The Cayman Islands: A guide for hedge fund managers

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Introduction

The Cayman Islands continue to be the pre-eminent offshore jurisdiction for hedge funds. Around 85 per cent of the world’s hedge funds are domiciled in the Cayman Islands, enabling the jurisdiction to outrank competing offshore centres (BVI, Bermuda and Jersey among them) as the top spot for hedge funds.

This guide explains the attractions of the Cayman Islands as a destination for managers wanting to establish hedge funds offshore, and examines the commercial, legal and regulatory considerations that combine to make Cayman their preferred jurisdiction.

Cayman Hedge Funds: Legal and Tax

Legal

Hedge funds established in the Cayman Islands will typically take the form of a company, a limited partnership or (less commonly) a unit trust. If statutory segregation between assets and liabilities of sub-portfolios is desired, the SPC model will be attractive. Each of these vehicles can be used as a stand-alone fund, a fund of funds or as part of a master-feeder structure. Their managers need not be domiciled in the Cayman Islands (more about this later).

Generally, all open-ended funds established in Cayman will need to be registered with the Cayman Islands Monetary Authority (CIMA). A fund will be deemed open-ended if it issues ‘equity interests’ (shares, partnership interests or units) that participate in the fund’s profits and gains, and which are redeemable (or otherwise capable of being repurchased) at the investor’s option. The reference to equity interests is important, because this excludes debt instruments (including warrants, convertibles and sukuk instruments); funds issuing such instruments will not be required to be registered with CIMA. There is nothing to prevent a fund that is not obliged to register with CIMA from applying for and obtaining a registration if the manager wishes.

There are three means of obtaining registration. First, the fund is licensed directly by CIMA. Secondly, an administrator licensed by CIMA provides the fund’s principal office in the islands. Both routes entail an examination of the promoter’s reputation and fitness. Third, and most popular by far, the fund either requires a minimum initial investment of US$100k (or equivalent) per investor, or has its shares listed on a stock exchange recognised by CIMA (eg, LSE, ISE); this is the ‘section 4(3)’ fund. The scope of regulation extends to Cayman Islands incorporated or established master funds, which have one or more CIMA regulated feeder funds and hold investment and conduct trading activities. All three means of registration entail an annual fee of US$4,268.29, except in the case of registered master funds, for which the fee is US$3,048.78.

Directors of CIMA registered fund companies are required to be CIMA registered or licensed, depending on the status of the director in each case. Fees are payable accordingly. Please refer further to our guide on CIMA’s director and registration licensing regime.
An open-ended fund with 15 or fewer investors, the majority of whom are empowered under the fund’s constitutional documents to appoint and remove directors/general partners/trustees (as applicable), is exempt from CIMA registration. However, this exemption does not apply to master funds.

There are no restrictions imposed by the Cayman regime on investment strategies of hedge funds, or their use of leverage, shorting or other ‘alternative’ techniques. There is no concept of an ‘eligible investor’ in a Cayman-registered fund.

CIMA has released a Statement of Guidance which establishes key principles of good governance which must be observed by each Cayman Islands regulated mutual fund. Such principles require, inter alia, the board of directors to properly oversee the activities of the fund’s service-providers, suitably identify, disclose and manage all conflicts of interest and meet at least twice a year or otherwise more frequently as determined by the size, nature and complexity of the fund.

Tax

The Cayman Islands have no direct taxes of any kind. There are no corporation, capital gains, income, profits or withholding taxes. There are no inheritance taxes or death duties.

Upon application to the government, Cayman companies, limited partnerships, trusts and SPCs can expect to obtain a written undertaking that they will be exempted from taxes for a minimum of 20 years (companies and SPCs) and 50 years (limited partnerships and trusts). Trusts are exempted if the beneficiaries are not resident or domiciled in the islands. A hedge fund registered in Cayman will in this way take the form of an exempted company or SPC, exempted limited partnership or exempted trust, the obvious benefit of which is that income or capital gains (whether accumulated or distributed) will not be subject to tax in Cayman. The same income or gains may, however, be taxable in the hands of the manager or investors in their home jurisdictions.

There are no exchange control or currency restrictions in the Cayman Islands, in sharp contrast to other offshore centres.

The Cayman Islands do not have any double taxation treaties.

Considerations for Managers

A hedge fund in Cayman can be managed by an individual or management entity located anywhere in the world. A manager can expect to be advised by onshore lawyers and accountants on the optimum structure and domicile for both the manager (and any ‘carry’ vehicle) and the fund itself, together with the tax planning that will be of overriding interest to the investment principals and the fund’s target investors.

Regulatory

The vast majority of managers of Cayman funds do not have a presence in Cayman. There is no requirement for the manager of a Cayman hedge fund to be resident or domiciled in the islands.

An investment principal or management firm based anywhere in the world may provide investment management and advice to a fund registered in Cayman. No Cayman Islands laws or regulations will apply to that manager. Sometimes the management firm will, for tax reasons, establish an offshore management entity that may form part of its onshore group, and in Cayman that entity can take the form of a company, limited partnership, trust or SPC registered in the islands. Alternatively, the management firm (if a company or partnership) may choose to register itself in Cayman as a ‘foreign’ entity.

To any management entity registered in Cayman as a company or partnership, or as a registered foreign company or partnership (as a Cayman Manager), the Securities Investment Business Law (SIBL) applies. SIBL regulates ‘securities investment business’ broadly encompassing managing securities, dealing in securities, arranging deals in securities and advising on deals in securities. Certain exemptions from SIBL’s licensing regime are available, notably to a Cayman Manager regulated in respect of securities investment business by a recognised overseas authority (eg, FCA), a Cayman Manager carrying on securities investment business exclusively to companies within the manager’s group, and a Cayman Manager carrying on securities investment business to sophisticated persons, high net worth persons or Cayman funds the investors of which are such persons. An exemption costs US$6,100 per year.
A Cayman Manager not able to invoke an exemption or whose activities are not otherwise excluded from SIBL will require a licence from CIMA, which may come with conditions attached. A licence for most types of securities investment business costs a minimum of US$10,000 per year. Most Cayman Managers are able to claim an exemption from SIBL’s licensing requirements.

Non-Resident Managers: Tax

The zero tax position that will apply to a hedge fund registered in Cayman as an exempted entity will apply equally to a Cayman Manager that is registered as an exempted company or SPC, exempted limited partnership or exempted trust. The exemption is obtained by the Cayman Manager declaring that its business will be carried on mainly outside the Cayman Islands and an annual return to this effect must be filed. No physical presence (office space, staff, etc) in the islands is required.

Any income or capital gains realised by the non-resident Cayman Manager (and its members) from the fund will not be subject to tax in Cayman. The same income or gains may, however, be taxable in the hands of the members in their home jurisdiction. Issues or transfers of interests in the Cayman Manager will not be taxable in Cayman.

Resident Managers: Legal

Given the zero tax status enjoyed by exempted entities registered in Cayman but doing business mainly outside Cayman, investment principals rarely seek to establish residency or physical presence in the islands. All the same, the Cayman Islands benefit from top quality professional service providers (administrators, banks, trust companies, audit firms, lawyers) and any management firm (front, middle or back office) choosing to be resident will have access to an extensive support base of professional services.

Cayman law distinguishes between doing business within the islands and outside the islands. Firms resident and doing business within the islands are subject to laws and regulations governing resident businesses, chief among which is the Local Companies (Control) Law (LCCL). Foreign management firms may conduct business within the islands by establishing an ordinary (as opposed to exempted) resident company. Foreign ownership is restricted under LCCL: a local company must be Caymanian controlled, at least 60 per cent of its shares must be beneficially owned by Caymanians and the majority of its directors must be Caymanian. If the management firm can show that no Caymanian participation could be procured, despite all necessary steps having been taken, the government may issue a 12 year licence to set up shop in the islands.

An ordinary company’s register of members is open to inspection by the public in the islands (this is not the case with an exempted company). The company must have at least one director (not necessarily resident in the islands). Corporate directors are permitted.

There are no capitalisation requirements, controlled foreign company rules, transfer pricing rules, or exchange controls. The Cayman Islands do not have any double taxation treaties.

Patents and trademarks registered in the UK and EU can be registered in the Cayman Islands.

SIBL applies equally to resident management firms registered in Cayman as it does to non-resident management firms registered in Cayman and doing business outside the islands as exempted entities.

Resident businesses pay annual registration fees and an annual trade or business licence fee.

Resident Managers: Tax

There are no direct corporation or other business income, capital gains or other taxes applicable to resident businesses in Cayman. There are no direct taxes on distributions or disposals received from or made by funds domiciled in the islands or outside. No taxes are payable on dividends paid by the management entity to foreign shareholders (corporate or otherwise), dividends received by the management entity from foreign companies or interest paid by the management entity to foreign shareholders.

There are no tax residency distinctions in the Cayman Islands. Individuals are not subject to any forms of direct taxation. There is no direct taxation on their overseas income. There are no estate or inheritance taxes, or death duties.
Stamp duty and certain other ad valorem duties are payable on prescribed documents brought into or executed in the islands, and on certain leases and conveyances of land.

**Resident Managers: Immigration**

The application process for overseas executives to live and work in the Cayman Islands is, in contrast with other offshore centres, straightforward and efficient.

A work permit may be issued for periods of up to six months (a **Temporary Work Permit**). The maximum period a person may remain in the islands on a permit is nine years. Any person who has been legally resident in the islands for a period of at least nine years can generally apply for permanent residency for himself, his spouse and dependants.

Unlike most other offshore jurisdictions, there are no restrictions on overseas executives buying or renting real estate in the Cayman Islands.

**Summary**

The factors that combine to make the Cayman Islands the offshore jurisdiction of choice for hedge funds and hedge fund managers alike are readily apparent. The complete absence of tax in the islands features prominently among the attractions for fund managers: the time and effort required in other offshore (and quasi-offshore) jurisdictions to achieve tax efficiencies can be spent on other things.

The islands’ geographical proximity to the US has historically ensured their appeal to managers of alternative funds there, but with the increasing globalisation of the alternative fund industry, the islands are now the primary offshore jurisdiction for hedge funds worldwide.

The global financial system has changed radically over recent years, with a focus now crystallising on issues such as liquidity management, risk management, transparency, failure resolution and cooperation between regulators. The Cayman Islands Government, CIMA and the financial services community in the islands are actively addressing these issues with a view to enhancing the existing regulatory and legal framework in Cayman to ensure its continuing development as the leading offshore jurisdiction for alternative funds.

Notwithstanding current market volatility, and despite moves made increasingly by competing offshore centres to emulate Cayman’s tax efficiency, its effective regulatory regime and the speed-to-market it makes possible, the Cayman regime remains the pro forma for offshore hedge funds and their managers.
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