



Leaner and Meaner? A Cayman Perspective on Hedge Fund Trends

This article considers recent trends in the hedge fund industry, as seen from the Cayman Islands legal perspective, following the upheaval of the recent global economic downturn. In the shakedown we have been left with a contracted industry – less funds and less managers – but it is the best, the most efficient and the most successful managers who have survived, and inherited a new model where investors have more control and transparency and liquidity are the key trends.

Fund launches over the past nine months have revealed a number of trends in the hedge fund industry applicable to this jurisdiction. While the Cayman funds industry has certainly taken a knock (as has the industry generally), we are not seeing the threatened drift away from Cayman to destinations like Luxembourg and Dublin. The latest numbers from the Cayman Islands Monetary Authority (“CIMA”) show registered mutual fund numbers hovering around 9600, reflecting the islands’ continuing market dominance, and that does not include the thousands of private equity funds established here. Accordingly, despite attacks on offshore centres, the attraction of Cayman, for US managers in particular, is still strong - in large part because setting funds up here is so simple – minimum red-tape, service providers with a wealth of knowledge and experience and zero tax.

Recent trends that will be of interest and relevance to service providers in the Cayman Islands include:

1. Investors are focusing ever more on liquidity and transparency;
2. Investors have more control and are able to dictate terms of the fund to a greater degree;
3. The level and quality of investor due diligence continues to increase;
4. New launches are typically smaller and seed investors appear to be in demand;
5. An increase in managed accounts, single investor funds, distressed asset funds and funds investing in emerging markets;

6. An increase in the number of side letters crossing our desks;
7. Overhauled constitutional documents and an increasing emphasis on getting the documents right from the outset;
8. Incentive fees that are more favorable to the investor and aligned to the ongoing success of the fund; and
9. Anticipation of increased regulation which is surely on its way

A Buyer's Market

In the current market it is not surprising that managers are having to compete to attract investors and are finding the raising of new funds difficult. This has meant a swing in the balance of power squarely toward the investor.

Investors are demanding increased transparency, seeking assurances of better portfolio liquidity (and the matching of fund level liquidity with portfolio liquidity), negotiating the liquidity terms of funds and conducting extensive due diligence on fund documents, custody arrangements and service providers. Conyers Dill & Pearman has seen a dramatic increase in the number of investors coming to the firm to review fund documents and provide legal advice (to highlight any unusual terms or inconsistencies) prior to investment. Conversely, we are also regularly being asked to respond to comments from prospective investors on documents that Conyers has prepared for Cayman incorporated funds. Investors are increasingly able to dictate terms in the fund documents prior to launch, or in side letters thereafter. This can lead to a longer lead-in time for fund launches as investors take time to review the documents and negotiate terms. The obvious impact on funds is an increase in costs.

Side Letters

Conyers has seen an increase in the number of side letters we are being asked to advise on as investors demand additional liquidity and transparency terms from managers. These often include "Most Favoured Nation" clauses which essentially provide that if better terms are offered to any other member in the future, such terms shall also be offered to the investor which is party to the side letter. Consideration needs to be given to whether the proposed terms in a side letter contravene the constitutional documents of the fund, the potential risks inherent in granting preferential terms to a special investor, and legal advice obtained in that regard. Further, the efficacy and enforceability of side letters has not yet been tested in Courts in the Cayman Islands and the risks associated therewith should be considered by funds and investors alike. Where side letters are governed by a law other than the Cayman Islands, conflict of laws issues may also arise.

Structural and Strategy Changes

New funds are typically smaller which, again, is not surprising in the current market. We have seen an increase in the use of managed accounts and single investor funds for large institutional investors who can dictate terms and not have to compete for liquidity. However, the use of single investor funds has not been as prevalent as was initially anticipated they may be. The cost inefficiencies have probably made them unattractive to all but the most significant investors.

Investors are favoring managed accounts, and a structure Conyers is more often being asked to establish is the segregated portfolio managed account platform or fund. This structure is designed so that each investor subscribes into a separate segregated portfolio of a Cayman Islands segregated portfolio company (“SPC”), with each segregated portfolio then making direct investments or investing through a separate master fund. The investment of each member is then ring fenced but the incorporation and ongoing costs at the SPC level can be shared.

Funds with investment strategies concentrating on distressed assets and emerging markets are also on the rise. As a result, Conyers has seen an increase in activity in its offices in Brazil, Hong Kong, Singapore and Mauritius, probably also enhanced by Cayman’s recent IOSCO membership.

Fund Documents

Legal advisors, investors and funds have learned from the turmoil of the past two years and are ensuring fund documentation is sufficiently flexible, clearly drafted and provides the tools and mechanisms necessary to deal with potential future problems. Fund managers and investors are now far more aware of the potential pitfalls and want to deal with them clearly in the documents from the outset.

Some of the key changes made to constitutional documents include:

- side pockets, gates, lock-ups, and suspension and redemption payment terms are more rigorously scrutinized, are being included in constitutional documents from the outset, where possible, or being left out entirely under pressure to attract investors;
- provision for the establishment of valuation committees;
- more detailed provisions regarding payments in kind, including specific references to special purpose vehicles and/or liquidating trusts that may be established by the fund in the future for the purpose of liquidating investments;
- specific provisions relating to the suspension of redemption payments and when a member loses their rights as such on redemption, following the decision of the Court of Appeal in *In the Matter of Strategic Turnaround Master Partnership Limited*.

Conyers' global funds team has recently undertaken a complete overhaul of the firm's suite of fund documents to provide for the above and other legal issues, matters and contingencies.

Fees

We have not seen the dramatic decrease in manager fees which some predicted back in 2008 and 2009. The consensus seems to be that, in general terms, the previously standard 2% management fee has experienced downward pressure so that 1.75% and 1.5% are now common¹. However, the standard 20% performance compensation rate has generally held up.

Some managers are, under pressure from investors, including clawback language in the fund documents so that the manager sets aside a portion of the incentive fees in a separate account that are subject to clawback and if fund performance in a subsequent period is positive it can be released and paid to the manager. If it is negative, the clawback amount will be returned to the fund. Further, some managers are taking compensation by way of allocation class shares in the fund, aligning their interests to the continued success of the strategy. Managers are also trading lower fees for reduced liquidity (and vice-versa) to attract investors.

Regulation

New regulation in the hedge funds industry remains something of an unknown quantity. However, adviser registration and increased reporting in the United States and increased regulation in Europe is inevitable. Increased regulation will mean increased costs for funds.

Offshore regulators, including CIMA, will likely take a lead from the form that regulation of funds and their managers in the major onshore jurisdictions eventually takes. The challenge will be for CIMA and the Cayman Islands Government to increase regulation in Cayman to meet the new global standards, while continuing to apply the pragmatic approach to fund regulation that offshore regulators have evinced in the past.

Conclusion

The dominant theme that is presently driving trends in the hedge fund industry is the focus on liquidity. The investor is king and they are presently able to dictate terms to a greater degree, leading to tighter liquidity and transparency terms in fund documents or side letters, different fund structures and fees aligned to the long term

¹ See Schulte Roth & Zabel, *Private Investment Funds Seminar*, 14 January 2010.

performance of the fund. In the writer's opinion, these trends will have a positive impact on the industry, leaving us with a leaner but more successful, aware and efficient industry overall.



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This article is not intended to be a substitute for legal advice or a legal opinion. It deals in broad terms only and is intended to merely provide a brief overview and give general information.

About Conyers Dill & Pearman

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