




A NEW ERA FOR PRIVATE AND LIMITED INVESTOR FUNDS

Two pieces of legislation have been introduced in a push to keep the Cayman Islands investment funds regime at the forefront of international best practice. Under both laws, previously unregulated entities will now be brought into the regulatory framework, as Anne-Marie Leadbetter and Kevin Huys of Harbour explain.



As we usher in a new decade, we also look toward a new age in the funds industry in the Cayman Islands with the recent introduction of the Private Funds Law 2020 (PFL) and the amendment to the Mutual Funds Law (2020 revision) (MFL).

The genesis of these two pieces of legislation is a push to keep the Cayman Islands investment funds regime at the forefront of international best practice. Under both laws, previously unregulated entities will now be brought into the regulatory framework by this new legislation, and going forward the majority of fund entities will be required to register with the Cayman Islands Monetary Authority (CIMA).

Over the course of this article, we will provide an overview of these changes and highlight some of the requirements that will benefit from the appointment of professional, independent directors to these fund entities.

Rules for private funds

One of the key requirements resulting from the application of the PFL is that CIMA will require a minimum of two natural persons to be named as directors for each private fund, or at the general partner level for partnerships or the corporate director.

In addition, the law has set out specific requirements in relation to valuation, custody, cash monitoring, securities identification and audit. Appointing a Cayman-based independent director who is familiar with the CIMA regulations governing alternative investment vehicles can provide the necessary expertise to help navigate the new requirements and continue to enhance the fund's governance to assist with these and other challenges as the private fund industry grows and matures.

The valuation of private fund assets must be carried out in accordance with the private fund's valuation policy and this must be completed at least annually. The valuations should be performed by a qualified independent person, and if there is no independent party in this role then the potential conflict must be disclosed to investors.

Independent directors can assist by providing a level of independent governance to review and approve valuations and give comfort to the investors and the auditors that the investment valuations are accurate and reliable. Where third party valuation agencies are used, the independent directors can provide oversight to confirm that an independent review of the valuations has been completed which will give all of the interested parties comfort that the private fund's valuation policy has been applied consistently, accurately and equitably.

The PFL also has requirements concerning the custody of assets and cash monitoring. CIMA has noted that a custodian should be appointed, in most cases, to verify the title and existence of the private fund's assets. Further, a party should also be appointed to monitor the cash flows and ensure that these have been properly recorded in the books and records of the private fund.

In certain circumstances, this may not be practical due to the type of assets held or where no administrator or other third party has been

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appointed. In those cases, these requirements can be performed internally provided this potential conflict is disclosed to the investors.

Alternatively, an independent third party may be used. An independent director who is accountable for the overall governance of the fund can also be appointed and tasked to ensure that these specific requirements are met with the appropriate controls in place to reduce any potential conflict.

Private funds can benefit operationally from the expertise, experience and oversight of independent directors, and their appointment will give investors and auditors additional comfort knowing that appropriate governance has been put in place. Appropriate controls over the valuation and custody of assets and the proper accounting of the cash flows of the fund are critical for compliance with the PFL and the private fund's overall success.

In the hedge fund arena, the past decade has seen independent directors become increasingly more involved in audits through regular communication with auditors. This has resulted in increased audit efficiency and quality. Appointing independent directors to private funds will create the opportunity for similar advantages to be realised in their audit processes.

It is important to remember that CIMA requires that operations and procedures of a private fund be appropriate and proportionate to the individual circumstances of each private fund. An independent director can help ensure that the private fund operates in a manner that is consistent with these requirements and can provide comfort to investors that the private fund's investments are properly valued, secured and accounted for.

Managers will benefit from the advice and input an experienced and thoughtful independent board can add. In any case, having an independent director can help guide you through these new requirements and provide additional robustness to fund governance that both managers and investors are sure to appreciate.

The rules for limited investor funds

Previously under section 4(4) of the MFL, an open-ended fund that had fewer than 15 investors—whereby a majority of those investors were able to appoint or remove the operator of the fund—was exempt from registering with CIMA.

The 2020 amendment to the MFL removes this exemption and requires that any fund with more than one investor registers with CIMA and complies with the accompanying regulations. These regulations include a requirement to file certain constitutional documents and other information with CIMA along with the requirement to have at least two natural persons acting as directors of the fund, or the general partner for partnerships.

Unlike the requirements of the PFL, these persons are required to register and comply with the Directors Registration and Licensing Law. Cayman-based independent directors are likely to already be registered with CIMA and can easily fulfil this role. A significant positive resulting from the MFL is that these previously unregulated funds will now benefit from the added independence and governance that comes with the appointment of CIMA-registered independent directors.

Keeping on top of the changing legislation can be time-consuming, but having engaged independent Cayman-based directors to assist the managers and provide another viewpoint on issues will enhance oversight and continued compliance with the CIMA requirements. The independent oversight provided by an independent board helps the manager avoid, manage and mitigate any potential conflicts of interest. This ultimately allows the manager to focus on what is important to them—making investment decisions and growing assets.

As previously unregistered private and limited investor funds look to grow their assets and investor base, the appointment of independent board of directors can provide substantial benefits. Institutional investors in hedge funds have placed a significant emphasis on the need for high quality corporate governance and robust controls.

Why should their investments in private equity or closely-held funds be treated any differently? As the private funds industry grows, managers will need to continue to differentiate themselves from their competition. Delivering steady returns with reduced operational risk due to independent oversight could help them attract investors more easily than peers that may not embrace the benefits of an independent board.

A major consideration when selecting your fund board is to remember that the board of directors provide an oversight role and they are charged with representing the best interests of all investors. This is best accomplished if the majority of the board have no other role or potential conflicts. A diverse board comprising members with different backgrounds will help ensure that different perspectives are considered. It is essential that the board of directors is engaged and that each director has the capacity to spend the required amount of time on his or her role.

Building boards with the right culture and expertise adds value to funds and will better position them to get an edge in an increasingly competitive marketplace. ■



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