



Opalesque Round Table Series '09

CAYMAN ISLANDS

Editors' Note

Dear Reader,

The Cayman Islands are by far the largest offshore domicile for the establishment and administration of investment funds, the second largest offshore center for captive insurance and a significant banking and structured finance hub.

This new Opalesque Roundtable is researching what is behind Cayman's success story and what the future holds for the jurisdiction. In 1993, Cayman was the first offshore jurisdiction to pass specific hedge fund legislation. The process accelerated when the Cayman Islands Monetary Authority established the Investment and Services Division (ISD) in 1997. Hear from Don Seymour, the previous head and founder of the Investment Services Division and a former Director of CIMA, more details about the innovations Cayman was and is still offering. Why did the global financial markets embrace Cayman funds to the extent that they dominate offshore finance for years now?

But Cayman is also facing some headwind at the moment. Are the Cayman really a "tax haven"? Or are certain stances against offshore structuring based on ignorance, if not part of a political agenda? What do people actually find when they come and visit the Cayman Islands, their workforce and regulatory as well as financial infrastructure?

Apart from Don Seymour, who now serves as Managing Director of [dms Management Ltd.](#), you will hear from:

- Jennifer Frizzelle, Partner with [KPMG](#)
- Darren Stainrod, Managing Director of UBS and Head of [UBS Alternative Fund Services](#)
- Peter Cockhill, Partner with [Ogier](#)

a timely update on latest innovations from the Cayman and other essential developments within the alternatives industry:

- True stories and anecdotes from the 2008 hedge fund meltdown and why evaluation can be trickier than you think
- Why a counterparty quote may not be enough any more to evaluate level 2 or level 3 assets
- FAS 157 and more: how do auditors and administrators cope with the new accounting and evaluation requirements?
- What are the latest innovations coming out of Cayman? What are the Sovereign Wealth Funds up to?

Enjoy "listening in" to the Opalesque Cayman Roundtable!

Matthias Knab
Director Opalesque Ltd.
Knab@opalesque.com

Participant Profiles



STANDING (LEFT TO RIGHT)

Matthias Knab, Peter Cockhill

SITTING (LEFT TO RIGHT)

Don Seymour, Jennifer Frizzelle, Darren Stainrod

Introduction

Don Seymour

DMS

I am a Managing Director of dms Management Ltd. dms Management Ltd. is the largest company management firm in the Cayman Islands with nine directors and over 40 staff. Our principals serve as independent directors to some of the most notable hedge funds in the industry and advise hedge funds in distressed conditions. Prior to founding dms, I was the founder and Head of the Investment Services Division of the Cayman Islands Monetary Authority (CIMA) and a former Director of CIMA. I also serve as the Vice-President of the Cayman Islands Directors Association.

Peter Cockhill

Ogier

I am a partner in Ogier and co-head of our global investment funds team. Ogier is an offshore legal and fiduciary services organization. On the legal side, we have a large and diverse group that straddles our four core jurisdictions which are BVI, Cayman, Guernsey, and Jersey, and we advise on fund formation, structuring, and ongoing advice to hedge funds, private equity funds, hybrid funds, and an increasing number of bespoke limited or single investor funds. On the fiduciary services side, we provide RTA and registered office services and non-executive directorships to BVI and Cayman funds and we provide administration services to private equity funds domiciled in Guernsey or Jersey.

Darren Stainrod

UBS

My name is Darren Stainrod, I am a Managing Director of UBS and Head of UBS Alternative Fund Services, responsible for our operations in Cayman, Dublin, and Toronto, as well as our business development offices in London and New York. We provide administration as well as shareholder and corporate services to hedge funds and funds of funds.

Jennifer Frizzelle

KPMG

My name is Jennifer Frizzelle, I am a partner with KPMG in Cayman Islands. We provide audit, tax, and advisory services to the alternative investment industry, including hedge funds, trusts, structured finance vehicles, fund administrators, investment managers, and directorship companies. Our Cayman Islands practice is an important contributor to KPMG's wider service offering to this community.

Matthias Knab, Opalesque: The Cayman Islands are the foremost domicile for hedge funds globally. Can you give us some background how the Cayman Islands became what they are now?

Don Seymour

I will confine my comments here to the hedge fund sector only, because if we discussed the overall financial sector, we would have to go back quite a long time.

The Mutual Funds Law was passed in 1993 in the Cayman Islands. Even though it was possible to establish a hedge fund in other jurisdictions such as the BVI prior to 1993, the Cayman Islands were the first offshore jurisdiction to pass hedge fund specific legislation.

Other jurisdictions like Bermuda and the Bahamas followed suit several years later, but the Cayman Islands was the first to implement legislation that was specific and effective for the unique needs of the offshore hedge fund industry.

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There were some funds formed after the law was implemented, but since the regulatory and industry focus was primarily on the banking and insurance sectors during this time, the Cayman Islands remained an insignificant player as a hedge fund jurisdiction until the Investment Services Division of the Cayman Islands Monetary Authority (ISD) was established. I recall in the early years how difficult it was for me to get resources allocated to the hedge fund sector because of the dominance and preeminence of the banking sector. Many did not believe that the industry could be as successful as banking since there were at least 6 or 7 jurisdictions that were ranked ahead of Cayman. I strongly believed that we were going to be successful, however no one, including me, could have foreseen that Cayman would become as dominant as it is today.

I was hired by the CIMA in 1997 to establish the Investment and Services Division (ISD), which I created subsequently in 1998, personally developing much of the regulatory framework that endures at the CIMA to this day.



The ISD was created to bring specific regulatory focus to the hedge fund sector. It was very effective because it was created using a bottom-up approach in close collaboration with market participants.

Another critical key to our success was the decision for ISD to move at the speed the market wanted us to move, not at the speed that traditional regulation moved. Our competitors would take the proverbial 6-8 weeks to approve an application to register a hedge fund, if you were lucky. It is well known that work will expand to fill the time allotted and registering a hedge fund is rarely so complicated that it requires 6-8 weeks. At ISD, I reduced registration to around 3-5 days.

Don Seymour

Although first-mover advantage was important to the eventual success of the industry, the most important development overall was the implementation of the appropriate regulatory framework to support the administration of the law.

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The ISD was created to bring specific regulatory focus to the hedge fund sector. It was very effective because it was created using a bottom-up approach in close collaboration with market participants. Because of the significant contribution from the private sector, ISD was able to really strike a successful balance implementing regulatory policies that were not only highly effective but also market friendly.

After ISD was established, the international market began to express a strong preference for the ISD approach and the Cayman Islands gained momentum and started to move up the rankings, eventually winning the top spot. You could say that market participants found our regulatory framework more appropriate than that available in competing jurisdictions, so in the end clear market preference from the international community propelled the Cayman industry to the dominant position that it enjoys today.

Another critical key to our success was the decision for ISD to move at the speed the market wanted us to move, not at the speed that traditional regulation moved. Our competitors would take the proverbial 6-8 weeks to approve an application to register a hedge fund, if you were lucky. It is well known that work will expand to fill the time allotted and registering a hedge fund is rarely so complicated that it requires 6-8 weeks. At ISD, I reduced registration to around 3-5 days. This was even more remarkable considering that no other CIMA division moved this quickly, but I was given wide discretion by Neville Grant, then the Managing Director of the CIMA, to implement whatever policies I believed were in the best interests of the industry. I also inculcated a strong attitude of client service and accessibility. My team and I would frequently work late or on public holidays to accommodate legal counsel and other service providers on whatever particular matter they were working on to meet their deadlines. We were hungry for success and wanted to let the world know that we were open for business and keen to serve. No deal was broken because of any laxity from the ISD. Fortunately, this culture and legacy of performance still endures at CIMA today and ISD continues to contribute positively to the continued success of the industry.

As the Head of ISD, I was often consulted by my regulatory counterparts in other jurisdictions to discuss our approach and to share our experiences in the Cayman Islands. It was during these discussions that I realized that Cayman did have a demonstrable edge. Some competitors criticized and mocked our approach; however, today, this criticism seems vacuous as they all have now begrudgingly adopted the same approach to attempt to emulate the success of the Cayman Islands.

Peter Cockhill

Tim Ridley (the ex-head of CIMA) recently produced an interesting series of articles that charted the progression of the Cayman financial services industry. There has been an uninterrupted growth pattern to Cayman financial services, although the services themselves have evolved since their establishment about forty years ago. Cayman is the second largest offshore centre for captive insurance, is a significant banking and structured finance centre and is by far the largest offshore domicile for the establishment and administration of investment funds.

There is currently a pause in growth as business has been affected by the global economic recession. CIMA's figures since 1993 showed year on year growth that will not be borne out when 2009 is compared to 2008, but business levels remain high, even though there has been a reduction in the number of new products being offered and an increase in the attrition rate with more funds closing than the historical norm. The success of Cayman's financial services sector is due to a number of factors, but hedge funds have been a standout story which illustrate the bigger picture.

The regulation of hedge funds by CIMA and the development by the private sector and the legislature of a legal and regulatory framework that was effective and proportionate has been a significant contributor to Cayman's attractiveness. Legislation has been attenuated to the product being offered. Cayman realized early that its market was the sophisticated non-retail investor and the regulation was configured to that market - which was a key differentiator from some of our competitors. We introduced safeguards like the local audit sign-off, but generally the philosophy was not to prescribe restrictions on the offered products. At the same time, we did set up regulation at the investment manager and the core service provider levels in the Cayman Islands as they provide the services the investors rely on.

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The success of Cayman's financial services sector is due to a number of factors, but hedge funds have been a standout story which illustrate the bigger picture. The regulation of hedge funds by CIMA and the development by the private sector and the legislature of a legal and regulatory framework that was effective and proportionate has been a significant contributor to Cayman's attractiveness. Legislation has been attenuated to the product being offered. Cayman realized early that its market was the sophisticated non-retail investor and the regulation was configured to that market - which was a key differentiator from some of our competitors. We introduced safeguards like the local audit sign-off, but generally the philosophy was not to prescribe restrictions on the offered products. At the same time, we did set up regulation at the investment manager and the core service provider levels in the Cayman Islands as they provide the services the investors rely on.

I believe the interconnection between the Cayman Islands, the service providers in the dominant centers New York and London and the hedge funds themselves, has enabled Cayman to grow at the rate it has done. The migration of managers in the late 90s onwards from the U.S. to London in order to access European investors again helped the development of the Cayman Islands, because they took with them a preference of their legal advisors, their administrators and their auditors for Cayman, because they already knew or worked with service providers here.

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That same pattern was repeated with a number of the firms opening up in Hong Kong in the late 90s. A couple of the law firms were the pioneers there, but globalization of the administrators' also helped, plus the forceful advocacy of the Cayman Islands Monetary Authority and its private sector cohorts.

Darren Stainrod

UBS has been active in the Cayman Islands for over 30 years; initially through wealth management and trust services, which contributed to the infrastructure, the expertise and the human capital that Peter mentioned, and the hedge fund services really grew out of those roots.

UBS Alternative Fund Services is a typical example of the dynamics of how the administration services branched off. We had a trust client who had a fund domiciled here. They then wanted to have the accounting performed here too, then another client did the same, and so on. In order to facilitate these services, UBS carved out an administration specific unit in the late 1980s. Therefore when the hedge fund industry started to take off in the early 90s, we were well

Obviously Cayman is a jurisdiction where it is easy to attract professional people from overseas. It is tax-friendly, has a nice climate and lots of things to do. We have pretty good immigration laws, so it is possible to bring in very qualified people in sufficient numbers to run a large financial business.

As Don and Peter alluded to, it worked very well to have the friendly regulations which attract hedge funds - for example without limitations on the strategies that they can trade or the amount of leverage that they can use - combined with the sufficient regulation to protect the investors, like requiring audited financials and good anti-money laundering (know your customer rules). So there is sufficient regulation, but it is friendly enough for hedge funds to make the domicile attractive to them.

This infrastructure together with the human capital, like the number of highly qualified lawyers, also lays the ground for meaningful innovation like the SPC structure, or the specific unit trust formulated for Asian clients, and I believe at the moment there is some work going into Shari'ah-compliant products for the Middle East, and so forth.

There are always a lot of discussions and close consultations going on between the private sector and the government bodies. Drafts are widely circulated and discussed so that all interested parties have had a say before they are actually enacted.

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Jennifer Frizzelle

I echo the sentiments expressed by the group, but would like to touch a bit more on talent. Cayman has a very deep pool of talent, especially relative to its overall population, that really knows, understands and has been intimately involved in the development of the alternative investment industry. You would be hard pressed to find another jurisdiction with such a concentration. And it is quite clear that this industry is very much ingrained into the fabric of Cayman. Clients certainly find it easy to do business here. You will find that the various service providers -



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Clients certainly find it easy to do business here. You will find that the various service providers - administrators, lawyers, directors, accountants – work fluidly with the legislators and regulators. And even better, they understand each other. This in turn creates a simple and comfortable environment for investment managers seeking to domicile and service their products here.

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Peter Cockhill

It is hard sometimes to pocket things into neat categories, but there are a number of advantages that Cayman enjoys: one would be it's geographical proximity to the largest economy in the world. Technological innovations and telecommunication improvements have coincided with the bull run of the last 15 years and the development of alternative investments.

Another factor, as Darren mentioned, is the fact that it's been very welcoming to capital. Cayman has encouraged talent to locate here by not restricting ownership of law firms and financial services businesses and these in turn have become very significant local employers. This has enabled the economy to leverage off foreign know-how in order to create local know-how and as a result of this we have a disproportionately qualified local work force. This aggregation of talent perpetuates itself and underpins the industry. A related benefit is the Cayman diaspora. We have a huge number of people through organizations such as Citco, UBS and others, where people who held senior positions in Cayman have migrated to offices in cities like Toronto, New York, Amsterdam, London, or Dublin and they actually partially seeded those operations with the human capital coming out of the Cayman, so there is a flow of intellect moving both ways.

It has been a combination of factors. Cayman has had some luck with timing, proximity, cultural affiliation (our English common law background and English language) and technological advancements. It has been smart in capitalizing on those advantages by encouraging and developing human capital and being highly responsive to its end users in the manner it regulates and delivers its services.

Matthias Knab

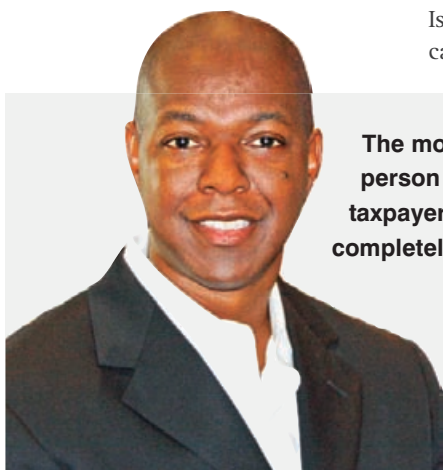
While true finance professionals obviously are familiar with this background and the mechanics of global investing, it seems that the Cayman Islands have a kind of image problem in some countries or some mainstream media. What goes missing in this public perception? Is there something that you want a nonprofessional to understand better about the offshore regulations and services?

Don Seymour

The most important point is that there is absolutely no tax advantage to be gained by a person who is ordinarily subject to tax in the United States. This notion that an U.S. taxpayer can gain a tax advantage through using a Cayman Islands hedge fund is completely wrong.

This thinking, which has been circulated in the U.S. as a common or a popular idea, that people using Cayman Islands hedge funds would be evading tax is absolutely incorrect on every level.

It would also be very instructive for them to understand how sophisticated the Cayman Islands are as an offshore financial centre. US Congress recently proposed that hedge funds register with the SEC, maintain an anti-money laundering regime and improve disclosure requirements. The Cayman Islands has implemented these proposed initiatives since 1993. In many ways the US is just catching up with where the Cayman Islands have been for the last 16 years.



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Don Seymour

Darren Stainrod

You are absolutely right, there are only limited and clearly regulated vehicles any U.S. investors can buy into. One is through an offshore vehicle, in which case they have to be a tax-exempt organization in any case, or through a U.S. vehicle, which is administered in Cayman, in which case we supply the K1s reporting the holdings and income of all investors in the fund on an annual basis to the IRS. So absolutely, there is zero tax evasion within the structures of the funds industry within Cayman.

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Darren Stainrod



Peter Cockhill

There is an image problem in the popular media for Cayman that we are addressing at the moment through the reinvigoration of the Cayman Islands Financial Services Association. The association has engaged PR consultants and lobbyists in the U.S. and in the UK in order to ensure that correct and unbiased messages are conveyed.

Having said that, there seems to be a clear confusion in the minds of reporting journalists between the idea of squirreling away money in a tax haven and the use of Cayman Islands, which is a jurisdiction cemented into the global international financial network. As Don and Darren just said, there is no possibility to hide tax receipts that should be declared through a Cayman end product, because Cayman funds are not an end product. If you reside in a country that imposes tax, you will have to account for whatever receipts you receive, whether they are aggregated offshore or onshore, this is a matter for the local jurisdiction.

Cayman is receiving a political bashing because there are a lot of fiscal deficits in the onshore world and some of the leading economies have increased their tax rates to pay for the shortfall in their governmental funding. That is their right and their business. Unfortunately, fear of tax leakage is leading some politicians and bureaucrats to target Cayman on the grounds that it does not impose direct taxes so therefore it must be engaged in a scam of some kind. Cayman and "offshore" have also been tagged with some responsibility for the financial crisis. However, as a

number of leading economists and regulatory oversight bodies have pointed out, and as CIFSA will repeat with increasing vigor, the origins of the financial crisis have nothing to do with Cayman or, really, with hedge funds. The failures were with onshore banks and their regulators. Cayman presents a convenient scapegoat, but we believe that as the analysis does not bear out the allegations, we should be able to address this poor image in the popular media.

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Peter Cockhill



Jennifer Frizzelle

Actually Cayman has been progressive with its tax information sharing arrangements. Coupled with the development of sustainable business, it's disappointing that its tarnished public perception hasn't been replaced.

Over the years, there have been a number of representatives from different countries that have come to investigate, whether formally or informally, practices in Cayman. Typically the findings conclude that there is a sound regulatory culture, sometimes even more robust than larger countries. Unfortunately, these conclusions do not make it back into the mainstream media. Perhaps it's contrary to what the public wants to believe.

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Certainly those residing in Cayman can contribute to these discussions via CIFSA and other means, but real dialogue really should involve onshore parties who have used Cayman as a domicile and service center. These individuals have first hand experience of the regulatory requirements, tenacity of service providers, and commitments to quality. They can most effectively dispel these inaccurate portrayals. Cayman has become a key component of the global financial landscape for legitimate reasons, and everyone in the industry shares in the responsibility to articulate this fact.

Darren Stainrod

This discussion is not about the realities; it is about changing the perception. Recently the reality was highlighted a number of times in well-reported tests where people have tried to setup shell companies around the world, and the easiest places were always London and New York, whilst in Cayman and other offshore jurisdictions there is just no way to do this without providing significant due diligence including disclosure of ultimate beneficial ownership and trading purpose of the company.

From our perspective, we often found that offshore clients are absolutely used to providing all the

anti-money laundering and know-your-customer (KYC) documents, and we generally experience more difficulty in getting the same documents within the U.S. entities from U.S. investors - they are just not used to having to provide all that information. You can really see the difference in the standards between the offshore and onshore jurisdictions, and yet it's the onshore jurisdictions that are slinging the mud in these situations. But obviously, they have the weight. So definitely this is about how to change that perception and a lot of working groups are trying to do just that, but it will be a long and difficult process.

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Darren Stainrod



Don Seymour

The inevitable question that arises is "why are you using Cayman if you are not avoiding tax?" The truth is that Cayman is a successful jurisdiction, not only because we have an effective regulatory framework, but because of the enormous professional talent available in the jurisdiction. Cayman lawyers, auditors, administrators, and other service providers are among the best in the world at their craft. That fact may be humbling to some more established jurisdictions, but I hear often from the leaders of multinational organizations that Cayman service providers are the standard by which they judge other service providers in the various jurisdictions that they operate in around the world. So again, Cayman professional talent is number one when you move offshore.

Secondly, investing from the Cayman is tax neutral. There are over seven million words in the U.S. Tax Code. Imagine the complexity. There are no taxes on commercial activity in the Cayman Islands so this simplicity becomes a tremendous advantage in structuring since there is not an

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Don Seymour



additional overlay of complex taxation. The code here is completely tax neutral, and that makes the Cayman Islands so pivotal in global finance. This efficiency helps allocate capital throughout the global financial world using first class talent. Much of the negative propaganda is being promoted by less successful competitors who are simply finding it difficult to compete with the first-class talent in this jurisdiction.

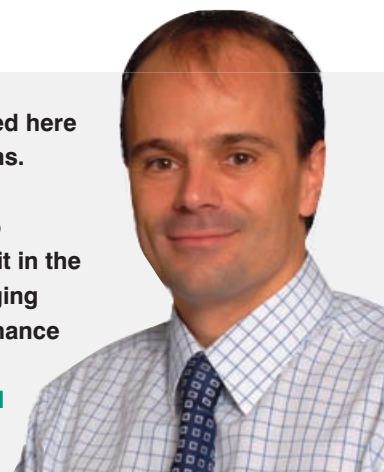
Peter Cockhill

Cayman is an aggregation, structuring, and allocation center. The money gets aggregated here because it doesn't attract transaction taxes, here there is no extra stipend on transactions. If you are a New York manager and you're seeking U.S. tax-exempt investors, then you need an offshore fund which is a look-through for U.S. purposes, so you're not going to get additional taxation in respect of the fund vehicle. Individual investors will pay their tax according to the tax laws of the country in which they are domiciled.

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If an asset manager that tries to access international investment capital, they need to go somewhere where investors are not penalized for aggregating their capital. So they put it in the Cayman Islands, but the money doesn't stay here - it gets invested for example in emerging markets, into the U.S. or an established European market, it could be going into microfinance or TALF funds. Over the last three months we have set up quite a few TALF funds.

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Money is channeled and aggregated offshore and then goes back onshore. Given Cayman's image problem it is ironic that some of these funds are set up to help sort out the problem that emanated onshore due to the combined effects of low interest rates, an asset bubble and lacks regulation of their financial institutions. I am not claiming that this makes Cayman a morally good jurisdiction, but making a point about its efficient and important role.

Matthias Knab

Can you share with us some recent developments within each of your practice areas that are relevant for the financial industry?

Darren Stainro

Over the last year, the asset losses across the global hedge fund industry have of course affected the Cayman as well, resulting in decreased revenues for many service providers as well as the onshore managers. Another often-overlooked development is that the complexity of servicing to hedge funds has substantially increased. An example of this would be the accounting rules as they attempt to catch up with the financial situation in terms of fair value accounting rules, and ever more disclosures etc.

Secondly, the products themselves have become more complex in terms of trying to deal with the illiquid securities by the use of side pockets, SPVs, managed accounts and other kinds of structures. All of this has created a lot more work for administrators, law firms, independent directors and audit firms. The obvious challenge is dealing with this increased workload while at the same time asset based revenues have decreased.

A third challenge is keeping up to pace with technology. While this is an issue that is always there, it becomes even more difficult in an environment of shrinking revenues and budgets. Of course One positive development is that it has become easier to hire talent, and staff turnover has become less of an issue. I am probably stating the obvious here, but the human part is very important to the administration business, especially for UBS' business, which is very strong in servicing funds of funds. Administering funds of funds can still involve a range of manual processing, where it is vital to have good, qualified people, who care about what they are doing, and are able to develop and maintain good client relationships.

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UBS also has a full banking license in Cayman, which is a definite strength within the fund of fund world, particularly when it comes to processing at month ends when deadlines are tight. That has really been one of UBS' strengths here in Cayman and is one reason why UBS still has a very large presence here.

One other trend is the increased demand for credit facilities. This is something we have always provided, but especially in Q4 2008 and to some extent in Q1 2009 the increase in demand has been enormous. Funds of funds in particular struggled to get liquidity from gated funds and so forth, which led to that mismatch between the liquidity terms within the funds of funds and those of the hedge funds themselves. To bridge that gap, the funds of funds looked to the administrators and the providers of credit.

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That was compounded by the strengthening of the U.S. Dollar. A lot of hedge funds and funds of funds derive their investor base from Europe and Asia. Many investors come into a fund in Euro, GBP, Swiss Francs or Yen classes. As the U.S. Dollar strengthened at the same time the redemptions were coming in Q4 of 2008, there were large unrealized losses in U.S. Dollar terms, which put additional strains on liquidity right at the worst time. This led to large demands from funds of funds clients for extra credit facilities to bridge the gap during that period. At the same time a lot

of other credit providers were exiting the game and leaving clients without facilities. These dynamics have eased off now that the USD is weakening again, redemptions have slowed to a trickle and many funds are opening their gates.

Peter Cockhill

Darren put his finger on the mismatch between the levers within hedge funds and the stresses and strains caused by liquidity requirements and the illiquid nature of large portions of the underlying portfolio.

We have all seen a lot of development on the operational and legal levers required to address that mismatch. Creative structures and solutions were put in place, and a lot of investor liaison and compromises had to be reached between funds, managers, directors, and new investors. This is still work in progress.

Going forward the benefit for the industry is that now these structures and procedures are either tested or being improved on. For example, some of the new offerings now have a rather more bespoke nature, we have seen a lot more hybrid funds.

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There has been disgruntlement where people say they came into an open-ended fund and wound up with a closed-ended investment due to the side pocketing. As a result, we now see that a lot more funds are setup envisaging some form of private equity and co-investment. They are being more closely scrutinized to ensure that they have the mechanics to operate in the environment which they will be investing in, whereas previously a lot of products were off the shelf and weren't necessarily very well aligned to the universe in which they were investing. This is a distinct improvement.

The other trend is the macro level regulation that is on the horizon. I think Cayman is well set in that regard. How things will pan out remains to be seen, because there is a lot of political bickering that will go on for some time. I would hope that we will see accepted global standards of regulation of managers. This will really play well into Cayman's hands, because we already have a well-regulated jurisdiction here. I also hope that as a result of this process the myth that Cayman is a "tax haven" will be disposed of once and for all and we will be recognized for what we are: not a lot different from New York or London, except that our tax code is a lot smaller, and the ease at which one can do business and the immediacy of dealing with a small jurisdiction will continue to be a structural advantage for Cayman.

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In terms of the overall industry, we are in a recalibration like everywhere else in the world. I think the frothy days are over, but we still have a very strong business. However, we will not be improving on the number of setups and the level of regulated funds that were there last year. There have been closures and there are still a lot of funds that are working their way out through their redemption process. This can continue in some cases for another 15 months.

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As independent directors of hedge funds, our major challenge has been dealing with investor dissent during the global financial crisis. We have seen serious dichotomies emerge between different investor groups within the same fund structure about how best to manage liquidity and to respond to unprecedented problems created by the global financial crisis. Generally we have found fund-of-funds investors needing liquidity now at any price, while other investors like endowments preferring a longer term horizon and wanting to preserve future value. Often, the margin between the differing views has been very narrow, sometimes just a few percentage points.



Where no clear consensus has emerged the minority are sometimes not satisfied with the preferences of majority, notwithstanding being bound by majority rule, so dms directors have had to go back and work with legal counsel to devise some very imaginative solutions to satisfy the needs of both constituencies, often making significant and pioneering judgment calls.

As a local regulatory update, let me mention the creation of the Cayman Islands Directors Association. We created the first professional, self-regulatory association that will comprehensively address the unique needs of the professional directorship industry practice in the Cayman Islands.

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Together with that, various valuation challenges have come to the forefront. There are new guidelines which I am sure Jenny will address too: which assets go into which buckets, making the right decisions about Level 1, Level 2, Level 3 assets and getting the boards involved with that and checking if all those decisions make sense.

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The association currently has 140 members, including all of the leading professional directorship firms. There are series of seminars planned to provide thought leadership and issue statements of guidance on fund governance matters. CIDA has already issued the first code of conduct to govern the professional behavior of its members. I think that over time, if not now, it will become the most authoritative voice on the directorship profession in the Cayman Islands. Due to the dominance of the Cayman Islands in the hedge fund industry, it should also become a leading force for fund governance throughout the offshore industry.

Jennifer Frizzelle

As you can imagine, the accounting industry has had a very, very challenging year, especially as it pertains to fair value.

Don alluded to FAS 157, which requires the classification of assets into three different pricing categories based on valuation inputs. 12 months ago, this was poised to be the most significant challenge to the busy season. But with liquidity challenges in the market, once-simple fair values became very complex. How would Lehman assets be marked? How would credit risk be reflected in the value of derivative contracts? In certain instances, our clients were in uncharted waters. Disclosure of the fair value method suddenly became the easy part of the equation. The determination was the tough part.

These challenges had significant resultant impacts, especially in the fund of funds world. In cases of uncertainty, known or unknown, surrounding the fair values of assets in underlying portfolios, what impact did that have on a client's ability to mark their positions to a reported net asset value? And how about liquidity constraints as a result of redemptions or gates?

The AICPA issued draft guidance recently supporting the general consensus that the net asset value is only the starting point to a fair value mark. Discounts or premiums should then be applied based on an evaluation of a host of considerations, including those noted above. There isn't a "one size fits all" solution.

This means that clients and their auditors have been required to apply greater levels of judgment than in the past. Audits are requiring more time, the outcomes are uncertain and costs are increasing. And no doubt everyone is aware that the application of judgment can be easily questioned in a litigious environment.

The standards continue to be redefined, not only on the U.S. side, but internationally as well. For example, the IASB recently released updated guidance on the evaluation of an active market. Because there can be slight variations in concepts, the financial industries would benefit from convergence of fair value standards in the very near term. In reality, this will take a number of years.

Don Seymour

To add to that, I think one thing that I really had to re-learn or re-think during this whole crisis was the market value concept. I used to believe, or I grew up believing that the market is efficient and there are willing buyers and willing sellers, and at some price you can find that equilibrium.

But what happens when you have unwilling buyers and unwilling sellers, this had not been conceived or wasn't included in any market theory. It was just difficult for me to understand that nobody wanted to buy at any price, that liquidity was totally gone from the market.

We had a situation just yesterday where a valuation of a bond was suggested to us at 60. The service provider went back and pushed the dealer for a bid. The dealer then said "if I had to buy that bond, I would buy it at 25, but the 60 is not a bid, it's just our estimation of the value"

Further inquiries revealed that this dealer has a fund, a proprietary fund or some vehicle in which they hold the same bond, and that fund has it marked at 60, so they felt for their litigation

protection or for whatever reason they could not suggest any other price. But in the end, the conversation between the service provider and the dealer was if they had to buy the bond, they would be bidding 25. Issues like this raise serious questions about valuation practices.

These values may be strictly in accordance with the offering document requirements to use independent dealer prices, but raise serious questions if a fund is suspended because all investors have tendered redemption requests. If the Fund was forced to sell those securities today, it would achieve a dramatically different price. What do you do now? Do you follow the offering document or do you adopt what the liquidation price because all investors have tendered their redemption

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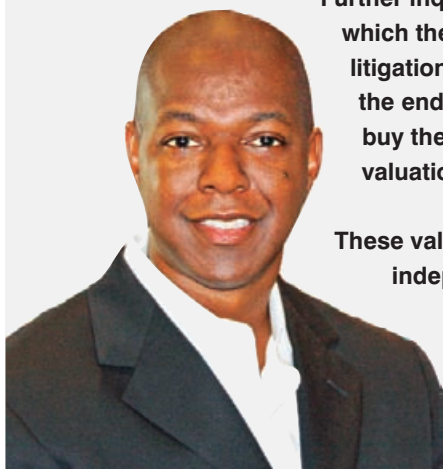
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requests clearly signaling that they want to exit the fund.

This shows some very serious discussions and decisions that boards have to make about valuation issues that require the highest business judgment, not simply the application of abstract concept. To continue Jenny's comment about the litigation risk, some boards have been challenged because of these narrow splits or decisions they had to make. Some boards were challenged about whether or not you can drop a gate retroactively. What does redemption mean? When is your redemption actually affected?

There are cases pending in the courts that should give some clarity on what a redemption means and how liquidity can be managed in distressed circumstances.

Jennifer Frizzelle

There is no question that parties, including investors, are more interested in fair value sources than ever before. Personally, I believe this is a good thing. For example, you cannot just get a counterparty quote and be done. You need to understand how the quote was derived. Was it from a market maker? Was it based on recent trades? Or was it based on a model? If it was a model, what were the inputs? These are important factors to understand.

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Another observation is that we are seeing a lot of activity around valuation committees, whether it be defining approaches, formalizing policies or simply establishing them. This is a positive trend. One could arguably say that these steps should have been taken earlier. There is no doubt a heightened awareness of responsibilities surrounding valuation.

Darren Stainrod

The industry, having worked through this crisis together, has definitely closed a lot of gaps in many ways. The communication between auditors, administrators, directors and the managers is a lot closer now. These valuation committees, if they didn't exist before, have been forced into existence by the requirement of having to deal with these issues on a regular basis.

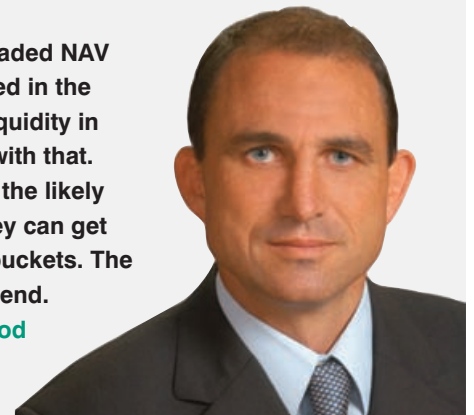
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We have always had to revalue all of the funds assets before issuing an NAV, so there has not been a major shift for us. However, it was fairly standard with the industry a few years ago for a lot of administrators to carve out the level 3 type instruments and just say "this is not our job, we are not expected to look at this, we don't have the expertise." Now it is accepted as the job of the administrator to be at least validating the prices to independent sources, so that whilst they aren't directly responsible for the valuation, which ultimately falls with the Directors, the administrator is now usually at least responsible for ensuring that these prices are reasonable. So the administrators should at least be rechecking and aware of any significant material differences in a manager's valuations to the markets, which has forced again a lot more work on the administrators in terms of validating and revaluing those prices, as well as dealing with the managers and auditors in many cases.

In the fund of funds world, receiving bad prices from the sub-funds has also created a lot of problems. It may be okay for a hedge fund to side pocket the issue, but when it is the fund of funds that owns both the ongoing class and the side pocket, what does that fund of funds then do when it comes to receiving and updating estimates? It is very hard to get estimates and prices on side pockets, as by their nature they are holding the illiquid items. We have seen fund of funds side pocketing the side pockets or having to restate a lot of prices that they have traded on due to poor estimates, which has created a whole lot of problems.

On top of that there is the issue caused by FASB 157 of the difference between traded NAV and fair value NAV, whereby the prices received from sub-fund administrators used in the traded NAV of a fund of funds need to be discounted according to a view of it's liquidity in the financial statements. We have had different ways in which clients have dealt with that. Some looked individually into each sub-fund, assessing on a detailed basis what the likely recoverability is. Other clients have bucketed sub-funds according to whether they can get out in three months, six months or a year and then applying a discount to those buckets. The issue came up early in the year when some clients had already finalized the year-end.

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Jennifer Frizzelle

Documentation has become a critical requirement. Believe it or not, we would receive pushback on this in the past. Now, there is no question. When there is an estimate or judgement applied, a written document needs to be in place to support how that fair value estimate is reasonable at that point in time.

Matthias Knab

Don, you mentioned that the recent market crisis caused you to rethink some of the assumptions or beliefs on market efficiency and price discovery. There was recently an informal survey at a congregation of U.S. professors teaching economics, and they asked them "how many of you do believe in efficient markets", and of all the hundreds maybe two and three raised their hands. Then they asked "well, and how many of you are teaching it?" This is exactly the dilemma here, we have to come up with a new market theory.

All of you at this Roundtable here have the advantage to be intimately tied into the global hedge fund community and can see many signals before a lot of other people. What do you see happening regarding new fund launches or asset flows? What are some of the most recent developments?

Peter Cockhill

The industry was in a state of retrenchment until quite recently. We set up a lot of funds that didn't find a home or get started, and subsequently their fund formation process became rather elongated. This started in September 2008, and by the time we reached Christmas, there was a very marked slowdown, but this has picked up again.

Right now there are a number of emerging market funds launching, U.S. bailout funds, and more traditional distressed debt and long/short equity funds, which I think is healthy sign. It shows that there still is true venture capital out there and money looking for nascent markets to allocate to.

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Of course, part of the reason why there is not a complete retreat on a global scale is that many markets in the established economies are still going nowhere, so this trend may also ebb and flow as the leading economies find their way out of the current crisis.

As I mentioned earlier, we are seeing more effort and work going into the structuring work of the funds. There is more due diligence from the investors who are coming into the funds, they are requiring certain representations and also check on the fund's service providers.

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Sovereign wealth funds and some of the large funds of funds are looking for bespoke co-investment, rather than going into a commingled vehicle. So for them additional partnerships or corporations are created which will then be managed by the manager alongside the fund vehicle for everybody else.

Additionally, I believe that we will also see an ever-increasing move towards probity, which will help a jurisdiction such as Cayman. People want to see a complete separation of duties and responsibilities between the service providers, and they want to see that those are organizations of stature. In Cayman, unlike most other offshore financial centres, it is possible to hire all the service providers in the jurisdiction without compromising on quality or reputation.

Don mentioned already that there will be more litigation as a result of the frustrations of some investors who are looking to take their money out of a fund at any price, versus the longer-term oriented investors. Our litigation department is as busy as it has ever been, some of that is posturing, but some of it will wind up in the courts and ultimately will provide additional precedent, which will help guide us in the future conduct of operational and legal structuring of the funds.

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Sovereign wealth funds and some of the large funds of funds are looking for bespoke co-investment, rather than going into a commingled vehicle. So for them additional partnerships or corporations are created which will then be managed by the manager alongside the fund vehicle for everybody else. But of course a sizable allocation is required to make that worthwhile. While we have seen a certain shift into such set-ups, I don't think this will become a predominant structure by any means.

The big unknown is that whether or not the coming regulation will be proportionate. We know that the managers will be regulated, it looks like there will be tax changes in some of the jurisdictions, and the carried interest may well disappear in the U.S. There is definitely enhanced regulation yet to take place in the UK; and now whether this could be a full Europe-wide solution remains to be seen, but there are other parts of the world, and there are a lot of global assets that managers can access.

My gut tells me that we are going to see enterprise whereby managers from established jurisdictions, if they find they cannot access the capital they would otherwise, will be setting up operations in other regions like Dubai, Doha, Singapore, Hong Kong. They will go to places where they can work with proportionate regulators and will still be able to attract international money, because there is an enormous amount of opportunity out there. From a Cayman-centric perspective, the threats that face the industry are also opportunities.

I personally hope that we will be getting the coalescence Jenny referred to, including single valuation standards and principles of accounting standards. This will be good for everybody and will give us the transparency that people are looking for.

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Darren Stainrod

The industry will continue to move towards independent directors and independent administrators following Madoff. It is quite clear that the blow-ups and Ponzi schemes linked to hedge funds seem almost only to have occurred in the U.S.

Europe has had issues within the banking industry, but from the hedge fund side the problems experienced in the States did not come up because of the regulation, especially the upfront requirements to be a registered manager. Also in many European and Asian countries it is mandatory to have independent boards and independent administrators, and as a result there has been minimal fraud around hedge funds in Europe and Asia. This is obviously in stark contrast to the U.S. where a lot of fraudulent activities are being uncovered. The current state of affairs damages the perception of the industry and is something that must be addressed through either regulation or investor demand for increased security. Already we see many of the remaining self-administered hedge funds, whether they are the smaller ones or some of the very large ones with very good reputation and infrastructure move to independent administration.

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For the small price of ten basis points or so they will be getting that important comfort level for their investors. These days, it is easier to pay that than having to continue the constant conversations with investors trying to justify and prove that the infrastructure and the controls on the fund's side are adequate and sufficient.

Don Seymour

This will probably be the most obvious statement ever, but I think that the Madoff scandal is a big wakeup call for the industry. But before I get more into that, let me mention briefly our firm is seeing new growth and developments stemming from the dichotomies I mentioned earlier about having investor groups with different views in the same vehicle. As a consequence, we are seeing new structures for large institutional investors being created to mitigate against these problems in future.

Large institutional investors are requesting managers to setup a single hedge fund structure just for their particular investment. This is a variation on the traditional manager's use of a separate account structure, but on top you have the infrastructural protections of the offshore hedge fund such as the independent board, the independent administrator, an audit plus an effective regulatory framework. This gives them that comfort that didn't exist in an environment like Madoff. Even though Madoff wasn't a hedge fund, you see lessons learned from Madoff fraud being implemented throughout the hedge fund industry.



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Another trend I see is the trend towards outsourced due diligence services and these firms are proliferating again because of the Madoff fraud.

From our perspective, we see three clear themes in the industry. One is independence, which has become a key feature. People want an independent administrator, independent service providers. Before the crisis, there was probably an over reliance on the manager to basically do everything. The call for more independence includes of course more compliance, where more entities are checking on all relevant aspects of running a fund.

Then the other theme is certainly transparency. We have seen greater efforts from investors to gain more transparency into the fund and its operations, which in the end goes to operational risk control. Many years ago the hedge fund model was the "two guys in a basement" operation, and the focus was how well one could trade. Operation functions were viewed as cost centers and unnecessary overhead. But today, Madoff made people realize that 65 billion dollars can disappear overnight simply because of poor operational risk controls. Madoff allegedly didn't lose or have one dollar at risk in the market. All the losses, all 65 billion dollars can be attributed to massive fraud enabled by lax operating controls. If one just focuses on portfolio performance and not effectively managing operational risk, one can still lose stupendous amounts of money. The demand for greater transparency and protection is being addressed by some large investors by establishing a single hedge fund structure just for their investment, where they can set and better control the parameters for some of these operational risk issues.

The last theme would be infrastructure, which goes with the operational risk issue. Investors today want to see a well-developed and effective infrastructure surrounding their investment.

Jennifer Frizzelle

Business is certainly not at pre-crisis levels, but we have experienced a nice little pickup in the last few weeks, especially out of our existing managers. Hopefully they are applying prudent approaches and ensuring that they are able to retain or grow capital.

Darren Stainrod

What we haven't seen though is the huge number of funds closing to the extent it was feared or anticipated. While there was talk of 30% or even 50% having to close down, that number seems to be more like 5-10%. It could be that at the moment some managers are hanging in there, waiting desperately to see if money will flow back into the industry, so some closure are still coming, but currently we are certainly only seeing 5-10% that have closed or indicated to us that they will close. There may be a small number of funds that probably haven't got very good chances of surviving, but those are few and far between.

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For the funds of funds, with the banking license here we hold their cash, and this has been near record levels since the beginning of the year. I don't know whether they anticipate bigger redemptions or if they are waiting for opportunities to arise and the confidence to come back, but certainly there are significant amounts of money on the sidelines within the funds of funds business. Just from our firm alone, if that were to be redistributed to normal levels back into the hedge funds, that would mean several billions of dollars back into the industry.

Apart from these funds, people have sidelined huge amounts within cash funds. So once confidence picks up, that will inevitably be reinvested. Whether this will flow into alternatives like hedge funds and funds of funds remains to be seen, but the indications we get from conferences and surveys is very positive.

Darren Stainrod



While assets are down at most funds, they are still alive and kicking. For the funds of funds, with the banking license here we hold their cash, and this has been near record levels since the beginning of the year. I don't know whether they anticipate bigger redemptions or if they are waiting for opportunities to arise and the confidence to come back, but certainly there are significant amounts of money on the sidelines within the funds of funds business. Just from our firm alone, if that were to be redistributed to normal levels back into the hedge funds, that would mean several billions of dollars back into the industry.

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Once that happens, new products that will compete for these funds will no doubt emerge. I don't know what the timing is, there may be another dip in the markets first, but eventually the money will come back. We already do see new products coming from certain areas; Brazil, for instance, never really suffered as much and we have enjoyed a steady flow of new business from Brazil during the past six months.

Matthias Knab

Just briefly on Peter's comment that managers may go to Singapore, Doha, Dubai etc. to run their business in the best way to seize the current opportunities. Before coming to the Cayman, I spent one week in Japan and conducted a Roundtable there that was also extremely interesting.

People forget that such a development already happened in Japan, where basically all hedge fund assets of the second largest economy of the world are being managed out of Singapore, Hong Kong, London, or anywhere else, this has already happened, because they hedge fund managers found the local Japanese regulations too restrictive. Even some Japanese nationals have moved outside of Japan to run their hedge fund out of Japan, and it takes a lot for a Japanese national to move out of the country.

There is also some positive news from Japan. The registered Japanese onshore managers told me that the Japan FSA and their inspectors have gone through an enormous learning curve, they understand the hedge fund and global finance industry much better now. There is more cooperation and the confrontation or hostility that was there some years ago has really almost phased out. So the hope is that over time, reason and cooperation may come back in the relationship between the regulation, legislation and the industry.

Darren Stainrod

Another jurisdiction that has just recently enacted very favorable legislation for hedge fund managers in particular, is Switzerland. As a lot of hedge fund assets actually emanate from the private banks in Switzerland, it makes a lot of sense to forge legislation there to capture those assets and attract managers to the country. Switzerland may definitely be a jurisdiction that could gain through such policy changes, especially if tax rates and laws in traditional centers like London become less attractive.

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Darren Stainrod



Matthias Knab

Don you mentioned this morning that actually the past 12 months were really a huge stress test for the global hedge fund industry and for Cayman in particular. Could you please elaborate a bit on that?

Don Seymour

As a former regulator, I have seen a lot of propaganda cast against the Cayman Islands like "you have too many funds, how can you service this universe responsibly", and so on. There were assertions that the Cayman Islands service providers are under-resourced based on the amount of business that is here. I believe given the size of our industry relative to the population - as Cayman is so dominant in the offshore financial industry - those questions have been raised, but I think Cayman has passed the big test with flying colors.

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I don't want to overstate the case, but throughout the global financial crisis - whether it was challenges posed to the directors, auditors, administrators, or to the legal counsel - all service providers rose to the challenge and worked effectively together to try to protect and maximize the interests of the investors in Cayman funds. It was an extremely difficult and stressful time but everyone performed brilliantly.

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challenges posed to the directors, auditors, administrators, or to the legal counsel - all service providers rose to the challenge and worked effectively together to try to protect and maximize the interests of the investors in Cayman funds. It was an extremely difficult and stressful time but everyone performed brilliantly. There were absolutely no failures among Cayman service providers and I think that is truly a real credit to the strength of the talent in this jurisdiction. I think that we have come through well; and while no one has a crystal ball, so no one knows if there will be a second wave, but at least where we are now I would state that Cayman Islands' financial industry and regulators have met the test and passed with flying colors.

Jennifer Frizzelle

I believe you are right; everybody did well. I would also argue that the industry is going to come out stronger as a result of having gone through the crisis.

The move towards a full operation model, from one that was disproportionately focused on asset management, is positive. Parties are revisiting the best practice frameworks developed by the MFA, AIMA, and the President's Working Group.

These frameworks involve independent directors, independent administrators, a focus on valuations and robust compliance. No doubt this will make the industry far more sustainable in the long term. We may have lost a few funds along the way, but hopefully the funds that survived will be stronger because they have withstood the challenge and adapted appropriately.

Darren Stainrod

I agree with Jenny and just want to point again to the potential risk of an overkill of regulations and legislations from the U.S. or Europe that could damage the industry. Most people agree that improved regulation and legislation is needed, but a knee-jerk reaction like the approach the E.U. wants to follow according to the Commission's draft Directive on Alternative Investment Fund Managers for example would challenge the industry yet again. The type of regulation that needs to come out should be sensible and not an overreaction.

Peter Cockhill

We are going to see changes like less leverage employed by funds, the Financial Stability Board looks at systemic risk, how many hedge funds that will affect is going to be interesting as it is likely not to be many as only enormous funds could pose a risk to the system. But I think we are

One might say a modernization or evolution is happening. Hedge funds and alternatives will still be different from long-only funds, they won't be turning into mutual funds, but it is like a growing up process. We went through our first life-circle, a bit like entering middle age from youth. It may not be as exciting as before, but we have a lot more experience and tools available now. I believe there will be a continued demand for structuring administration centers like Cayman. The game is changing, but it is far from over.

Peter Cockhill



heading for calmer times, and a lot of the changes are tied to the banking world. Banks are going back to taking deposits, and it appears there will be a separation of investment banking and proprietary trading from taking in people's savings.

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Don Seymour

When I look at the proposed legislation coming out of the U.S., I would say that Cayman is actually more sophisticated than even what is being proposed there. The U.S. proposes to register hedge funds, while Cayman has been registering hedge funds with its regulator CIMA since 1993. The US is also proposing that hedge funds have a proper AML regime – again Cayman funds have had proper AML regime for over a decade. Another proposal is to provide better access to information. CIMA requires the fund's annual return where the fund's positions, its counterparties, leverage levels and other material information is reported to the regulator on an annual basis. In addition we have the requirements for annual audits here as well, which hedge funds in the U.S. do not have.

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So even if the US legislation would be passed in full - with the exception of the requirement to disclose the identity of the investors in the fund – the US legislation would merely just be catching up with where the Cayman Islands is already, because Cayman hedge funds are already that sophisticated.

Don Seymour

So even if the US legislation would be passed in full - with the exception of the requirement to disclose the identity of the investors in the fund – the US legislation would merely just be catching up with where the Cayman Islands is already, because Cayman hedge funds are already that sophisticated. So my view is that the Cayman Islands doesn't feel threatened by this legislation or that it has the potential threaten the future success of our jurisdiction.

The other directors in my firm asked me to send out a recommendation or invitation via this Roundtable to the global hedge fund and hedge fund investor communities to actually visit the Cayman Islands more. As the consensus is that going forward infrastructure and independent service providers are more important, coming here, meeting with the firms and people here actually seeing what is going on will be very helpful. So come in, visit your directors, administrators, auditors, your legal counsel, look at the operations or meet with the regulators and see how professional this business is operated and managed here. This will go a long way to dispel any notion or propaganda that serious business doesn't occur here.

Matthias Knab

I would agree, this is my first time to Cayman even though I had been very close to here before when I was chairing conferences on the Bahamas or three years in a row in Miami. After having spent about one week here on the Cayman, where I also was involved with a conference for two days and the rest busy meeting people and operations here, I agree with your partner's thinking.

I met a lot people, service providers, regulators; I have visited a number of operations and I am impressed with the professionalism, efficiency and dedication. Opalesque being the leading alternatives publisher, we have a large number of readers and clients here on the island, so as a matter of fact I say to myself and to the many people I met here that it was quite foolish of me not to have come earlier.

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