HFMWEEK FOCUS

CAYMAN ISLANDS

Over almost 20 years, Cayman has distinguished itself as one of the world's key financial centres. Now, as financial turmoil affects the industry globally, *HFMWeek* talks to some of Cayman's fund experts about new regulation, the fortunes of its hedge fund business and future opportunities

HFMWeek: What advantages does the Cayman Islands offer as a hedge fund jurisdiction?

Iain McMurdo (IM): Cayman is the leading jurisdiction for fund formation, with over 10,000 hedge funds registered with CIMA (Cayman Island Monetary Authority). Recently, the jurisdiction has lived up to its reputation. The key advantages are the quality of its local service providers, speed of formation of fund vehicles, flexible statutory regime and absence of exchange control provisions. Cayman funds have responded to the constantly changing economic climate; whether through restructuring funds to manage investor expectations or through amendments to the fund documents in response to difficult market conditions. In addition, a number of fund managers have formed new fund vehicles to react to opportunities in the market caused by the credit crisis.

Kenneth Krys (KK): The Cayman Islands continues to offer a well-established and cost-effective regime for hedge funds. The regulatory and legislative environment is continually evolving to strengthen the jurisdiction's appeal: A revised Proceeds of Crime Law has been introduced; regulations and winding-up rules are being drafted to support recent changes to insolvency provisions in the Companies Law; the Exempt Limited Partnership Law is being reviewed; and the Cayman Islands Directors Association was launched earlier in the year and a code of conduct issued. Revisions to several other laws, including Mutual Fund Law and the Money Laundering Regulations have also been made in 2008, and lastly, CIMA has published its first Investments Statistical Analysis, which provides details on the performance of the hedge fund industry not previously available. These are all examples of steps that hedge funds are taking to be on the cutting edge of industry practice.

HFMWeek: What approaches are Cayman-based funds utilising to lessen the impact of the current financial instability? How has the crisis affected the number of start-ups?

Scott Somerville/Toni Pinkerton (SS/TP): Today, hedge funds are facing a multitude of operational challenges. Issues such as restricting liquidity, lack of representative market values, increasing margin requirements, managing events of default under-lending agreements, monitoring exposure to credit risk of counterparties and addressing increasing levels of redemption requests all require that hedge fund service providers, including administrators, investment managers, directors and legal counsel, work together to develop solutions to these pressing issues.

Many investment managers have diversified their exposure to prime brokers and counterparties in an attempt to manage credit risk. Leverage in investment strategies that were historically highly leveraged has also been significantly reduced, and, in many cases, completely removed. This reduction in leverage has freed up collateral with counterparties, providing cash to hedge funds to facilitate redemption requests while at the same time reducing volatility for remaining investors.

Illiquidity has led investment managers to scrutinise their funds' constituent documents to ensure capital is distributed equitably among redeeming and continuing investors. While some investment managers have offered fee incentives to investors who agree to longer lock-up periods and more restrictive redemption terms, funds, it seems, are able to continue to abide by their original terms to maintain the confidence of investors.

Circumstances where redemption requests exceed available cash and portfolio positions are illiquid have required directors to suspend redemptions. While these funds may be hopeful that such measures will provide the temporary relief to allow for the orderly disposal of less-liquid assets, we are generally not seeing the revival of these funds.

Kenneth Krys is managing director of **Krys & Associates Cayman Ltd.** Ken is a chartered accountant, chartered financial analyst, certified fraud examiner, certified anti-money laundering specialist and chartered business valuator.

Scott Somerville is head of Investment Funds at **Maples Finance.** Scott, who joined Maples Finance in 2003, has overall responsibility for the fiduciary, fund administration and registrar and transfer agency divisions.

Toni Pinkerton, a senior vice president at **Maples Finance**, has responsibility for the fund administration division of Maples Finance. Toni joined Maples Finance in 2004.

Iain McMurdo, partner at **Maples and Calder**, specialises in investment funds. Iain joined Maples and Calder in February 2008. Previously he was a partner at Walkers in the Cayman Islands and, prior to that, he worked for Freshfields in London.

KK: Many funds are facing liquidity issues due to the credit crisis and there has been a definite increase in the number of structured or voluntary wind-downs and closures in recent months. In order to access different strategies and maximise opportunities in the current environment, some of those funds are being 'reinvented' to save on closing and re-establishment costs. Liquidity issues are also being addressed by introducing new share classes with longer redemption terms and altering existing documentation to restrict redemptions. However, these strategies can be hard to sell to shareholders in the current environment. We believe the number of start-ups has reduced, but there is still reasonable activity in this area. For those that target distressed assets, there are opportunities to purchase assets at 'low' values. Others are concentrating in emerging markets to find opportunities.

IM: Managers are looking at ways to deal with securities in their portfolio that are illiquid. Following the demise of Lehman and the ensuing market turmoil, many securities are impossible to sell as there is virtually no market for them anymore. The restructuring of the funds has included the adoption of side pockets to package illiquid securities which are impossible to sell or value, and revision of the fund terms to reduce liquidity in return for reduced fees for the manager. Managers are also considering the employment of gates and the suspension of redemptions to manage the redemption requests from shareholders or the illiquid nature of the portfolio of the fund.

The number of funds set up either by existing managers or start-ups is lower than this time last year. Unsurprisingly, raising new funds in the current market is difficult and only those start-up managers with a proven track record will be successful.

HFMWeek: Derivative funds account for a large proportion of the Cayman market. How has this fact complicated the industry's response to the credit crunch?

SS/TP: Derivatives are used by hedge funds for a number of purposes, including yield enhancement, overlay strategies, synthetic exposure and protection against economic/portfolio events. The recent credit crisis has highlighted the fact that many investors did not fully understand the pricing and valuation risk of such investments within hedge fund portfolios.

As investors submit redemption requests, investment managers are encountering difficulties in unwinding certain positions without having to incur substantial losses. Rapidly decreasing market values have put pressure on investment managers to find free collateral to meet increasing variation margin calls. Counterparties have increased initial margin requirements, thereby putting pressure on investment managers, given that cash and credit facilities are scarce in current markets.

In the future, we expect the appetite for complex financial products to decrease, with investors looking for more transparency from hedge funds.

KK: Directors are now spending time with the investment managers and their legal counsel considering options and strategies. This may also mean having to liaise with investors more frequently. The liquidity crisis is causing problems in the valuation of some derivatives where the securities are thinly traded or where there is significant volatility in the marketplace. This is, in turn, leading to delays in the striking of net asset values (NAV) and audit opinions being issued. The latter issue is a particular problem for fund of hedge funds.

HFMWeek: To what extent is the increased scrutiny of offshore jurisdictions by the US and Europe impacting Cayman-based business?

IM: The financial services industry in the Cayman Islands acknowledges the need for a proactive approach to both US and European interest in offshore jurisdictions. The Cayman Islands funds industry has always cooperated and assisted with international initiatives. We have worked with the UK and US governments and international bodies to ensure that the Cayman Islands legal and anti-money laundering regime complies with international standards, and the Cayman Islands has also introduced transparency measures. The continued growth of the industry shows that these policies have increased institutional investor confidence in the jurisdiction.

Any new regulation would need to be carefully thought out. Changes in onshore regulations may lead to onshore jurisdictions losing business to other jurisdictions. This has happened before. For example, the introduction of an interest equalisation tax in the US in the 1960s and more recently the US Sarbanes Oxley legislation that saw a large shift of listing of international companies from the US stock exchanges to London.

The onshore regulators will need to appreciate the vital role that Cayman Islands companies and investment funds play globally. Any onshore regulation that disturbs capital flows may have repercussions for the major economies dependent on foreign investment.

SS/TP: US and European politicians and regulatory bodies continue to scrutinise the role offshore jurisdictions play in the world of global finance. Given that the Cayman Islands is widely recognised by institutional investors and investment managers as a leading jurisdiction for the establishment of offshore funds, due to its sound political, legal, regulatory and professional environment, we have not seen any change in business despite this scrutiny. The Cayman Islands' government and members of private industry continue to work together to have an open dialogue with foreign governments and associations to ensure that the Cayman Islands' financial sector continues to be recognised as a leading offshore hedge fund jurisdiction.

KK: Cayman has always been scrutinised, and history has shown that the regulators and Cayman Islands' government have been effective in reviewing the legislation, regulation and oversight of the finance sector and addressing any issues or concerns that arise. There is no evidence that the recent comments in the US and EU have impacted Cayman to date, but this is difficult to assess given the turmoil in the market. It is, however, something that is worth monitoring.

HFMWeek: What are your expectations for growth in the sector? Are there any new products on the horizon?

SS/TP: Given that we are currently in unprecedented times in the financial markets, it is extremely difficult to predict what will happen in the sector in 2009.

Despite the current state of the global financial markets, some hedge fund managers and strategies continue to produce favourable returns for investors. The risks associated with leverage have been substantially reduced, investment managers have diversified their counterparty risk and investment opportunities are available. Investors who have access to capital are exploring new markets, and looking to take advantage of discounted positions that others are looking to unload.

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We are seeing new launches in the private equity space and in distressed strategies. Infrastructure-based investment strategies in the Middle East, North Africa and other emerging markets continue to attract interest. We are also seeing a renewed interest in mortgage-backed securities and other distressed markets. Managers are approaching new launches cautiously and new hedge fund documents are taking protective measures allowing for the segregation of illiquid assets through side pockets and protecting against redemptions through longer lock-up periods and gate provisions or closed-ended structures.

IM: I do not expect significant growth in the hedge fund sector during the next 12 months. The number of start-up managers will be less than last year and I expect consolidation with existing managers merging to realise critical mass. Larger managers will be opportunistic and lure top performing portfolio managers away from underperforming managers and banks to expand, and add new, strategies to their portfolio. I also expect more fund closures as they experience increased redemption requests and realise that they have little prospect of recovering their prior high-water marks and therefore little prospect of performance fees in the short term.

In the medium term, it is difficult to say, but one can envisage greater regulation. In terms of new products, we are already seeing new funds being launched to take advantage of the dislocation of the value of certain asset classes. Liquidity continues to be a problem for managers and I expect to see more 'hybrid funds' which are either closed ended with a defined term or have drastically reduced liquidity terms (and reduced fee structures as a result).

KK: In the short term, there will be little growth as the impact of the crisis is absorbed. A stable and flexible infrastructure, one that can adapt to changing needs, such as the one in Cayman, will be important in the longer term. There are, however, prospects for growth. Strategies will change and adapt to suit the prevailing conditions. There may be some opportunities in distressed asset funds, emerging markets and 'essential' industries (food/health etc) and it remains to be seen what impact the downturn will have in China and India. ■