

Corporate governance: Best practice for hedge funds

May 2016

Fund managers are now subject to more regulation than ever. This has been driven by pressure from governments and regulatory authorities around the world. The well established principle that sophisticated investors can make their own assessment of risks and protect themselves, has been changed somewhat by the addition of greater corporate governance standards in laws and regulations. The Cayman Islands continues to be the jurisdiction of choice for hedge fund managers, and has sought to keep up with these global trends.

This note looks at the Cayman Islands Monetary Authority's corporate governance statement, which applies to regulated mutual funds and hedge funds. Directors, general partners and trustees of funds need to consider the guidelines when launching a fund, on an ongoing basis and during major milestones (such as launching or ceasing a share class, or winding up). In the second part of this note, we have suggested some practical ways that operators might meet their obligations.

CIMAs Statement of Guidance on Corporate Governance for registered, administered and licensed mutual funds ("**Corporate Governance SOG**") applies to all types of open ended funds regulated under the Mutual Funds Law (2015 Revision). This sits alongside the Directors Registration and Licensing Law, 2014 which requires directors of regulated mutual funds to register with the Cayman Islands Monetary Authority.

CIMA Expectations on Mutual Fund Governance

The Corporate Governance SOG places obligations on the governing body and operator(s) (being the trustee, general partner or directors) of a regulated mutual fund.

There are seven principal areas with which the Corporate Governance SOG is concerned.

1. Oversight of regulated mutual fund operations including service providers. A fund's governing body has ultimate responsibility for overseeing and supervising the activities and affairs of the fund. The governing body must monitor and regularly take steps to satisfy itself that the mutual fund and its service providers are conducting their affairs in accordance with all applicable laws, regulations, rules, statements of principles, statements of guidance and anti-money laundering or combatting terrorist financing requirements – including those of the Cayman Islands and CIMA (the "**Legislative Requirements**"). These should be by periodic review of operations seeking regular input from service providers (including the investment manager) to the fund.

2. Identifying, disclosing, monitoring, and managing conflicts of interest. Conflicts of interest must be disclosed and documented – both in the offering document and in accordance with the requirements of the fund's constitutional documents.

3. Meetings of governing body of the fund. The fund's governing body should meet at least twice a year in person or electronically (if permitted under the constitutional documents). Where the size or complexity of the fund requires it, meetings should be more frequent and should involve service provider attendance.

4. Duties of operators. Among other things, the Corporate Governance SOG imposes on operators (the definition of which expands beyond directors of a company) a number of common law duties already applying to company directors. Operators must exercise independent judgment, and act in the best interests of the fund as a whole (taking into consideration the interests of its investors as a whole). An operator must operate with due skill, care and diligence, and must make enquiries concerning and deal in a timely manner with issues raised with it on matters that are within its scope of responsibility as operator. Operators must act honestly and in good faith at all times. An operator should ensure that it has sufficient and relevant knowledge and experience to carry out its duties, and should assess whether it has, together with any other operator, sufficient and relevant collective knowledge and experience to perform its duties. And, similar to the requirements placed upon company directors, each operator must exercise the care, skill and diligence that would be exercised by a reasonably diligent person with the general knowledge, skill and experience held by such operator.

Additionally, the operator is required to communicate 'adequate information' (although such term is not defined) to the fund's investors where it is properly able to disclose.

Operators must ensure that they have sufficient capacity to apply their minds to oversight and supervision, and must ensure before taking on appointments to additional funds, that they are able to act effectively in accordance with Legislative Requirements.

On a continuing basis, operators are responsible for ensuring that the fund's offering documents and constitutional documents comply with Cayman Islands law, including clearly describing in offering documents the investment strategy, conflicts of interests policy, and the equity interests on offer, in accordance with Mutual Funds Law requirements.

An operator is responsible for approving the appointment and removal of service providers and the terms of the contracts relating thereto – and that CIMA and investors are notified of changes to such appointments. Operators retain "ultimate responsibility" for functions delegated to service providers and are required to regularly monitor and supervise delegated functions. They are also required to review all contracts of appointment to ensure clear definition and separation of responsibilities, and to regularly determine and assess that service providers are performing in accordance with the terms of contract. This includes regularly seeking confirmation from service providers that they are acting in accordance with the constitutional and offering documents of the fund. In particular the operator must regularly monitor the investment activities and performance of the fund to determine the performance of the investment manager. Operators should review the financial statements of the fund, and should regularly monitor the calculation of net asset value (and the proper determination thereof).

5. Documentation. The operator must keep full, accurate and clear written records of meetings including meeting agenda with attachments, lists of attendees and description of manner of meeting, matters considered and decisions made, and information requested from and provided by service providers and advisors.

6. Relations with CIMA. An operator must be transparent and honest when dealing with CIMA in regard to the affairs of the fund. It must disclose, in addition to the requirements set out in the Mutual Funds Law, any matter which could materially and adversely affect the financial soundness of the mutual fund, and any non-compliance with the Legislative Requirements. Where the operator is uncertain whether to communicate such information, it should be prudent and diligent and communicate the information.

7. Risk Management. The operator should ensure that it provides suitable oversight of risk management of the mutual fund and ensure that risks are always appropriately managed and mitigated. Material risks must be discussed at meetings of the governing body and such body should take appropriate action where necessary.

Practical Implications

Below is a non-exhaustive list of questions which should be periodically considered by a fund operator (including a company director) when considering its obligations under the Corporate Governance SOG:

On launch of the fund and any new class of equity interests:

- Conflicts can arise from side letter agreements, transfer of assets into the fund and many other situations. Have conflicts of interest been reviewed and disclosed? Is there a plan for managing such conflicts?
- Has there been confirmation of the basis for the statements made in the offering documents?
- Does the director have sufficient time capacity to devote to the oversight and supervision of the fund?
- Is there a clear written record of the appointment of service providers and of the authorisations made by the board in connection with launch?
- Has the issue of risk management been discussed by the operators and have material risks been identified and considered?

Monthly basis (or, if more frequent, periodic dealing day basis):

- Have the operators monitored, reviewed and approved the calculation and determination of net asset values?
- Is the fund manager acquiring and divesting investments in accordance with the investment objective, strategy and restrictions set out in the offering documents and/or constitutional documents?

Semi-annual basis:

- Has the governing body (eg., board of directors) met in the last six months? Given the fund's complexity or size of investment, should the board meet more frequently?
- Review the operations of the fund manager and the fund's service providers against the fund documents, CIMA requirements and other legal requirements.
- Review risks and risk management policies of the fund.

Yearly basis:

- Has the director reviewed and considered the financial statements of the fund?
- Has 'adequate' information been disclosed to investors?
- Has the fund made its annual filings with and payments to CIMA?

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- Has the director made its annual directors registration fee payment to CIMA?

The above is, of course, not a complete list of questions to be posed by a regulated mutual fund operator, or intended to be specific legal advice. Any one fund will have facts specific to its own structure and operation. Please get in touch with your regular Collas Crill contact, should you have further queries.