivative markets. By mandating central clearing and requiring execution on designated contract markets, exchanges, or swap execution facilities, the Act should provide for greater price discovery, reduced counterparty risk, and new regulatory oversight. In order to effectuate these changes, modifications to operational processes and in some cases, the financial instruments themselves, will be necessary. One example of this is the changes to trading conventions in Credit Default Swaps (“CDS”) introduced in 2009. By establishing fixed coupons, standardising payment frequencies, harmonising effective dates, and clarifying credit event and settlement price determination procedures, CDS contracts were modified to facilitate trade compression, central clearing, and faster trade processing.

As a result of the Act, these types of changes will continue to unfold. As derivative operations become more standardized, greater efficiency, reduced operational risk, and lower operating costs will be possible through the development of efficient and scalable derivative trade processing operations to accommodate reengineered derivative instruments.

**Norm McGregor**

FATCA, which as previously mentioned is part of the HIRE Act, will be a massive undertaking from an operational standpoint for many stakeholders in the hedge fund industry due to the requirement to gather information on the ultimate investors. We are having discussions with our clients on this matter all the time now because people are starting to realize that even though this legislation is not effective until 2013 it will change how they operate.

Offshore funds investing in US securities or with US investors, will now have reporting obligations if they wish to continue accessing the US markets. Funds will need annual KYC procedures in place to avoid the 30% withholding tax they are talking about.

**Karen Watson**

And the 30% is on gross proceeds.

**Norm McGregor**

Correct. This type of penalty is so onerous that essentially if a fund is going to remain in the U.S. market, they really won't have any choice but to gather this information and report. Given that guidance at this point is limited, we're working with our clients to identify and address the potential issues they may face as a result of complying with FATCA. The first step of this



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process is really educating the organization on the impact this will have on their business and their investors.

We've got a dedicated FATCA resource on our website aimed at capturing in one place the latest materials on this legislation which is a good starting point for our clients to draw upon. From there, we'll sit down with our clients and start working with them on the operational aspects ranging from ideas on the efficient collection of data (and what steps to take when it is not available) to an analysis of the systems in place and enhancements needed to effectively monitor and ultimately report on an annual basis. FATCA presents a number of challenges to the industry and so it is certainly an area that we'll be continuing to focus on over the next few years.

**Jon Fowler**

The HIRE Act it is going to be important. Prima facie each private equity or hedge fund which is a "foreign financial institution" will have to sign an agreement with the IRS in relation to information exchange and withholding. That said there is one fairly radical way to avoid any issue under the Act; if the fund has no U.S. source income. It is conceivable that some funds could simply say they will not invest in U.S. assets.

The IRS has started to draft the relevant HIRE Act guidelines. The first draft came out relatively recently and certain aspects were encouraging, such as the indication that a fund could, in certain circumstances, rely on the W-8BEN or a W-9 declaration when doing due diligence on underlying investors. We'll have to monitor how things develop from here.

We can confirm some of the trends Don was referring to in terms of fund governance and director independence for Cayman registered hedge funds. The vast majority of funds we have formed this year have at least one independent director and over 60% have two independent Directors. 80% have independent fund administrators.

The number of prime brokers per fund at launch is an interesting one. I expected far more funds to set up with multiple prime brokers to avoid counterparty risks post-Lehman, but only about 25% of the funds we have set up this year have more than one prime broker at launch.

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Jon Fowler

Norm McGregor

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Interesting point Jon, as I would have thought that a higher percentage would be using multiple prime brokers.

Perhaps I'll add a comment on the new launches. While it is true that the majority of the inflows are going into the larger institutional fund platforms, we're also seeing a healthy start-up market. In light of this, we've put together our own platform focusing on the needs of emerging managers primarily because the environment has changed and new managers need more assistance to get off the ground.

As Jon mentioned, the Dodd Frank Act will make registration at some level a reality for emerging managers which can be a challenge. The biggest changes however are the expectations from investors for institutional type infrastructure in place at the outset - regardless of the funds' size. The due diligence questionnaires and meetings are certainly not getting any shorter and so emerging managers are turning more and more to larger, multi



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Norm McGregor

disciplinary firms who can provide practical advice at the launch stage and resources they can leverage as the fund grows.

Karen Watson

When managers start out, their first intention is to get going and build a track record, and then when they grow their business and AUM they think about or are able to add multiple primes. What we are seeing in practice is that a start-up fund will mostly be launching with one prime broker, but they will have one or two in the back pocket that they are ready to go with as soon as they have built their assets.

Right after Lehman went bankrupt, there was a trend where funds went out and opened prime



brokerage accounts and split their trading and assets to various prime brokers in order to spread out their credit risk. This seems to have been a wave that has passed, it is not that much of a hot topic now.

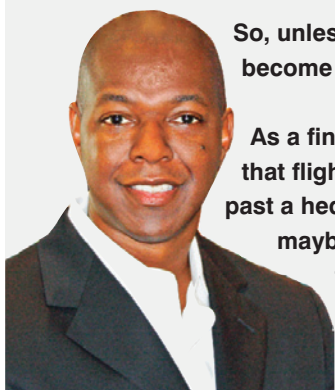
#### **Don Seymour**

To a certain extent, prime brokers are now the masters of the universe. The market has become more concentrated with the loss of Lehman and Bear Stearns, and we have seen prime brokers actually dictate almost draconian terms to our clients, so they can merely keep an account open with them.

So, unless a fund has sufficient size and actually trades through these dual prime brokers, it has become a very difficult luxury to maintain multiple prime brokerage accounts.

As a final comment and summing up, let me add that post crisis we witnessed a flight to quality, and that flight to quality has benefited the Cayman Islands because the Cayman Islands represents the highest quality. In past a hedge fund manager may have experimented, setting up a fund in Gibraltar fund, a Malta fund, maybe a Cayman fund and so on. But as the dollars have become more scarce, people have had to focus, and you focus on what the premium product is, and we have seen this in the number of new hedge funds that continued to be

**To a certain extent, prime brokers are now the masters of the universe. The market has become more concentrated with the loss of Lehman and Bear Stearns, and we have seen prime brokers actually dictate almost draconian terms to our clients, so they can merely keep an account open with them.**



**So, unless a fund has sufficient size and actually trades through these dual prime brokers, it has become a very difficult luxury to maintain multiple prime brokerage accounts.**

**As a final comment and summing up, let me add that post crisis we witnessed a flight to quality, and that flight to quality has benefited the Cayman Islands because the Cayman Islands is that quality. In past a hedge fund manager may have experimented, setting up a fund in Gibraltar fund, a Malta fund, maybe a Cayman fund and so on. But as the dollars have become more scarce, people have had to focus, and you focus on what the premium product is, and we have seen this in the number of new hedge funds that continued to be formed here in Cayman.**

**Don Seymour**

formed here in Cayman.

As in any business, our global industry faces challenges and changes. Any one who has been around a while has seen that our jurisdiction has faced major challenges in the past. We do benefit from a very pro-growth private and public sector that have together achieved a legacy of success; there is a history of really solving enormous global geopolitical challenges and ensuring success for users of Cayman Islands financial services.

Therefore, despite the AIFM directive, Dodd-Frank Bill and all the US developments, Cayman is doing a lot of work behind the scenes to make sure we are well positioned to meet those challenges and to continue to succeed.

#### **Karen Watson**

Just to touch on one trend we have not spoken of, is the transformation of investor requirements post-crisis. These include increased due diligence, significantly more transparent access to fund trading and portfolio information and, in some cases, modified management and performance fees that are required to attract investors. Though, of the latter, the reactionary modification of fee structures we saw with new funds launching in the aftermath of the crisis has receded somewhat and standard fee structures still remain prevalent, albeit at a slightly lower scale in particular in relation to management fees more so than incentive fees.

#### **Jon Fowler**

Let me share a few data points from Maples' Cayman Islands hedge fund practice for 2010. All

these numbers are from our own practice here on the Cayman Islands, but as we have approximately 40% of that market, we believe they give a good indication of the status of Cayman Islands hedge funds at this time.

In terms of management fees, less than half of Cayman funds we registered are still at 2%, but over three-quarters are in the range of 1% to 2%, so there is a general shift downwards. Incentive fees remain predominantly at 20%.

We are seeing very few funds with incentive fee clawback mechanisms. There was a lot of press about this at the beginning of the year, but we are not really seeing that play out into the market. The vast majority of hedge fund structures in Cayman are still exempted companies, and only about 10% of those are segregated portfolio companies. Stand-alone funds are running at approximately 30% of our work load, with specific managed account structures running at around 15%. Of course, you can do a managed account without setting up a separate vehicle, so that figure probably greatly under-represents the number management account structures that are out there in different forms.

About 50% of funds still have a fund level gate. Only about 15% so far that we have seen have an investor level gate, but it is out there as a concept and, of course, there has been press in relation to it. About 25% of funds have a soft lock, and about 15% a hard lock.

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**On a more macro level, it is worth noting that at the OECD Global Forum meeting in Singapore, the OECD recognized that the Cayman Islands' legal and regulatory regime complies with international standards for transparency and exchange of tax information. Cayman was one of the first to be reviewed along with 7 other countries, the others being Bermuda, Botswana, India, Monaco, Panama, Jamaica and Qatar.**

**This qualitative review follows the initial OECD quantitative review process by which a jurisdiction to be adjudged to be compliant needed to be signatory to at least 12 tax information agreements. Cayman achieved this "white list" status fairly early on and now has 20 signed tax information exchange agreements, is awaiting signature on a further 6 agreements and is negotiating with an additional 4 OECD member states. This recognition by the OECD adds to earlier recognition of Cayman's adherence to international standards by the International Monetary Fund (IMF), International Organization of Securities Commission (IOSCO) and the Caribbean Financial Action Task Force (CFATF).**

**While this positive review did not come as a surprise those inside the industry, it is important to the jurisdiction which has been battling this mis-perception that the Cayman Islands is a secrecy jurisdiction and a tax haven. These reviews show objectively the true nature of the Cayman Islands as a tax neutral and transparent international financial centre with an important role to play in the global economy.**

**Jon Fowler**



As a side note, the numbers of closed ended private equity vehicles registered in Cayman are back to 2006 activity levels, with 2007 and 2008 having been bubble years. A lot of private equity funds are reaching or surpassing their target capital, which is a very strong sign. There has also been an uptick in the downstream work. The PE funds are again able to borrow to fund their deals. Liquidity is returning in that market, and we particularly see a growth in funds targeting Latin America.

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