COLLAS CRILL

Recent amendments to the Private Funds Law 2020: Are you now in scope?

JULY 2020

In January, we published an article detailing draft legislation named the Private Funds Bill on 8 January 2020 (the '**Bill**').

In March, we published another article after the Bill was enacted into law as the Private Funds Law 2020 on 7 February 2020 (the '**Law**').

The Law has now been further amended by the Private Funds (Amendment) Law, 2020 which was enacted into law on 7 July 2020 (the '**Amendment**') and this article has been updated to reflect the most recent amendments.

By way of a reminder, the Law sets out requirements for the registration of closed ended funds (funds in which investment interests are not redeemable at the option of the investor) with the Cayman Islands Monetary Authority ('**CIMA**'). This brings closed ended funds within the scope of a regulatory regime for the first time in this jurisdiction.

The majority of closed ended funds with more than one investor come within the scope of the Law. Specifically, the Law applies to **'Private Funds'**. Non Cayman Islands Private Funds are also captured by the Law if they invite the public in the Cayman Islands to subscribe for investment interests.

The new definition of Private Fund

'**Private Fund**' means a company, unit trust or partnership that offers or issues or has issued investment interests, the purpose or effect of which is the pooling of investor funds with the aim of enabling investors to receive profits or gains from such entity's acquisition, holding, management or disposal of investments, where:

(a) the holders of investment interests do not have day-to-day control over the acquisition, holding, management or disposal of the investments; and

(b) the investments are managed as a whole by or on behalf of the operator of the Private Fund, directly or indirectly.

Carve outs

The Law helpfully excludes several 'non fund' arrangements from its scope. The 'non fund' arrangements which are specifically excluded from the Law are:

- pension funds;
- securitisation special purpose vehicles;
- contracts of insurance;

- joint ventures;
- proprietary vehicles;
- officer, manager or employee incentive, participation or compensation schemes, and

programmes or schemes to 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 representing investments;
- clearing services;
- settlement services;
- funeral plan contracts;
- individual pension accounts;
- structured finance vehicles;
- preferred equity financing vehicles;
- a fund of whose investment interests are listed on a stock exchange (including an

over-the-counter-market) specified by CIMA by notice in the Gazette;

- occupational and personal pension schemes;
- sovereign wealth funds; and
- single family offices.

The Schedule provides that these 'non fund' arrangements will be defined in rules and guidance issued by the Ministry of Finance but to date no guidance has been forthcoming. A full list of the 'non fund' arrangements is set out in the schedule to the Law, which can be found here.

In addition, entities registered or licensed under the following are excluded from the Law:

- the Mutual Funds Law (2020 Revision);
- the Banks and Trust Companies Law (2020 Revision);
- the Insurance Law 2010;
- the Building Societies Law (2020 Revision); or

- the Friendly Societies Law (1998 Revision).

Key changes as a consequence of the Amendment

The changes to this definition are significant in four respects. All of the changes widen the definition of a Private Fund, meaning that some entities which were not previously caught will now be caught. Those changes are:

1. **Removal of the 'principal business' requirement**: There was previously an argument to be made that something was not a 'Private Fund' if it could be said that its 'principal business' was not the issuing and offering of investment interests. That argument is no longer viable as a result of this change. The Ministry of Finance has noted in its summary of the changes that the list of non-fund arrangements which are carved out of the definition of a Private Fund still includes funds not operated 'by way of business' and, therefore, if the entity is purely conducting non-commercial activities, it may be arguable that it falls outside the scope of the Law.
2. **Application to an entity where it 'offers or issues or has issued' investment interests**: Previously the definition referred to the 'offering and issuing' of investment interests. The Ministry of Finance had provided guidance previously that the requirements of the Law could not be avoided simply because a fund was no longer offered and had closed to new investors. This amendment gives that guidance statutory authority and the argument that something is not a Private Fund because its issuing of investment interests was all in the past, with no plans to issue any more, now fails.
3. **Removal of the 'spreading of investment risks' requirement**: Previously the spreading of investor risks was a requirement for something to be considered to be a Private Fund. Some commentators had suggested that this could mean that funds with a single investment were out of the scope of the Law. The Ministry of Finance had previously issued guidance that this was not the case and it was our view that funds with single investments were potentially included. The Amendment has now provided statutory certainty on this point.
4. **Removal of the reward requirement in respect of the management of assets:** Previously something was not a Private Fund unless the asset management was 'for reward based on the assets, profits or gains of the company, unit trust or partnership'. This provided an argument that certain entities in a fund structure fell out of scope of the Law as fees were not taken at that level in the structure. The Ministry of Finance has indicated that this amendment seeks to address this issue and that indirect reward, taken at another point in the structure, should be caught. If no fees are taken in relation to the management of the assets of the entity or any other entity in the structure, whether directly or indirectly, there may still be an argument that the entity is not operated 'by way of business' as discussed in point 1, above.

It is not expected that the Amendment will affect entities that were previously classified as in scope of the Law as there are no additional carve outs.

Possible exemptions for Alternative Investment Vehicles

Under the Law, where International Financial Reporting Standards or generally accepted accounting principles of the United States of America, Japan, Switzerland or a non-high risk jurisdiction permit consolidated or combined financial account reporting, and a Private Fund choses to report as such with an Alternative Investment Vehicle, that Alternative Investment

Vehicle will not be required to comply with the following requirements: (1) audit; (2) valuation; (3) safekeeping; (4) cash monitoring; or (5) identification of securities.

An Alternative Investment Vehicle ('**AIV**') is defined 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.'

Similar entities formed to hold or dispose of assets which are established in the Cayman Islands but are related to a fund in another jurisdiction (Delaware being a common example) or related to a fund which is a registered mutual fund, do not benefit from these reduced requirements and may be required to register, unless they fall outside of the definition of a private fund.

Registration with CIMA

Existing private funds must be registered by 7 August 2020 (the '**Transition Date**').

Following the transition period ending on 7 August 2020, a newly established Private Fund will be required to submit an application to register with CIMA within 21 days after it accepts capital commitments from investors and in any event, may not accept capital contributions from investors until the Private Fund is registered by CIMA.

Helpfully, a Private Fund may engage in oral or written communications and enter into agreements with potential investors who are high-net-worth persons or sophisticated persons prior to the submission of its registration application to CIMA.

Applications for registration of Private Funds will need to be submitted electronically through CIMA's REEFS web portal.

In order to apply to be registered with CIMA, as part of its electronic application submission, a Private Fund will need to submit a copy of its certificate of incorporation/registration (as applicable), constitutive documents, offering memorandum/summary of terms/marketing materials (as applicable), auditor's letter of consent, administrator's letter of consent (if applicable) and a structure chart for the entity, together with payment of the prescribed registration fee to CIMA. Private Funds which register by 7 August 2020 will be liable to payment of a registration fee of US$365.85 while Private Funds which register following 7 August 2020 will be liable to payment of a registration fee of US$4,634.14.

Once CIMA receives a complete application from a Private Fund, it will consider the application and register the Private Fund once satisfied. The Law sets out that CIMA will communicate its decision to register a fund as soon as reasonably practicable after its review of the application and the registration date of the Private Fund will be the date of submission of the complete application for registration to CIMA.

Ongoing obligations

A summary of the ongoing obligations of a registered Private Fund are set out below:

- Directors: Private Funds must have a minimum of two (2) directors for applicants that are companies. In the case of general partners or corporate directors of a Private Fund, a minimum of two (2) natural persons must be named in respect of the general partner or corporate director.
- Valuations: Private Funds must have appropriate and consistent procedures for the proper valuation of its assets. Valuations must be carried out at least once a year. Valuations must be carried out by an independent third party, an administrator, or the manager or operator of the fund provided the valuation function is independent of the management function or that potential conflicts of interest are properly identified, managed, monitored and disclosed to investors.
- Safekeeping and segregation of fund assets: The starting point under the Law is that Private Funds must appoint a custodian to hold the custodial fund assets and to verify that the fund holds title to any other fund assets and maintain a record of those assets. In practice, a large proportion of Private Funds do not appoint a custodian. A fund may notify CIMA that it is neither practical nor proportionate to appoint a custodian having regard to the nature of the assets which it holds. In this case, the fund must appoint an independent third party or the manager or operator of the fund to carry out the title verification function. If this function is carried out by the manager or operator, it must be independent from the portfolio management function and potential conflicts of interest must be properly identified, managed, monitored and disclosed to investors. CIMA's new Rules on the Segregation of Assets – Registered Private Funds ('Segregation Rules') require that the Fund ensures that no manager, operator or custodian uses assets of the fund to finance its own or any other operations in any way. The operator of the Fund must establish, implement and maintain (or oversee the establishment, implementation, and maintenance of) strategies, policies, controls and procedures to ensure compliance with the Segregation Rules.
- Cash monitoring: Private Funds must appoint a person to monitor its cash flow, ensure all cash has been booked in cash accounts opened in the name, or for the account of, the fund and ensure that all payments made by investors have been received. An independent third party may be appointed to perform this role. The manager or operator of the fund may also be appointed provided this function is independent of the management function or that potential conflicts of interest are properly identified, managed, monitored and disclosed to investors. In addition, should this function be performed internally by the manager or operator of the fund, the fund's auditor will be required to confirm that the function was carried on throughout the year when signing off the fund's audited financial statements.
- Identification of securities: Private Funds which regularly trade securities or hold them on a consistent basis must maintain a record of the identification codes of the securities it trades and holds. This information must be made available to CIMA upon request.
- Annual fee: an annual fee of US$4,268.29 (together with an additional fee of US$304.88 in respect of each of the Private Fund's AIVs up to a maximum of twenty-five (25) vehicles, as applicable) must be paid to CIMA by 15 January of each year.
- Annual return: a Private Fund will need to submit an annual return to CIMA in respect of each financial year.
- Inform CIMA of changes: details of any changes to the Private Fund which materially affect the information submitted upon the fund's initial registration must be submitted to CIMA within 21 days; and

- Accounts and audit: Private Funds will need to prepare annual accounts in accordance with the International Financial Reporting Standards or generally accepted accounting principles of the United States of America, Japan, Switzerland or a non-high risk jurisdiction and an audited set of accounts must be filed with CIMA within six months of the fund's year end. The audit will need to be undertaken by a Cayman Islands auditor approved by CIMA. A Private Fund is required to submit an audit for its 2020 financial year within six (6) months of its financial year end, unless an extension is otherwise granted by CIMA. This means that if a transitioning Private Fund registers with CIMA in August 2020 and has a financial year end of 31 December, it will need to file its audited accounts with CIMA in respect of its financial year ending 31 December 2020 by 30 June 2021.

CIMA guidance

CIMA has published the rules setting the parameters as to how the Law will be implemented in relation to the segregation of assets and the contents of marketing materials.

Based on the Rule on Contents of Marketing Materials all Private Funds, save for AIVs, will be obliged to include certain information in their marketing materials. 'Marketing materials' are defined as any document which is used to solicit investors to invest in a fund. Private Funds are not required to prepare an offering document and this is not a pre-requisite to registration.

Pre-existing ongoing obligations

- In addition to the new obligations proposed by the Law, operators of Private Funds should be aware of the pre-existing continuing obligations that Private Funds are subject to:
- Anti-money laundering: Private Funds are subject to the requirements of the Anti-Money Laundering Regulations (as amended) and will usually either delegate anti-money laundering functions to a service provider or rely on the manager or administrator to perform the functions. Private Funds are also required to appoint natural persons to the roles of Anti-Money Laundering Compliance Officer, Money Laundering Reporting Officer ('**MLRO**') and Deputy MLRO.
- Automatic Exchange of Information: all Private Funds should already be complying with their reporting obligations under the Foreign Account Tax Compliance Act ('**FATCA**') and the Common Reporting Standard ('**CRS**') which requires the collection and reporting of financial account information in relation to investors.
- Data protection: Private Funds and their functionaries and service providers will be data controllers or data processors under the Data Protection Law, 2017 ('**DPL**') and must ensure that all personal data is handled in accordance with the DPL.

Winding-up of existing Private Funds

An existing Private Fund which is in liquidation / being wound up or that has commenced the liquidation / wind-up process prior to 7 August 2020, and which submits evidence (in the form of resolutions, auditor confirmations etc.) to CIMA that its liquidation / winding-up will be completed prior to 7 August 2020, will not be required to apply for registration under the Law.

Supervision and enforcement

The Law provides CIMA with new supervisory and enforcement powers to ensure the requirements of the Law are complied with. For example, if CIMA deems it necessary to comply with its functions under the Law, it may request additional information from a Private Fund, carry out on-site inspections, impose additional conditions or apply to Court for an order to take any action it deems necessary to protect the interests of the investors. Failure to comply with the provisions of the Law may result in the imposition of fines on a Private Fund and / or its operators.

Contact

In light of the Amendment and the fast-approaching registration deadline please get in touch at regulatory@collascrill.com or with your usual Collas Crill contact, who will be happy to speak with you.

We will keep you informed of any further updates relating to the implementation of the Law.