FOCUS ON

CAYMAN ISLANDS

The Cayman Islands' position as a top hedge fund jurisdiction has been the source of some speculation of late, with the challenges of the AIFM Directive and Ucits growth forcing the region to adapt to a new investor-driven climate. *HFMWeek* talks to those in the industry about Cayman's strengths and how it continues to thrive despite these challenges

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Michelle Carroll leads the audit and assurance within Kinetic Partners. Prior to joining Kinetic, Michelle spent 14 years with PwC, working exclusively within the asset management sector. Michelle specialises in risk management and process review, as well as auditing and reporting under SAS 70 and AAF 01/06.

Q HFMWEEK (HFM): WHAT IS CAYMAN DOING TO ATTRACT NEW HEDGE FUND BUSINESS?

A DARREN STAINROD (DS): It is continuing along the tried-and-tested route of maintaining effective but user-friendly regulation to protect investors, while at the same time ensuring that global anti-money laundering (AML) and know your customer (KYC) standards are adhered to. This creates a strong and attractive environment for hedge funds, providing them with the freedom to trade in all strategies and use leverage. It allows them to have products that can create alpha beyond anything that can be achieved onshore. The Cayman product is still the preferred choice in the hedge fund industry, as indicated by the number of new registrations, which are almost back to the peak level, despite the increased competition.

TONI PINKERTON (TP): Cayman continues to promote its core strengths to its institutional and sophisticated client base. While there was a time when Cayman was under scrutiny by its onshore counterparts, with recognition by Iosco, the IMF and the OECD, supported by continued growth, Cayman has confirmed its place in the global financial markets. Attention is now diverted to global regulatory developments, which are finally providing the clarity required to move to the next phase of assessing the requirements and formulating strategy for implementation. In addition, the Cayman Islands government has recently announced its desire to encourage fund managers to consider the Cayman Islands as a base for operations.

MICHELLE CARROLL (MC): I think internally, Cayman individuals work well together but I would like to see more active marketing of their strengths outside of Cayman. I am aware that recently the Cayman Financial Services Council was established to champion the development of new legislation in Cayman and to review new products in other jurisdictions, but although what the Council proposes to do is great, they need to make sure they do not forget about the need to market outside Cayman and specifically to investors. According to the Cayman Islands Monetary Authority (CIMA), Cayman is currently averaging around 50 new funds a month (net) – I don't think investors realise how large this is relative to other jurisdictions and I wonder why Cayman does not show it off.

Q HFM: WHAT TYPES OF FUND LAUNCHES ARE CHOOSING CAYMAN?

A DS: We are seeing a return of interest in alternative and hedge fund products, mainly from sovereign wealth funds and a growing number of institutions. We are also seeing managers leaving proprietary desks as banks look at the implications of the Volker rule. The launch sizes are small, however, as the seed capital is still in short supply. It will be interesting to see if Cayman is able to tap into the resurgence of Asia, and especially China, over the coming years as there is certainly huge potential and Asian hedge fund managers typically prefer Cayman products.

TP: Monthly statistics published by CIMA continue to demonstrate the strength of Cayman alongside the development of onshore products. Cayman continues to be the leading hedge fund jurisdiction with 9,594 funds registered at 30 September, approaching historical highs. Statistics also indicate healthy growth in the private equity space, with approximately 125 limited partnerships registered each month in 2010. While most of the capital inflow is into institutional platforms, there has also been considerable activity in the start-up market.

MC: Cayman is still the best-known place to launch alternative funds, particularly hedge funds and private equity. Cayman will never be a retail fund centre but I think the important thing for Cayman is for it to continue to be good at what it is known for.

Q HFM: HOW IS CAYMAN RESPONDING TO THE AIFM DIRECTIVE AND WHAT ARE YOUR CONCERNS?

A DS: Cayman did lobby through the Cayman Islands Financial Services Association (CIFSA), The Alternative Investment Management Association (Aima) and also government meetings with the EU, and it appears that some of those messages were taken on board as the regulation is more balanced than initially expected. This will allow hedge fund managers to continue to market Cayman funds to EU investors under the private placement rules. If the decision is made to extend passport rules in 2015, we are optimistic that Cayman will qualify for an EU passport. It is well

positioned in terms of the number of tax agreements we have in place with European nations and we are high up on the OECD list of compliant nations with the anti-money laundering (AML) rules.

TP: The hedge fund community in the Cayman Islands – including CIMA, industry associations and participants – have been actively monitoring the AIFM Directive since the first draft was issued in April 2009. Given existing levels of international co-operation and compliance, Cayman is well placed to meet the criteria for third-country funds on issues of tax and regulatory information exchange agreements, co-operation agreements and Memoranda of Understanding with key Member States. Private placement regimes and passive marketing will be retained for the time being, allowing Cayman funds to continue to be marketed into Europe.

Now that the Directive has been adopted by the European Parliament, the possible effects are moving onto the radar of US managers with a European investor base, alongside new US regulations. Requirements for more onerous reporting independence impose challenges on managers that may not have the infrastructure to support the new requirements. Many managers are turning to fund administrators to provide scalable, cost-effective outsourcing solutions. Raising further concern for US and other third-country managers targeting European investors is the possible replacement of existing national private placement rules with an EU marketing passport in 2018. If adopted, this will require compliance with additional criteria including remuneration, leverage, depositaries, restrictions on outsourcing and capital requirements.

MC: The primary concern for Cayman was the third-country measures (which helpfully was also the primary concern for the US) and I think the outcome is perceived within Cayman as the best they could have hoped for.

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> MICHELLE CARROLL, KINETIC PARTNERS

The two most important points now are: firstly, that the resolution of the Directive removes uncertainty which has contributed to delayed investment; and secondly, there can now be discussions about the real options available to investors, such as what are the pros and cons of investing in an AIFM-compliant fund versus a traditional Cayman fund. Cayman sees the final Directive as an opportunity. The cost of being compliant will negatively impact the performance of the fund.

For a lot of investors, this fee drag will not be seen as beneficial and Cayman needs to capitalise on that.

I don’t have any concern specific to Cayman, but I worry about the impact of a future alternatives fund blow-up. I do not have any specific indication that there is one out there, but any kind of fraud is bad, particularly now, as it will force the global alternatives industry backwards, whether the blow-up is a Cayman fund or a Ucits fund.

Q HFM: GIVEN THE GROWTH OF ONSHORE STRUCTURES SUCH AS UCITS, HOW WILL CAYMAN REMAIN RELEVANT AND CONTINUE TO COMMUNICATE ITS SKILL-SET AS A CENTRE FOR HEDGE-FUNDS?

A DS: There is certainly some momentum in terms of the growth of the Ucits industry within Europe, from managers trying to capture more retail-type investors in Europe and also as a hedge against the AIFM Directive. However, we see them essentially as a complementary product rather than as direct competition to the Cayman product.

TP: While there has been some convergence between traditional onshore retail-based Ucits funds and offshore alternative hedge funds, the two products are complementary, rather than mutually exclusive solutions. The regulatory constraints of a Ucits fund are designed to provide investors with a level of protection that allows them to be distributed to a wide investor base, often on a retail scale. For large institutions such as pension, endowment and sovereign wealth funds and other sophisticated investors, for all or a portion of their investment portfolios, the costs associated with that level of protection create a drag on performance in an environment where they know and accept the risks disclosed to them through the private placement memorandum of the fund.

MC: Cayman is relevant and should continue to be important to the funds management industry. Cayman has a good model: it has effective infrastructure on the ground, it has competent regulation, a reliable court system, specialist resourcing, attractive taxation and is willing to flex its legal and regulatory environment to work with other countries’ needs. Most importantly, it has the clear backing of the Cayman government. I am not sure the UK can boast that its regulator, the industry and the government are all working to ensure the success of the financial services sector. Personally, I think Cayman could be seen to be shouting louder about these advantages.

Ucits, the AIFM Directive, Fatca and Dodd-Frank are all examples of the hurdles that Cayman must face and, by and large, Cayman is showing willingness to meet these challenges.

Q HFM: HOW CAN YOUR FIRM HELP HEDGE FUNDS TO ESTABLISH IN CAYMAN?

A DS: We are a global firm, with hedge fund administration offices in Dublin, Luxembourg and Switzerland, we are also opening an Asia operation in early-2011. We assist with attracting and launching funds in all of those jurisdictions, and because Cayman is a flexible product it is popular in all of these centres. In terms of establishing in Cayman, we are still the largest administrator on the island, because it suits our model and we are able to attract a large percentage of qualified and talented professionals from around the world. We are certainly able to further the reputation of Cayman and support hedge funds with the quality of staff that some of the onshore jurisdictions struggle to attract and retain.

TP: Our affiliate, Maples & Calder, advises hedge fund managers on the structuring of new funds and will establish and register funds in the Cayman Islands. Hedge fund managers and their onshore counsel work with Maples & Calder because of their market leading reputation and expertise and value the advice on a wide range of fund-related matters. Maples & Calder was established in the Cayman Islands more than 40 years ago and is regularly consulted by the Cayman Islands Government on offshore initiatives.

Maples Fund Services provides fully outsourced fund servicing solutions from six locations in key jurisdictions. We combine the power of proprietary and leading third-party technology with dedicated client service led by experienced professionals.

MC: Kinetic Partners are based in Cayman as well as London, New York, Geneva and Dublin, and we have good relations with the large majority of service providers in all of those jurisdictions. For us, the key is to provide our clients with a good overview of all their options so that they can come to conclusions that are right for them. Specifically for Cayman, we regularly help the manager set up in Cayman, we assist with the launch of funds and the selection of service providers and we provide audit services to the funds.

Q HFM: HOW DO INVESTORS PERCEIVE CAYMAN AS A JURISDICTION AND HOW DO YOU CONVINCE THEM OF ITS WORTH?

A DS: Cayman has struggled to shake off its reputation from the past, but sophisticated investors who use hedge funds understand the unique benefits of Cayman and the flexible products that are available here. While traditional funds are increasingly allowed to use some of the strategies that hedge funds have, it is still not to the extent available in an offshore product such as Cayman. New investors are often surprised at the stringent level of regulation that we have, particularly in terms of the AML rules we ask for. In addition, UBS implements a higher standard than the Cayman regulations. Investors are often asked for due diligence that they are not asked for with their onshore investments. More experienced investors know and understand that it is a very well-regulated jurisdiction with good products and a strong professional workforce.

TP: The Cayman hedge fund product is well established and understood by institutional and sophisticated investors, and industry statistics continue to support the validity of the product, even in these challenging times. Cayman expects to register approximately 1,200 new open-ended funds in 2010, with hedge fund registrations at 9,594 at 30 September, approaching the numbers reported before the markets collapsed. A Cayman fund gives managers more flexibility to generate performance for their investors.

MC: I do not think investors have a real problem with Cayman, but they are bamboozled by lots of rhetoric, which impacts their confidence in choosing a Cayman fund. I think we as a global industry have to be held partly responsible for this and I do not think it is a problem that just Cayman is suffering from. Investors are holding onto their money (maybe a little less so now than a year ago) because there are too many choices and too many unknowns – the AIFM Directive, managed accounts, Ucits, changes in regulation and regulatory bodies, more onerous tax and transparency requirements. All these things block the flow of cash from the investor to the investment vehicle, regardless of the jurisdiction. When I talk to investors, I do not talk specifically about the positives of Cayman, I am more concerned with the positives of investing in general and making the best choice for the client. ■