

Private Funds Law, 2020



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The most notable legislative development in the Cayman Islands in 2020 has been implementation of the Private Funds Law, 2020 (the "Law") which provides for registration of certain closed-ended collective investment vehicles (termed "private funds") with the Cayman Islands Monetary Authority ("CIMA"). More than 12,000 private funds were registered under this new regime during a short transitional period that concluded in August 2020.

What is a private fund?

The statutory definition of a private fund reflects certain characteristics that are consistent with the features imputed to collective investment schemes in other jurisdictions, notably the requirement for capital to be pooled and managed. The definition captures a managed, closed-ended fund (however structured) that offers or issues, or has issued, non-redeemable equity interests to two or more external investors that has the purpose or effect of pooling investor funds with the aim of enabling investors to receive profits or gains from such fund vehicle's acquisition, holding, management or disposal of investments.

The definition excludes certain vehicles that are otherwise regulated in the Cayman Islands, notably, CIMA licensed banks, trusts and insurance vehicles. The definition also expressly excludes a



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list of 25 scheduled 'non-fund arrangements', such as holding vehicles, joint ventures or private funds whose equity interests are listed on an approved stock exchange.

Certain types of commingled closed-ended fund vehicles routinely structured in the Cayman Islands, such as main funds, parallel funds, feeder funds, co-investment funds and alternative investments vehicles (including those vehicles which are formed for the purpose of making a single investment), will invariably fall within the ambit of the registration regime.

Registration Process

The Law sets out a registration process for private funds which involves the filing of prescribed details with CIMA and payment of an annual fee.

A registered private fund which intends to prepare an offering document or any other documents used to solicit investors ("marketing materials") is required to comply with certain CIMA prescribed rules on the contents of marketing materials (the "Content Rules"). The Content Rules will only affect existing registered private funds which prepare new or updated marketing materials or new private funds required to register with CIMA under the Law.

Continuing Requirements for Private Funds

Once a private fund is registered and has drawn down capital contributions from investors for the purposes of investment, the private fund will become subject to certain ongoing obligations which can be summarised as follows:

- **Valuation of Assets.** The Law requires that a private fund implements appropriate and consistent valuation procedures and that it carries out valuations at least annually. Such valuations can be performed by the manager or operator of the private fund (subject to functional independence or conflicts management and monitoring requirements), or by an independent valuer or an administrator.
- **Safekeeping of Fund Assets.** As a default position, the Law requires a custodian: (i) to hold private fund assets which are capable of physical delivery or capable of registration in a custodial account except where that is neither practical nor proportionate given the nature of the private fund and the type of assets held; and (ii) to verify title to, and maintain records of, fund assets. Where having a custodian is neither practical nor proportionate given the nature of the private fund and the type of assets held, title verification can be carried out by the manager or operator of the fund (subject to functional independence or conflicts management and monitoring requirements), or by an independent administrator or other third party.
- **Cash Monitoring.** The Law requires that monitoring of a private fund's cash flows, checking of cash accounts and receipt of investor payments be carried out by the manager or operator of the private fund (subject to functional independence or conflicts management and monitoring requirements), or by an independent administrator, custodian or other third party.
- **Identification of Securities.** The Law requires a private fund that regularly trades securities or holds them on a consistent basis to maintain a record of the identification codes of the securities it trades and holds.
- **Annual Audit.** The Law requires that a private fund file audited accounts with CIMA within six

months of its financial year end and that the audit is performed by an approved Cayman Islands-based auditor (of which there are in excess of 40, including each of the main globally recognised audit firms).

CIMA has issued certain rules to be followed by private funds which expand upon the above operational requirements. These rules mandate requirements with respect to the valuation of a private fund's assets (the "Valuation Rules") and the segregation of assets (the "Segregation Rules"). Most registered private funds will likely already have policies and procedures in place to ensure compliance with the matters covered by the Valuation Rules and the Segregation Rules, particularly where such private funds are managed or advised by an entity subject to 'custody rule' requirements pursuant to onshore regulation such as the US Advisers Act.

Valuation Rules

The Valuation Rules require a registered private fund to have in place a net asset value calculation policy (a "Valuation Policy") that ensures the fund's valuation of its assets is fair, reliable, complete, neutral and free from material error and is verifiable, with the methodology used to perform the valuation to be based on applicable accounting standards.

Unless otherwise required by applicable accounting standards, the Valuation Policy must require the private fund to value investments on the basis of 'fair value'. In estimating the fair value of an investment, the private fund should apply techniques that are appropriate considering the nature, facts and circumstances of the investment. Valuations must be carried out at a frequency that is appropriate to the asset held by the private fund and, in any case, on at least an annual basis.

A private fund must ensure its Valuation Policy is applied unless there is satisfactory reason not to do so. Where deviations from the Valuation Policy are likely to have an effect on the reported valuation of the private fund, they must be disclosed to the private fund's investors in advance of the determination of the valuation and agreed to by the private fund's general partner or operator.

A private fund's constitutional documents or marketing materials must explicitly describe the

limitations or potential limitations of the Valuation Policy and any material involvement by the investment manager in the valuation of the private fund's portfolio and any conflicts of interest caused by such involvement.

The private fund's general partner or operator has ultimate responsibility for oversight of the entire valuation process, and must approve and review at least annually, the Valuation Policy utilised by the private fund.

Segregation Rules

The Segregation Rules require a registered private fund's portfolio to be segregated and accounted for separately from the assets of the general partner, operator, investment manager and any other service provider appointed to ensure the safekeeping of the fund's portfolio, and they also require a private fund to ensure that none of such persons use the fund's portfolio to finance their own or any other operations.

The Segregation Rules also require a registered private fund to establish, implement and maintain strategies, policies, controls and procedures to ensure compliance with the Segregation Rules that are consistent with any disclosures made in the private fund's offering document and that are appropriate for the size, complexity and nature of the private fund's activities.

Sanctions for Non-Compliance

In addition to criminal and monetary sanctions for non-compliance set out in the Law, CIMA also has the power to impose additional administrative fines for breaches of prescribed provisions of the Law committed by entities and individuals that can exceed US\$1 million for 'very serious' breaches.

The introduction of the administrative fines regime reinforces the need for all private funds and their operators to understand their obligations under the Law and to ensure that they maintain appropriate systems and controls to meet these obligations, as failure to do so could now potentially result in the imposition of significant fines.

Conclusion

The Law introduces a proportionate regulatory overlay for closed-ended funds and is responsive to recommendations made by international partners. The Law reflects the Cayman Islands' commitment as a co-operative jurisdiction that has been recently affirmed by the EU and other international organisations and covers similar ground to existing or proposed legislation in a number of other jurisdictions.

The Law also provides several benefits that include: (i) allowing Cayman Islands private funds to be distributed more broadly, including to investors who are only permitted to invest in regulated products (whether, for example, due to internal policies or the securities laws applicable in their jurisdiction of domicile); (ii) streamlining set up and registration formalities for Cayman Islands private funds by way of simplified compliance procedures; and (iii) facilitating more efficient regulator-to-regulator communications.

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