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REGULATION

How to set up an alternative fund

ADMINISTRATION

Laying the foundations for change

LEGAL

Changes for the better?

An alternative view

Julian Stockley-Smith talks to *Asia FM* about the advantages for hedge funds setting up in the Cayman Islands, thanks to its positive approach towards alternative investment

There are a number of critical decisions an investment manager is faced with when launching a hedge fund. These include cost, regulation, governance and compliance – the choice of fund domicile will therefore be a key part of the decision making process.

Key considerations, whether for an emerging or experienced manager, are:

- What is the strategy?
- Which investor groups are able to invest in the strategy?
- Which investors will have an appetite for a particular strategy?
- Who are the likely investors (institutional, high-net-worth or retail customers)?
- Where are they domiciled?
- What is the regulatory environment like; how much time and cost is involved in compliance and regulatory oversight?
- What service providers will be used?
- How cost-sensitive is the fund or business going to be?

These questions are not dissimilar to those posed by principals of the JP Funds Group when establishing the fund services business, both for itself and the market professionals it supports within the fund industry. While the group has the ability to facilitate fund structures based in a number of jurisdictions, the overwhelming domicile of choice remains the Cayman Islands.

By any reasonable measure, the Cayman Islands is the leading offshore hedge fund centre in the world. The claim of being the leading jurisdiction is based on the number of alterna-

tive investment strategy (or hedge) funds registered there, with more than 10,000 hedge funds representing in excess of 80% of the world's hedge funds domiciled there.

The ongoing Cayman success story is born out of its flexible financial services and fund laws, pragmatic regulation and presence of locally-based fund servicing professionals (including lawyers, administrators, accountants and other supporting services). This success is not the result of random chance or tax treatment alone (which is now mirrored in numerous jurisdictions), but the legal and infrastructure framework that exists there. Originally, the success of the Caymans is attributed to the foresight of a number of key industry professionals in the 1990s, who were leading lawyers and accountants at the time. These individuals identified and developed the opportunities in a relatively young hedge fund industry and set about creating an environment to foster financial services and provide an economic backbone for the future of the islands.

Since then, the emergence of a strong yet pragmatic regulator, the Cayman Islands Monetary Authority (CIMA), as well as ongoing development of its legal framework, ensures the Cayman Islands maintain its position at the forefront of the offshore hedge fund industry.

The establishment of the Cayman Islands Stock Exchange also added to the scope of the fund industry in general and maintained its standing with other comparable fund centres. The CIMA is a full member of the International Organisation of Securities Commissions (Iosco)

A primary focus of regulation in the

Cayman Islands is very high standards of transparency and corporate governance, rather than increasing the often ineffective regulatory and compliance burden, in contrast to many of the other major fund centres.

This is illustrated in the recent *Weaving* case, wherein the Cayman court applied centuries-old fiduciary rules to find a fund's independent directors guilty of wilful neglect, handing down an industry landmark fine of \$111m to each of the directors. The ruling has sent a message, both to independent directors that they have a responsibility to investors, and to the world that the courts and the industry are willing to take action to ensure the interests of investors are kept at the forefront.

The roles of independent directors, independent administrators and independent auditors are critical to maintaining the integrity of the Cayman fund industry and the highest standards are expected from all participants. Cayman Islands regulatory changes have further improved compliance in line with generally accepted international standards in several areas, including anti-money laundering (AML) and anti-tax evasion; to date, the Cayman Islands government has agreed 26 international Tax Information Exchange Agreements (TIEAs). The Madoff scandal proved market reputation, licensing and regulatory oversight alone offers no protection against fraud. The same fraud made extensive use of a Luxembourg Ucits platform, which gave no comfort to victims who had already accepted the high financial price of regulation.

For the most part, the Cayman Island fund environment is permissive, provided an investment objective

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is acceptable in moral and practical terms and is fully disclosed to accredited investors. It is also important to note in Cayman it's about working with qualified investors that understand the nature of the venture, rather than expending resources dealing with more compliance and red tape than is effective.

As the regulatory burden increases in some regions of the world, the pragmatic characteristics of Cayman Islands funds are widely expected to become even more popular. It is logical that the cost of operating in a highly regulated environment will have an impact on overall performance and the viability of many strategies.

There will inevitably be some impact from the changing regulations in Europe and the US, with the net result of this yet to be seen. As previously intimated, this uncertainty is an opportunity for the Cayman Islands, given that the key global tenets of AML procedures and information disclosure agreements are already in place.

We find that qualified investors remain very comfortable with the Cayman Islands and generally have a sound understanding of what is really important in terms of the fund, including transparency, independent directors, independent fund administration, reporting and audit. Investors deterred by political rhetoric and unfavourable press are likely to have many opportunities in the future to recognise the value of a more intelligent approach to investor protection.

While Ucits and similar regimes may be excellent vehicles for retail strategies, they are clearly not the most suitable model for complex investment strategies or the alternative investment fund industry in general; it

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- *Julian Stockley-Smith*

is not anticipated they will replace the role or the standing of Cayman offshore structures. Anecdotal evidence suggests the industry is increasingly aware of the performance limitations imposed by increased costs and the regulatory constraints, as well as fundamental problems with offering complex strategies to inexperienced retail investors.

The impact of the AIFMD will be interesting, provided protectionist tendencies can be suppressed and a sensible framework is applied. We believe the Cayman Islands government is working towards recognition of AIFMD equivalency, and given that private placement rules remain in place until at least 2018, there is no immediate concern about the ability to offer Cayman funds in Europe under those rules.

The hedge fund industry appears robust and perhaps less exposed to economic malaise than one might expect; the JP Fund Group has found a steady demand for new fund structures and has recently introduced an emerging manager platform to offer a lifeline of support to those looking for professional assistance to enter the fund industry. Essentially, all the structuring, documentation, banking facilities, appointment of independent directors, independent administration and auditing is handled within the group. The nature of the structures in

this platform also create additional independence between the investment manager and the investor funds, adding to the level of overall security and transparency for the investor.

