



# Response to Cayman Islands Monetary Authority Private Sector Consultation on Corporate Governance

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## 1. Introduction

The HFSB welcomes the opportunity to respond to the Cayman Island Monetary Authority (CIMA) Private Sector Consultation on Corporate Governance.

The Hedge Fund Standards Board (HFSB) is the guardian of the Standards drawn up by international investors and hedge fund managers to create a framework of discipline for the hedge fund industry. The HFSB's mission is to promote the Standards through collaboration with managers, investors and the regulatory community. Appropriate governance arrangements are an important element of the HFSB framework.

The HFSB actively engages with the regulatory community and has responded to consultations on issues in relation to hedge fund regulation and good practices, including recent consultations from ESMA, IOSCO, FSB and others.

The HFSB is pleased to continue to feed into the global regulatory process and help CIMA improve its framework for corporate governance.

## 2. General observations

Strong governance arrangements are important in areas where conflicts of interest can arise and where there is an increasing remoteness between ultimate investors and the underlying managers. In the context of asset management, there has been an increased debate about the effectiveness of some boards of directors, and in particular their ability (and capacity) to handle conflicts of interest properly and to deal with situations of distress (e.g. fund illiquidity).

Governance is an integral part of the Hedge Fund Standards and is covered across all sections, including responsibilities of the board and interaction between the fund board and the hedge fund manager. It is important to highlight that many of the HFSB signatories (hedge fund managers that signed up to the Standards) manage funds domiciled in the Cayman Islands and thereby fall under the requirements set out by CIMA.

CIMA's governance principles and requirements are cast at a high level in order to be applicable to a wide range of financial services activities. To increase the relevance of the framework to specific areas of activity, CIMA may find the governance requirements in the Hedge Fund Standards to be a useful complement to its own high level framework in the area of hedge fund management. As set

out under Question 1 and 2 below, the HFSB would be delighted to discuss in more detail how CIMA can make use of the Hedge Fund Standards.

### 3. Specific comments

**Question 1: To facilitate the cross-sectoral application of the SOG, the Authority has restricted the corporate governance guidance in the SOG to fundamental principles and requirements. Does the industry find this useful and appropriate or would the industry prefer more detailed guidance?**

The high level principles are a good starting point to formulate universal governance requirements in different areas of finance. Many of the principles formulated in the Statement of Guidance are useful and high level enough to be applicable to a broad cross section of boards in the financial services market place, but there are also a number of areas where the principles appear to be tailored to bank or insurance boards, but not necessarily relevant to fund boards – this is summarised below.

As indicated in the introduction, the high level nature of the principles results in limited specificity to crystallise good practice in specific areas such as hedge fund governance. Question 2 delineates how CIMA can improve its approach, without necessarily having to develop separate and detailed sets of standards for different activities covered by the principles.

#### Observations and recommendations for improvements

- **Responsibility of the Board (3.2.2):** “setting of strategy and risk appetite” – this is usually governed by the offering documents (in particular risk appetite/strategy), the role of the board is to review regularly adherence of the manager to investment policy and investment restrictions (see Guidance to HF Standard 21.6).
- **Responsibility of the Board (3.2.3):** “*monitor compliance with the laws, regulations, rules of the Cayman Islands...*”- This should not be restricted to just Cayman Islands laws/regulations/rules.<sup>1</sup>
- **Responsibility of the Board (3.2):** There is no mention of managing potential conflicts of interest (e.g. between investors and the manager, and in between investors), which is among the main responsibilities (also see HF Standard 21.1)
- **Director Duties (4.8.1 (a)):** “... *Director in relation to the company*”: should read “... Director in relation to the Regulated Entity” (to ensure consistency with the remainder of the Statement of Guidance)
- **System of risk measurement and control (7.1):** The hedge fund manager is normally in charge of the day-to-day risk management of the fund, with regular reporting to the board (“board oversight”). The specific suggestion to maintain a “system of risk measurement and

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<sup>1</sup> The guidance included in the Hedge Fund Standards (Standard 21) specifically mentions board review of: any regulatory breaches, manager reporting of anti-money laundering requirements, legality of side letters/discretionary waivers, and reports on compliance with laws and regulation applicable to activities which are performed by the administrator. The guidance also highlights the importance of direct reporting from the manager’s compliance officer to the board.

control” might suggest that the board puts a dedicated “risk measurement system” in place, which is separate from the manager’s risk management (and measurement). This is uncommon and likely not feasible. Therefore, the suggested wording below might be more appropriate:

- *“The Board should provide suitable oversight of risk management (including operational risks) and regularly review the risk reporting provided by the management.”*
- **Determining risk appetite and developing policies, procedures and controls for identifying, assessing and managing all significant risks faced by the company (7.2):** In a fund management context, the risk profile and potential limitations of risk taking of the fund are usually set out in the funds’ offering documents. While the day-to-day risk management resides with the hedge fund manager, the boards have a particular role to manage situations of distress (e.g. situations of illiquidity requiring fund gating, etc.). While the board will have its own procedures to oversee the risk management of the hedge fund manager (incl. regular review of adherence to investment policy, review of business continuity, reports on compliance with laws and regulation, etc.), the hedge fund manager will be in charge of developing detailed procedures and controls for identifying, assessing and managing all significant risks. However, this does not mean that the board can take a very narrow view on their responsibility on issues in relation to risk management: The Hedge Fund Standards require the manager to discuss these risk management processes with the fund governing body.
- **Risk function /ALM committee / customer awareness / complaint procedures (7.4):** Some of the specifics in this section seem to be tailored to bank/insurance boards, including organisations catering for retail clients, rather than being broadly applicable. CIMA might consider highlighting a number of broader principles, including for example the board’s role in managing and mitigating conflicts of interest that can arise between the management and investors in areas such as risk management, valuation, ALM, complaints handling, remuneration etc. (not all of which will be applicable in all instances).

**Question 2: Does industry approve of the cross-sectoral application of the SOG or would you prefer sector-specific guidance? If you would prefer sector-specific guidance explain the reasons for your preference.**

High level principles provide flexibility, but they often lack the specificity and detail that can help crystallise good practice in specific areas of activity such as hedge fund governance. The specific issues that boards need to address may differ: conflicts of interests arising in the context of hedge funds are not the same as those in private equity, insurance or banking.

The HFSB believes that this is where a mechanism of sector specific Standards is a powerful way to fill the high level principles with relevant content. Standards are one of many techniques of regulation to achieve the public policy objectives embodied in legislation, and conceptually they are more granular than principles, but lack the rigidity of prescriptive rules (see Appendix A on the Role of Standards in Public Policy).

In order to make this approach more relevant to specific areas of activity such as hedge fund management, CIMA may wish to consider drawing upon the Hedge Fund Standards. The Standards are particularly suitable for areas such as governance, where they can allow exceptions whilst still aiming at the behavioural outcome intended by the legislation and the principles.

Drawing up on existing industry guidance has a number of advantages:

- **Consistency:** minimising the risk of deviating from what is considered good industry practice.
- **Flexibility:** There are different ways of embracing third party Standards, including “recommending them as guidance”, “encouraging sign-up on a *comply-or-explain* basis”, “mandatory application”.
- **Credibility and global recognition/equivalence:** The Hedge Fund Standards are recognised around the globe, and fund managers and investors in many markets make use of them, which makes it easier to communicate the approach to investors, managers, international regulators etc.
- **Leveraging a well-established process:** Rather than maintaining multiple sets of detailed Standards for the various areas covered by the Statement of Guidance, CIMA can take advantage of the work of global bodies such as the HFSB, so that it does not have to replicate a similar process or duplicates the existing materials.

The HFSB recommends that CIMA should reference the Hedge Fund Standards in the Statement of Guidance in relation to hedge fund governance and encourage fund boards to work with managers to adopt the Hedge Fund Standards. Other areas of financial activity can also be referenced in the Statement of Guidance.

### About the Hedge Fund Standards

The Hedge Fund Standards Board (HFSB) has developed standards and guidance specific to the hedge fund sector. The Standards include a dedicated section on governance and deal with the issues and specific conflicts of interests arising in this context. The Hedge Fund Standards are kept up to date by the HFSB via public consultations with the industry to ensure they stay relevant.

Managers sign up to the Standards on a “comply-or-explain” or explain basis, which provides sufficient flexibility to accommodate a large spectrum of firms. While the signatories to the Hedge Fund Standards are hedge fund managers, the fund governing body plays a prominent role in this.

The HFSB is governed by managers and investors, bringing together the “users” and “providers” in the market place. Many HFSB signatories manage funds domiciled in the Cayman Islands, and many of the investors involved with the HFSB invest in Cayman funds. The total AUM of HFSB signatories is ~500BN USD.

**Question 3: Do you consider the information proposed to be available on the public database to be relevant and appropriate or would it be beneficial to include further information such as (where applicable) custodian, fund administrator, insurance manager, or auditor?**

The HFSB has no objection to CIMA including further information in the database (e.g. as listed in the PPM, such as Administrators, Auditors, Custodians, registered office, etc.), which could also include past directorships of individuals. This will significantly improve investors' ability to conduct due diligence. It is important that information in the database is up to date.

Additional observations:

- CIMA may also wish to revisit the searchability of the database, to allow searches not only by company name, but also by Director name.
- CIMA may also wish to review the databases maintained by other regulators to assess the spectrum of feasible approaches. The [FSA](#) provides a freely accessible register that allows one to search for regulated entities both by name and individuals, etc. Various other regulators maintain registers where they list registrants by name, including the [SEC](#), [Singapore Monetary Authority](#), [Ontario Securities Commission](#), etc. The [Hedge Fund Standards Board](#) maintains a register of signatories on its website.
- Registers maintained by regulators are typically freely accessible. If CIMA decides to charge for access, it is important that different pricing models (e.g. at least two: pay per search vs. flat fee) allow to accommodate different types of users.

## Appendix A: The Role of Standards in Public Policy

### Summary

1. Standards set levels of quality in behaviour and working practice which can complement the public policy framework. In particular, in areas of complex, diverse or more innovative practice, they allow to achieve regulatory objectives more efficiently than detailed and rigid rules.
2. The process put in place by the HFSB relies on both investors and regulators to endorse and drive adoption of the standards. The HFSB process is designed to reflect the global nature of the industry and the fact that policymakers recognise the need for a global approach to hedge fund regulation.
3. In order for the HFSB process to be fully effective, it is important that it is supported by the EU Draft Directive as well as by individual jurisdictions.

### What can standards achieve?

4. In the financial services area legislation is generally drawn up to address public policy objectives. These generally include systemic issues, protection of investors or customers and issues relating to market integrity. However, it has long been recognized that relying on legislation alone is not always effective. The reasons for this include the slow pace of the legislative process as well as the inefficiency of relying on the courts as the only mechanism to address issues of compliance and sanction.
5. Consequently, systems of regulation have been created which are more flexible and cultivate appropriate behaviours and in the event of non-compliance can be corrected through a combination of regulatory direction, intervention and sanction.
6. Systems of regulation include various techniques to achieve the public policy objectives embodied in the legislation which addresses specific areas of business, firms, or markets.
7. These techniques include three levels of granularity. They are: Principles, Standards and Rules. For each of these, public authorities may choose different mechanisms to ensure compliance depending on how they view the effectiveness of each alternative.
  - **Principles** are normally expressed at a high level and are likely to be embodied directly or indirectly within the legislation itself. A good example is the set of principles which govern the behaviour of firms regulated by the Financial Services Authority in the UK. They are widely regarded as a satisfactory articulation of the behaviours that the legislation itself is designed to achieve.
  - **Rules** are at the other end of the spectrum. These are designed to state the precise manner in which firms are expected to conduct themselves and failure to do so will lead to sanction or intervention by supervisors or eventually courts. By their nature, rules need to be precisely defined in order to create legal certainty. They may be modified as circumstances

change but because rules need to be both precise and relevant to the intended outputs, they can become cumbersome and take a long time to change in response to evolving environments, at least due to the requirement to run lengthy and often iterative consultation. Therefore, rules work best when there is a limited need for change and where clarity can be achieved without exceptions or complex detail. A good example is registration of firms and authorization of their operations.

- **Standards** are typically less granular than rules, but generally set out the principals of behaviour required in greater detail than can be achieved in the legislation or the principles themselves. They are specific to particular areas of business such as Hedge Funds or to an area, like Governance where detailed rules will be difficult to draw up in a meaningful way. Standards are an appropriate way to express required behaviours in fast moving areas of business and to ensure that such principles of behaviour evolve with the development of that business. They can allow exceptions whilst still aiming at the behavioural outcome intended by the legislation and the principles. The alternative would be overly detailed rules in order to accommodate exceptions etc., which can lead to complexity, rigidity as well as parties circumventing the spirit of the rules by adapting new definitions, technical business models or escaping to other jurisdictions.

## Appendix B: Governance in the Hedge Fund Standards

Governance is covered throughout the Hedge Fund Standards, including areas such as Valuation and Risk Management. There is also a dedicated Governance section addressing the specific conflicts of interest that can arise in a hedge fund context.

Many of the governance concepts included in the CIMA Statement of Guidance on Corporate Governance are covered in the hedge fund Standards, with further specific detail applicable in the hedge fund context. Included below the governance section of the Hedge Fund Standards.<sup>2</sup>

### Fund Governance [Standards 21+22]

Potential conflicts of interest can arise between hedge fund managers, the hedge funds which they manage and investors in those hedge funds. To mitigate these potential conflicts, appropriate governance mechanisms and oversight are required.

An important issue to consider on establishing a fund, therefore, is the mechanism for addressing and containing such potential conflicts of interest. This issue may not have been accorded great importance when the hedge fund industry was in its infancy; perhaps reflecting the fact that the relationships between managers and their relatively few private investors were more informal or that managers themselves may have been the main investors. As such, these relationships were essentially based on mutual knowledge and trust at that time. As the industry has grown, however, the investor base has broadened with more and more institutional investors (insurance companies, pension funds, endowments and so on) and funds of funds starting to invest in hedge funds. The HFSB considers that this change in the investor base requires a reinforcement of oversight processes.

Of course, not all hedge funds are the same and so practices in any particular case may need to reflect the investor base, the size and age of a fund and other relevant factors. The legal structure will also need to be taken into account, with the governance mechanism applicable in the case of a fund structured as a company, for example, differing from that applicable in the case of a limited partnership or unit trust.

This indicates a “spectrum” of acceptable governance approaches. Conceptually, the HFSB believes that in most cases the preferred model involves establishing a fund governing body comprising a majority of independent directors, who are suitably qualified and experienced such that they are comfortable holding the manager to account for its performance and conduct. The HFSB recognises, however, that, amongst other things, the nature of the investor base, market practice in certain jurisdictions, the legal structure of the fund and the availability of individuals to serve on fund governing bodies will in some cases legitimately result in alternative governance mechanisms being adopted.

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<sup>2</sup> Source: <http://www.hfsb.org/?section=11502>



Where the preferred model outlined above is not adopted (for whatever reason), the HFSB believes that it is appropriate to consider whether the fund's constitution or offering documents should provide for certain decisions or actions (for example, material changes to fees, investment strategy, etc.) to be made or taken only with investor consent (obtained in accordance with the provisions relating to investor voting/ consent/approvals contained in the fund's constitutional documentation or offering documents) or, if applicable, where advance notice has been given sufficient for investors to redeem their investments before such decisions or actions take effect.

Of course, the HFSB acknowledges that irrespective of the chosen governance approach, in practical terms, investors usually choose a manager to invest with rather than appointing a fund governing body with a mandate to select an appropriate manager.

### **Fund governance Standards and Guidance [21]**

**21.1 Prior to the establishment of a fund, a hedge fund manager should assess where the fund governance structure should lie on the "spectrum" (see above). In light of that assessment, the manager should be proactive in seeking to ensure that a fund governance structure which is suitable and robust to oversee and handle potential conflicts of interest is put in place at the outset.**

In determining the fund governance structure which is suitable in the case of any particular fund, the HFSB believes that managers will wish to consider:

- the range of relevant skills and experience of the members of the fund governing body and the extent to which the fund governing body is able adequately to supervise, and hold to account, the hedge fund manager; and
- the extent to which the fund governing body is able to operate independently of the hedge fund manager.

**21.2 Where a majority of the individual members of the fund governing body are not independent of the manager or where there is no fund governing body, certain key actions such as (a) material adverse changes to: the fees and expenses payable by the fund to the manager or the redemption rights available to investors, or (b) material changes to the fund's stated investment strategy or legal structure should (unless required by law or regulation) only be taken with investor consent (obtained in accordance with the provisions relating to investor voting/consent/approval contained in the fund's constitution or offering documents) or if advance notice is provided sufficient for investors to redeem before such actions take effect.**

For the purposes of this Standard, the HFSB would not consider a member of a fund governing body to be independent if he or she is a director, employee, partner or officer of the fund's manager or of any member of the manager's group with the following exceptions:

The HFSB acknowledges that in certain structures, an entity within a manager's group may act as the governing body to certain funds managed (e.g. as a general partner to a limited

partnership fund). Where an individual acts as a director of such an entity and, but for this, would be considered independent of the manager, then, such an individual may still be viewed as independent for the purposes of this Standard.

**21.3 Members of the fund governing body should have suitable experience and integrity in order to discharge effectively their role with the appropriate level of independence.<sup>3</sup>**

**21.4 The composition of the fund governing body and the governance processes in place should be monitored and, if necessary, adjusted throughout the life of the fund to ensure that they remain effective and appropriate in light of, amongst other things, changes in the nature of the fund and its investors.<sup>4</sup>**

**21.5 The fund governing body should meet regularly and conduct such meetings in a manner which safeguards the intended legal, regulatory and tax status of the fund. Such meetings should be appropriately documented.<sup>5</sup>**

- In normal circumstances the HFSB would expect fund governing bodies to meet at least quarterly.

**21.6 Careful consideration should be given to the extent to which the adoption by the fund governing body of all or parts of established codes of corporate governance or other director guidance is appropriate.<sup>7</sup> Fund governing bodies should be adequately resourced in order to comply with any such corporate governance code or director guidance.<sup>6</sup> This includes ensuring that the fund governing body has adequate resources to comply with any such corporate governance code or director guidance.**

Whilst the HFSB recognises that managers cannot legally require independent boards to adopt good practice principles for their governance, they should nevertheless use their influence to encourage adoption and compliance. Naturally, the HFSB is also aware that the Standards in no way override legal, technical, contractual and tax realities.

As guidance to managers when considering which corporate governance code or director guidance are appropriate for fund governing bodies to adopt, the HFSB has set out below a selection of those principles contained in the corporate governance codes and director guidance published by AIC and AIMA which it considers to be of greatest importance<sup>7</sup>. The HFSB recognises, however, that not all of these principles will be applicable to all types of hedge funds:

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<sup>3</sup> See introduction, chapter 1.3: The fund versus the manager

<sup>4</sup> See introduction, chapter 1.3: The fund versus the manager

<sup>5</sup> See introduction, chapter 1.3: The fund versus the manager

<sup>6</sup> See introduction, chapter 1.3: The fund versus the manager

<sup>7</sup> AIC: Association of Investment Companies: The AIC Code of Corporate Governance, <http://www.theaic.co.uk>; Alternative Investment Management Association: AIMA's Offshore Alternative Fund Director's Guide (2008), [http://www.hedgefundmatrix.com/aimahfm/filemanager/root/site\\_assets/matrix\\_primary\\_source\\_documents/aima\\_oafd\\_jan\\_2008.pdf](http://www.hedgefundmatrix.com/aimahfm/filemanager/root/site_assets/matrix_primary_source_documents/aima_oafd_jan_2008.pdf)

- directors’ potential conflicts of interest should be disclosed fully to the fund’s investors (through the fund’s offering documents) and the board as a whole (at the first available meeting) (AIMA 1.4);
- fund boards should have sufficient collective expertise, availability and be otherwise qualified to understand the investment policy and strategies of the fund and the attendant risks (AIC 6, AIMA 1.4). Expertise should include areas, such as investment management, regulatory issues, accounting, administration and technical understanding of the fund’s strategies;
- the board should put in place a policy on tenure of directors and disclose it in the fund’s offering documents and its annual report (AIC 4);
- directors’ remuneration should reflect their duties and responsibilities, and the value of their time spent (AIC 8);
- regular face to face board meetings should be held, preferably quarterly (AIMA 1.6). Typical board agendas may include approval of accounts, investment performance review, review of any relevant regulatory breaches and review of the performance of third party service providers, such as the administrator and prime broker(s), review of the manager’s risk management procedures;
- there should be regular review of adherence by the manager to investment policy and investment restrictions, review and approval of side letters, compliance and valuation functions and regular review of business continuity. (AIMA 3.5 provides further detail);
- the manager, external valuation agent and administrator should be required to report regularly to the fund directors regarding performance, subscriptions, redemptions and adherence to investment policy and restrictions and applicable anti-money laundering requirements (including direct reporting from the compliance officer and any in-house valuation function) (e.g. AIMA 4.2 and 6.2 and 6.5);
- the fund directors should be made aware of their personal responsibility for the issuance and legality of side letters or discretionary waivers (AIMA 6.9 and 6.11); and
- the directors should consider whether the fund should take out D&O insurance proportional to any liabilities relating to the directors’ role with respect to the fund (AIMA 7).

**21.7 Regular reports on compliance with laws and regulations (in particular those relating to anti-money laundering) applicable to activities which are performed by the administrator on behalf of the fund should be obtained by the fund governing body from the fund’s administrator.<sup>8</sup>**

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<sup>8</sup> See introduction, chapter 1.3: The fund versus the manager

## Fund Governance – Disclosure Standards and Guidance [22]

### **22.1 Details of the fund governance structure which is put in place should be disclosed in the fund's offering documents.<sup>9</sup>**

This could include elements such as:

- biographies of each director setting out details of his/her experience relevant to performing the role of a member of the fund governing body;
- an indication as to whether each member of the fund governing body is independent of the hedge fund manager; and
- details of any corporate governance code or director guidance with which the fund governing body has agreed to comply.

### **22.2 The existence of any class of shares which are held only by the manager (or an entity connected with the manager) and which carry voting rights affecting any aspect of decision-making in respect of the fund should be disclosed in the fund's offering documents.<sup>10</sup>**

*Such classes of shares are often known as "founder" or "management" shares and carry rights to, amongst other things, vote (to the exclusion of any other shareholders) on the appointment or removal of directors and/or the termination of the investment management agreement between the hedge fund and its manager.*

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<sup>9</sup> See introduction, chapter 1.3: The fund versus the manager

<sup>10</sup> See introduction, chapter 1.3: The fund versus the manager