CAYMAN: QUICK, EASY AND SEAMLESS

IAN GOBIN OF HARNEYS COMPARES CAYMAN FUNDS TO US FUNDS AND DISCUSSES HOW CAYMAN CONTINUES TO LEAD THE MARKET

Ian Gobin is a partner in Harneys' Cayman office. Ian's practice has a dedicated focus on fund managers, their clients and their service providers. He advises on the legal and regulatory treatment of investment funds, private equity funds and management companies established in the Cayman Islands and the British Virgin Islands. He also advises institutional and private clients throughout Europe and North America on funds matters.

HFMWeek (HFM): Why set up a Cayman fund at the same time as setting up a US fund?

Ian Gobin (IG): It's a frequently asked question, particularly with start-up and emerging managers. Where a manager is setting up a US fund (a US limited partnership or US limited liability company, generally organised in Delaware) to attract US taxable investors, the manager will often market to or come across US tax-exempt investors, such as charities, pension funds, and university endowments, as well as non-US investors, who like the product and want to invest. If that's the case then simultaneously with the set up of the US fund, the manager will set up a Cayman fund as part of the pooled investment structure to take in the US tax-exempt investors and non-US investors.

Why? In short, to avoid potential US tax exposure that could result from direct investment in a US pass-through entity such as a US limited partnership or US limited liability company. It's been explained to me by US Counsel, and I apologise in advance for the tax talk:

1. US tax-exempt investor issues: When a US tax-exempt investor derives income that is separate from its US tax-exempt purpose, then such income may be subject to a form of US federal income tax known as unrelated business income tax (Ubit). Certain types of passive income are specifically exempt from Ubit, including short-term and long-term capital gains, dividends, and interest income. However, such Ubit exemptions do not apply if the income is considered "debt-financed income". Thus, if the partnership or other pass-through fund uses borrowed funds, there could be Ubit for the US tax-exempt investors that are direct investors in that fund. In addition, if the pass-through fund invests in businesses organised as partnerships (including publicly traded partnerships), the income and gains realised could be Ubit even if no debt financing is involved. US tax-exempt investors can avoid such Ubit exposure by investing through a Cayman fund that is treated as a foreign corporation for US tax purposes. There is no pass through treatment in the case of investments made in a fund that is treated as a corporation (hence the term "blocker" corporation). Thus, the Cayman fund, or the Cayman master fund in which it invests, can use debt without creating Ubit exposure for the tax-exempt investors in the Cayman fund.
2. Non-US investor issues: Non-US investors are also advised to invest in funds that are organised as foreign "blocker" corporations for US tax purposes. There are two US tax reasons. First, if the US partnership fund were to engage in a US trade or business (other than merely trading in stocks or securities for its own account), then the non-US investors in such fund would be subject to US income tax on their share of any of the fund's income that is treated as effectively connected US trade or business income (ECI). The non-US investor in the partnership fund would be required to file US income tax returns even if the fund's ECI for the year is nominal or a negative number. In the case of non-US individual investors, there is also US estate tax exposure if the investor invests directly in the US partnership fund. Non-US individuals are not subject to US estate tax at death if they own stock in a non-US corporation that owns US securities, whereas direct ownership of an equity interest in a US partnership fund would be treated as "property situated in the US" which is subject to such US estate tax.

Therefore, managers wanting to attract US taxable investors, US tax-exempt investors and non-US investors will generally set-up both a US fund and an offshore fund in a jurisdiction such as the Cayman Islands. As such the manager needs to decide from the outset which investor groups they will be targeting; and in doing so managers need to be realistic. Much will depend upon their track record, history and story for the new fund. The early stages in the capital-raising of a new fund will generally, with some exceptions, be challenging. To set up both a US fund and an offshore fund is not insignificant in terms of organisational and running expenses; particularly with a start-up or emerging manager, their survival depends upon making the right decision from the outset. Most US-based managers will likely have access to US taxable investors from the start but may not yet have the critical mass to attract allocations from US tax-exempt investors or may not yet have a network of international investors. For these managers the best route may be to set-up a US fund which will lead to the establishment of an offshore fund once they have established their track record. More established, mid-market and billion-dollar-plus managers will typically already have the internal infrastructure and resources to establish the US fund and the offshore fund at the same time in order to approach both markets from the outset.

HFM: Why choose Cayman rather than, say, the BVI for the offshore fund?

IG: This a question that I'll have to be careful with, given

that we're the oldest and largest offshore law firm in the BVI. Therefore, we have had the honour and pleasure of helping to shape the legislation over the years and design the fund products that are available in the BVI which meet the ever-changing challenges of the global funds industry.

There could be a number of reasons why the BVI would be the right jurisdiction for the manager to domicile their offshore fund and over 5,000 funds have their home in the BVI. Like the Cayman Islands, the BVI is a tax neutral jurisdiction. Both have no direct personal, corporate or property taxes. BVI law and Cayman Islands law are derived from English common law and supplemented by local legislation, ensuring that both BVI and Cayman Islands funds are structured as widely accepted vehicles on the international stage.

The two primary reasons we see managers elect to use the BVI are firstly the fact that it is slightly more cost-effective to establish a fund than Cayman and secondly that there are slightly fewer regulatory requirements; with registered funds not needing a local audit sign-off or director registration requirement, for example. While this remains appealing to our long-standing institutional managers, it is also attractive to start-up and emerging managers who are looking to find reasonable cost savings and flexibility in every aspect of their launches to allow them to grow their asset base as quickly as possible.

But why Cayman? There are more than 10,000 funds registered in the Cayman Islands (with probably a similar number of unregistered funds). The financial services industry in the Cayman Islands is highly competitive and there is a deep bench from which managers can choose their Cayman service providers. As such, it's the undisputed global jurisdiction of choice for investment funds. With over 30 years of servicing the funds industry, the Cayman Islands have grown through innovation and forward-looking policies which have served as models in other jurisdictions. The Cayman Islands Monetary Authority (CIMA) promotes a pragmatic regulatory environment for investment funds and the courts of the Cayman Islands have a specific financial services division, which allows for much quicker resolution of fund disputes than some notable onshore centres. A robust and quick launch and registration process for investment funds and fund managers allows managers to get their offshore fund and management vehicles up and running quickly to take advantage of market opportunities.

HFM: What is the process of setting up a US fund and Cayman fund like? How quick/seamless is it?

IG: Quick, easy and yes, seamless, provided that the manager chooses US and Cayman Counsel who, as part of their core businesses, structure investment funds. These are the folks who, if the manager chooses wisely, will become their trusted advisors for many years to come. If this is the case then US Counsel will work seamlessly with Cayman Counsel.

But before we get to the process, the manager needs to decide how their US fund will work in conjunction with their offshore fund. In deciding which route to follow, US Counsel will walk the manager through the options. The three most widely-used options are "side-by-side", "master feeder" and "mini-master". With a side-by-side structure, the US fund and the offshore fund both make investments directly with trade tickets allocated between them. Given the extra administration involved, we rarely have managers opt for side-by-side funds. Probably the most popular route is to set up a master feeder structure. Here an offshore master fund is created with the US fund and the offshore fund investing all of their assets into the offshore master fund, leaving the offshore master fund to make the investments. In a mini-master structure a US fund and an offshore fund are established, but in this structure, the offshore fund invests in the US fund which acts as the master fund and also as the fund into which the US taxable investors will invest. The offshore fund will be taxed as a corporation to benefit US tax-exempt investors and block Ubit and non-US investors.

In all models, it's also important for the US manager to consider how they will be paid in the most tax efficient manner. It is crucial that US managers discuss with their US Counsel about how this may be structured. At the moment, the current preference is for US managers to take their performance fee as an allocation from the relevant master fund (be it the offshore or in the case of the mini-master, the onshore (master) fund).

Once the structuring advice has been given and the structure is agreed, the manager will need to select the other service providers to the funds. These will include a fund administrator, auditor, bank, custodian, prime broker and, often, independent directors. We'll know about the fund from the manager, including details of the investment strategy, likely AuM and background of the principals and have a feel for both what the manager needs and what they are looking for in selecting the other service providers. We're always more than happy to make the right recommendations and introductions.

Simultaneously with the appointment of the other service providers, US Counsel will form the US fund and work begins on preparing the offering document for the US fund and the offshore fund, as well as the subscription documentation and investment management agreement. At the same time, Cayman Counsel will incorporate, assuming say, a traditional master-feeder structure has been decided upon, the exempted limited companies to be used for the master fund and the feeder fund (although it is not unusual to see exempted limited partnerships being used for master funds). This can be completed within the day. Standard form constitutional documents will be used, which will be amended and restated as necessary to tailor them to the offering document, once final. One key road block is often the establishment of a banking relationship for the fund. Sometimes this can be done through the relevant administrator but there may be trading or other requirements for the relevant strategy which will mean the manager may want to set this up. If this is the case, the manager is well-advised to start the banking discussions early and provide all relevant documentation and information required to the bank as soon as possible. The same applies for the other service providers being appointed. Cayman Counsel will review the offering document and build-in the Cayman Islands disclosure and legal requirements, such as Cayman Islands mutual funds law disclosure, Cayman Islands anti-money laundering legislation and automatic exchange of financial information disclosures, share rights including the terms of the offering, general disclosure language regarding providing information to law enforcement and other authorities. Cayman Counsel will also complete the set-up of the master fund and the feeder fund which would include the appointment of the directors and prepare the suite of Cayman launch documents, which will include board resolutions, various documents required by the CIMA, consent letters for the administrator and auditor and prepare the amended and restated constitutional documents of the master fund and the feeder fund. Cayman Counsel will also need to review the administration agreement, custodian agreement and prime brokerage agreements to ensure they comply with Cayman Islands law. Once all of the documents are in final form, it's down to the directors of the feeder fund and the master fund, who should have been involved with the process from the beginning, to review all of the documentation and ultimately approve by way of the board resolutions, the launch of the feeder fund and the master fund. Following which Cayman Counsel will attend to the various filings with the Registrar of Companies and the CIMA and when complete the offshore fund can take in investors and trade. Other than the legal work involved, transaction management is key. Both US Counsel and Cayman Counsel will be pressing all service providers to make sure they have what they need to jump through the various internal hoops required for them to be appointed and sign-off on the documentation and ultimately provide the services to the funds and that this is done efficiently and within the deadlines given.

Timing, from the initial kick-off call with the manager to the launch of the US fund and offshore fund is a manager moveable feast. It's not overnight, that's for sure, but neither should it take six months, unless then manager needs the six months to, for example, line-up investors, seed capital or on-board the service providers. Some managers have already worked on their detailed investment strategy and have considered the commercial terms of the offering. Some managers need advice on both. Some managers have all of their anti-money laundering documentation ready for the service providers and some haven't. Often it's the opening of the bank accounts and take-on sign-offs from service providers that can cause delays to the launch of the funds. All things being equal, the timing is around six to 12 weeks, six weeks being pretty aggressive, but it can be done and that's for the US fund and the offshore fund.

> "THERE ARE MORE THAN 10,000 FUNDS REGISTERED IN THE CAYMAN ISLANDS (WITH PROBABLY A SIMILAR NUMBER OF UNREGISTERED FUNDS)"

HFM: How popular are Cayman structures with US managers? Do you see this popularity continuing? Why?

IG: Very popular and more popular than any other offshore jurisdiction by, as you would say in the UK, a "country mile".

The glass half-empty brigade of investment fund commentators were all doom and gloom for 2016. Underperformance from some of the institutional fund managers, some institutional investors pulling out of institutional funds, over-regulation in the US, cyber-security, the SEC's treatment of managers, being some of the reasons why and leading to many journalists writing headlines such as "is this the end of the hedge fund?". We were fortunate to have been involved and co-sponsored a Private Funds Leadership Forum with a major US investment funds law firm at the end of 2016, attended by many of the industry's big names, the aim being to take the temperature of the investment funds market for the coming year. Let's just say that I'm extremely optimistic about 2017 in terms of new fund launches for US funds and Cayman funds. Although there might be a bump or two in the road, 2017 will be seen as a much better year than 2016! Famous last words? Let's hope not! ■