

Regulation of Closed Ended Cayman Funds

February 2020

The Cayman Islands Private Funds Law, 2020 (the "Law") was enacted on 7 February 2020 and requires that certain closed ended funds should be registered with the Cayman Islands Monetary Authority ("CIMA") by 7 August 2020. As part of that registration process such funds will need to provide prescribed information to CIMA which is likely to include the categories of their target investors and assets. Once registered these funds will be subject to ongoing risk based monitoring on the basis of their risk profiles as assessed by CIMA and will be required to:

- make annual filings including filing of audited accounts;
- value their assets in accordance with accounting principles of non-high risk jurisdictions (unless exempted);
- appoint a custodian or other specified party to hold and verify title to certain assets;
- appoint an administrator or other specified party to monitor cash flows;
- and keep records of the identification codes of certain assets which they hold or trade.

Who is Affected by the Law?

The Law applies to any "Private Fund" defined as any company, LLC, unit trust or partnership established in any jurisdiction:

- whose principal business is the offering and issuing of interests that carry an entitlement to participate in its profits or gains;
- the purpose or effect of which is the pooling of investor funds with the aim of spreading investment risks and enabling investors to receive profits or gains from its investments;
- whose investors do not have day-to-day control over the management of its investments;
- whose interests are not redeemable or repurchasable by the holder;
- and whose investments are managed as a whole by or on behalf its operator for reward based on the Private Fund's assets or gains.





The Law specifically exempts the following from its provisions:

- licensed, administered or registered mutual funds under the Mutual Funds Law (Revised);
- regulated EU connected funds under the Mutual Funds Law (Revised);
- issuers of debt or alternative financial instruments;
- specified non-fund arrangements (see the list below);
- licensees under the Banks and Trust Companies Law (Revised) or the Insurance Law 2010; or
- registered persons under the Building Societies Law (Revised) or the Friendly Societies Law (Revised).

The Law provides that a Private Fund may be registered as “restricted scope private fund” without specifying what the effect of such registration might be. A “restricted scope private fund” is defined in the Private Funds Regulations, 2020 as a Private Fund:

- that is a Cayman exempted limited partnership;
- that is managed or advised by a person who is licensed or registered by CIMA or authorised or registered by a recognised overseas regulatory authority;
- and in which all investors are non-retail in nature, being either high net worth persons or sophisticated persons.

The Law provides that where the accounting principles of a Private Fund permit consolidated financial account reporting and that fund chooses to consolidate its accounts with an “alternative investment vehicle” then that vehicle will not be subject to the audit, valuation, custody, cash monitoring or identification code maintenance requirements. An “alternative investment vehicle” is defined in the Private Funds Regulations, 2020 as a company, unit trust, partnership or other similar vehicle that:

- is formed in accordance with the constitutional documents of a Private Fund for the purposes of making, holding and disposing of one or more investments wholly or mainly related to the business of that Private Fund; and

- only has as its members, partners or trust beneficiaries, persons that are members, partners or trust beneficiaries of the Private Fund.

Specified non-fund arrangements will be defined under future regulations but are listed in the schedule to the Law as comprising the following:

- pension funds;
- securitisation and special purpose vehicles;
- contracts of insurance;
- joint ventures;
- proprietary vehicles;
- officer, manager or employee incentive, participation or compensation schemes, and programmes or schemes of similar effect;
- holding vehicles;
- individual investment management arrangements;
- pure deposit-based schemes; arrangements not operated by way of business;
- debt issues and debt issuing vehicles;
- common accounts;
- franchise arrangements;
- timeshare and long-term holiday product schemes;
- schemes involving the issue of certificates
- franchise arrangements;
- timeshare and long-term holiday product schemes;
- schemes involving the issue of certificates representing investments;
- clearing services;
- settlement services;
- funeral plan contracts;
- individual pension accounts;
- structured finance vehicles;

- preferred equity financing vehicles;
- a fund whose investment interests are listed on a stock exchange (including an over the counter market) specified by CIMA;
- occupational and personal pension schemes;
- sovereign wealth funds;
- and single family offices

The Registration Requirement

Application

A Private Fund is prohibited from carrying on or attempting to carry on business in or from within the Cayman Islands unless it:

- has applied to be registered with CIMA within 21 days of accepting capital commitments;
- has filed prescribed details with CIMA;
- has paid a prescribed fee;
- complies with any conditions imposed on its registration by CIMA;
- and complies with the provisions of the Law.

A Private Fund will be carrying on business in the Cayman Islands if it:

- is incorporated or established in the Cayman Islands; or
- makes an invitation to the public in the Cayman Islands to subscribe for its interests,

and it is in receipt of capital contributions from investors for the purposes of investments. The Law provides that a Private Fund can enter into any agreements with high net worth persons or sophisticated persons prior to filing an application for registration but does not clarify whether that is intended

to vary the requirement to apply to for registration within 21 days of accepting capital commitments. A high net worth person is an individual whose net worth is at least US\$1,000,000 or who has total assets of not less than US\$5,000,000 or its equivalent in any other currency. A sophisticated person is a person that (i) is regulated by CIMA or by a regulatory authority recognised by CIMA or has its securities listed on a securities exchange recognised by CIMA, (ii) by virtue of its knowledge and experience in financial and business matters is capable of evaluating the merits of the proposed subscription or is subscribing for at least US\$100,000; or (iii) any entity whose investors fall within (i) or (ii) or who are high net worth persons.

Registration

A Private Fund is prohibited from accepting capital contributions from investors in respect of investments until it is registered with CIMA. The registration process described under the Law is not the same as the registration process provided for under the Mutual Funds Law (Revised) for Cayman hedge funds and will allow CIMA to reject an application for registration. The Law obliges CIMA to communicate its decision to register a Private Fund or refuse an application for registration as soon as reasonably practicable after receiving the application. Any delays in CIMA confirming a registration will lead to delays in a Private Fund's ability to accept capital contributions for investment.

As part of the registration process a Private Fund will be categorised by CIMA based on an assessment of risk and will be subject to ongoing risk-based monitoring. This categorisation can be made at the time of registration or at any time following registration. Rules, statements of principle and guidance are expected to be issued by CIMA in relation to the risk assessment process for Private Funds.





Ongoing Requirements

A Private Fund will be subject to the following ongoing requirements during its operation:

- payment of an annual fee on or before 15 January in each year; and
- filing of details of any changes that materially affect information submitted to CIMA within 21 days.

With effect from its receipt of capital contributions from its investors for the purposes of investment a Private Fund will be subject to the following additional ongoing requirements:

- filing of an annual return with CIMA;
- preparation of its accounts in accordance with US, Japanese or Swiss GAAP, IFRS or generally accepted accounting principles of a non-high risk jurisdiction;
- annual audit of its accounts by a CIMA approved auditor in accordance with International Standards on Auditing or generally accepted auditing standards of a non-high risk jurisdiction;
- filing of its audited accounts with CIMA annually within six months of its financial year end;
- maintaining its records in an accessible manner and in accordance with CIMA's guidance;
- maintaining appropriate procedures for valuations of its assets (unless exempted);
- maintaining the services of a custodian or other specified party to ensure safekeeping of its assets;
- maintaining the services of an administrator or other specified party to monitor its cash flows; and
- for funds that regularly trade securities, maintaining records of identification codes of those securities.

A non-high risk jurisdiction is defined as any jurisdiction that is not on the list of high risk jurisdictions issued by the Financial Action Task Force. Further details on the Valuation, Custody, Cash Monitoring and Identification of Securities requirements are set out below.

Valuation Requirements

Procedures for the independent valuation of a Private Fund's assets should require that valuations are conducted in accordance with the rules of a non-high risk jurisdiction. Valuations should be conducted at a frequency that is appropriate to the assets held and in any case at least annually and in accordance with any rules, statements or guidance issued by CIMA. Valuations should be performed by:

- an independent third party appropriately qualified to conduct valuations in a non-high risk jurisdiction; t
- he manager or operator of the Private Fund or a person who has a control relationship with the manager, provided that either the valuation function is independent from the portfolio management function or potential conflicts of interest are properly identified and disclosed to investors; or
- an administrator appointed by the Private Fund which is established and authorised in a non-high risk jurisdiction and which does not have a control relationship with the manager or operator of the Private Fund.

Where a Private Fund's assets are not valued by an independent third party CIMA may require it to have its valuations verified by an auditor or an independent third party.

An independent third party is a person established in a non-high risk jurisdiction who does not have a control relationship with the manager or operator of the Private Fund. A control relationship between an entity and the manager or operator of the Private Fund is a direct or indirect holding of 50% of the economic interests or voting power by that entity in the manager or operator, such a holding by the manager or operator in that entity or such a holding by any person in the manager or operator and that entity.

The Law provides that CIMA may exempt a Private Fund from these valuation requirements either absolutely or subject to such conditions as CIMA may deem appropriate.

Custody Requirements

All assets of a Private Fund that are capable of being physically delivered or of being registered in an account opened in a custodian's books in the Private Fund's name must be held by a custodian in segregated accounts in the name, or for the account, of the Private Fund. Where appointed a custodian is also required to verify, based on information provided by the Private Fund and available external information that the Private Fund holds title to any other assets that it holds and maintain a record of those assets. A Private Fund's custodian should be established and authorised in the Cayman Islands or a non-high risk jurisdiction and should not have a control relationship with the manager or operator of the Private Fund.

If a Private Fund notifies CIMA that it is neither practical nor proportionate to appoint a custodian having regard to its nature and the type of assets it holds it will not be required to appoint a custodian but should appoint one of the following to carry out the title verification function:

- an administrator established and authorised in the Cayman Islands or a non-high risk jurisdiction which does not have a control relationship with the manager or operator of the Private Fund;
- an independent third party; or
- the manager or operator of the Private Fund or a person who has a control relationship with the manager, provided that either the title verification function is independent from the portfolio management function or potential conflicts of interest are properly identified and disclosed to investors.

Where a Private Fund's title verification function is performed by its manager or operator or a person who has a control

relationship with its manager CIMA may require it to have its title verifications verified by an appropriately qualified independent third party.

Cash Monitoring

A Private Fund is required to monitor its cash flows, to ensure that all its cash assets are booked in cash accounts opened in its name or for its account and to ensure that all its subscription payments are received. The Private Fund should appoint one of the following to carry out these cash monitoring duties:

- an administrator established and authorised in the Cayman Islands or a non-high risk jurisdiction which does not have a control relationship with the manager or operator of the Private Fund;
- custodian established and authorised in the Cayman Islands or a non-high risk jurisdiction which does not have a control relationship with the manager or operator of the Private Fund an independent third party; or
- the manager or operator of the Private Fund or a person who has a control relationship with the manager, provided that either the title verification function is independent from the portfolio management function or potential conflicts of interest are properly identified and disclosed to investors.

Where a Private Fund's cash monitoring duties are performed by its manager or operator or a person who has a control relationship with its manager CIMA may require it to have its title verifications verified by an appropriately qualified independent third party.





Identification of Securities

A Private Fund is required to maintain a record of the identification codes of the securities it trades and holds where it regularly trades any of the following:

- shares or stock of any kind in a company incorporated in any jurisdiction;
- partnership interests of a partnership established in any jurisdiction;
- trust units of a unit trust governed by the laws of any jurisdiction;
- debt instruments;
- warrants to subscribe for any of the above;
- certificates or instruments conferring contractual or proprietary rights in respect of any of the above where they are held by a person other than the person on whom the rights are conferred;
- options to acquire or dispose of any of the above, any currency, any precious metal or any such option;
- futures made for investment purposes; or contracts for differences.

A Private Fund that is required to maintain such records is obliged to make them available to CIMA on request. Identification codes are ISINs or, if these are not available an alternative identification code that conforms to international standards or a regional identification code or legal entity identifier of the issuer.

Oversight and Enforcement

CIMA has the power to instruct a Private Fund to have its accounts audited by an auditor approved by CIMA and to submit them to CIMA and to require the Private Fund to prepare and file one-off or periodic reports on such matters as CIMA may request. CIMA also has power to require documents and information from a Private Fund as it may reasonably require in connection with its supervisory and enforcement functions under the Law and may apply to the Cayman Grand Court for an order to preserve the assets of a Private Fund which is in breach of the requirement to be registered by CIMA or in breach of any conditions of its registration.

Where CIMA is satisfied that a Private Fund is:

- likely to become insolvent;
- carrying on business in a manner detrimental to its investors or creditors;
- not complying with the Law or the Cayman Anti-Money Laundering Regulations; or
- not being directed or managed in a fit and proper manner, it is able to cancel any registration under the Law, impose conditions on such registration, replace any promoter or operator, or appoint an advisor or controller of the Private Fund.

CIMA also has power to apply for search and seizure orders where there are reasonable grounds to suspect that an offence under the Law is being committed.

Where the auditor of a Private Fund in the course of providing its services suspects that the Private Fund is:

- likely to become insolvent;
- carrying on business in a manner prejudicial to its investors or creditors;
- carrying on business without keeping accounting records sufficient to allow a proper audit; or
- not complying with the Law or the Cayman Anti-Money Laundering Regulations,

they are required to give CIMA notice of and the reasons for such suspicion.

Transitional Provisions

The Private Funds (Savings and Transitional Provisions) Regulations provides that notwithstanding the Law a Private Fund that:

- begins to carry on business in or from within Cayman at any time during the period of six months beginning on 7 February 2020; or
- immediately before 7 February 2020 was carrying on business in or from within Cayman,

may continue to carry on such business until 7 August 2020 or such further period as may be specified by CIMA.



CONTACT POINTS

For more details on how we can help you, to request copies of most recent newsletters, briefings or articles, or simply to be included on our mailing list going forward, please contact any of the team members below.



Jonathan Law
Partner | Cayman Islands
E jonathan.law@dilloneustace.ie
T + 353 1 814 4057

OUR OFFICES

Dublin

33 Sir John Rogerson's Quay
Dublin 2
Ireland
Tel: +353 1 667 0022

Cayman Islands

Landmark Square
West Bay Road, PO Box 775
Grand Cayman KY1-9006
Cayman Islands
Tel: +1 345 949 0022

New York

33 Irving Place
New York
NY 10003
United States
Tel: +1 646 770 6080

Tokyo

12th Floor,
Yurakucho Itocia Building
2-7-1 Yurakucho, Chiyoda-ku
Tokyo 100-0006,
Japan
Tel: +813 6860 4885

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