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## DIRECTORS AND OFFICERS

# Establishing a Best-in-Class Governance Framework for Cayman Funds (Part One of Two)

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Over the past two decades, the role of professional independent directors in the alternative investment funds industry in the Cayman Islands has greatly evolved. The evolution has accelerated following major high-profile fraud cases; significant changes in U.S. and global economic cycles; and growing demand by regulators and investors alike for better governance and increased independent oversight of the management and administration of investment funds.

When establishing a best-in-class governance framework, it is essential to review and consider several key resources, including relevant Cayman Islands law; English common law; the Code of Professional Conduct adopted by the U.K. Institute of Directors; the Code of Professional Conduct adopted by the Cayman Islands Directors Association; the Fund Directors' Guide published by the Alternative Investment Managers Association; the Statement of Guidance for Regulated Mutual Funds; and the Statement of Guidance on Professional Indemnity Insurance for Trust, Insurance, Mutual Fund Administrator, Securities Investment Business and Company Management Licensees and Directors published by the Cayman Islands Monetary Authority (CIMA). In addition, it is essential to consider investor and allocator expectations and demands, together with market and

industry trends and best practices in governance.

This two-part series explains how to establish a best-in-class governance framework for Cayman funds. This first article covers board selection and composition, along with on-boarding directors. The second article will review board meetings, service provider reports and board self-assessments.

See our two-part series in which a CIMA regulator discusses key issues for advisers that manage Cayman Funds: "[AML, Fund Governance and the Cayman LLC](#)" (Sep. 7, 2017); and "[AIFMD Marketing Passport, Whistleblowers and Administrative Fines Regime](#)" (Sep. 21, 2017).

## Phase I: Board Selection and Composition

### Skillset, Experience and Diversity

Whether a fund's board should be composed of a majority or entirely of independent directors (and whether decision making can or should be made within or outside of the Cayman Islands) will be determined by onshore and offshore fund counsel when structuring the fund. At present, there are no requirements under

Cayman law to have Cayman resident directors. Given the continuing development and increasing complexities of Cayman regulation, however, many fund managers are opting for experienced Cayman-based professional directors with knowledge of the applicable regulatory regimes to help them navigate the ever-evolving changes in the legal, compliance and regulatory landscape affecting Cayman-domiciled funds.

Good governance includes putting together a well-balanced complement of board members, so it is important to understand the professional experience, skills and background of the directors to create a board with a diversified skill set. Although there are no strict criteria, a well-balanced board should include directors who have:

- previous experience serving on investment fund boards;
- knowledge of risk management;
- knowledge of the legal and regulatory regime where the fund is domiciled and regulated;
- knowledge of accounting or administration; and
- knowledge of valuation principles.

A diverse board composed of directors with varying backgrounds and with a gender balance and racial balance provides a valuable range of perspectives and assists with addressing investor environmental, social and governance factors. With more investors examining diversity and inclusion within investment managers and the alternative investment industry as a whole, those are increasingly important considerations when putting together a fund board. Although skillset, experience and diversity are key elements in selecting directors, capacity and independence are equally important.

## Capacity

Capacity can be difficult to define and can involve a significant amount of subjectivity. That being said, it is important to ensure that the chosen directors have sufficient capacity to carry out, with appropriate attention to detail, their fiduciary duties, obligations and supervisory functions in serving on the board. It is helpful to know whether the director's primary employment is that of an independent fund director and whether the director adheres to any relationship capacity restrictions. It is also important to understand whether the named director will have day-to-day familiarity with the fund or whether he or she will rely on his or her own staff to keep him or her abreast of developments – the former is preferable.

Similarly, when considering the fund's own internal directors (i.e., directors related to the investment manager), consideration must be given to the amount of time available to provide proper fund governance. Understanding how each director views his or her own capacity will also assist the manager with its assessment of his or her eligibility as a suitable candidate. Capacity has been a widely discussed topic over the years and is a key consideration for investors, allocators and operational due diligence teams.

See ["The Case In Favor of Non-Executive Directors of Offshore Hedge Funds with Investment Expertise, Fewer Directorships and Independence from the Manager,"](#) (Dec. 29, 2010); and ["Directors of Cayman Islands Hedge Funds Assume a More Substantive Governance Role in Response to Institutional Investor Demands"](#) (Apr. 16, 2009).

## Director Involvement/ Engagement

It is important when establishing a governance framework to agree on the level of director involvement that the fund's board will have and what powers the board may be comfortable delegating to the investment manager, other service providers or a sub-committee of the board. Any such delegations should be properly documented, and the terms upon which those matters are so delegated should be clearly understood.

Time should also be taken to discuss the board's expectations in relation to capital activity outside of the offering memorandum terms; share transfers; and the negotiation of and entry into side letters. Addressing those matters at the onset of a new fund-board relationship can greatly improve communications and many of the operational aspects within the governance framework of the underlying fund boards.

See "[What Are the Duties of Directors of Cayman Islands Hedge Funds, and Should Those Duties Be Codified?](#)" (Feb. 13, 2014).

## Independence

Independence is a key element in establishing a best-in-class governance framework. For many years, independence was primarily viewed as independence from the investment manager and included avoiding friends and family. Today's institutional investors want to see fund boards composed of a majority of directors who are independent of all service providers to the fund, including independent from one another – resulting in what is commonly known as "split boards."

Industry stakeholders are laser focused on independence and transparency, with questions often arising on fee allocations; agency cross- and related-party transactions; and other areas where conflicts of interest can arise, making the use of independent directors an integral part of establishing a sound control framework for identifying, disclosing, monitoring and mitigating conflicts. Many leading investment managers agree that the less the business teams can influence the control functions and operational teams, the better it will be for the fund and its investors.

See "[Cayman Islands Government Introduces Bill That Would Require Registration and Licensing of Certain Hedge Fund Directors](#)" (Mar. 28, 2014); and "[Cayman Islands Monetary Authority Introduces Proposals to Apply Revised Governance Standards to CIMA-Regulated Hedge Funds and Require Registration and Licensing of Fund Directors](#)" (Jan. 24, 2013).

## Phase II: On-Boarding Directors

There are several topics worth discussing at an early stage with potential directors to avoid any misunderstandings, including the board's level of involvement with the fund. Those topics may include remuneration; indemnification; directors and officers (D&O) insurance; and board support for the coordination of meeting dates, preparation of the agenda, collation and distribution of the various reports and minute-taking services.

## Remuneration

Directors employed by or affiliated with the fund's manager are not generally paid for serving as directors or advisory committee members. The factors that generally determine the level of a director's remuneration often include:

- the number of funds within the structure or platform;
- the complexity of the strategy or nature of the assets;
- the director's experience and skills;
- the amount of time that the appointment may demand; and
- the age of the fund (start-up versus mature fund).

Other more commercial factors may include the history of the relationship with the independent director or service provider firm, the number of directors from the same firm and even bundled service packages offered by the director services firm when additional ancillary are involved.

Given the nature of a director's role and the related responsibilities and liabilities, it is important for investment managers to remain focused on the quality of the director and the value that he or she can bring to the governance framework of the board rather than on the commoditization of the role within a package deal or a check-the-box exercise designed to build a majority of unaffiliated directors on the board.

It is generally accepted that, during the fund formation stage, the investment manager negotiates and sets the initial directors' fees on behalf of the relevant fund, and the director services agreement usually addresses how

increases will operate thereafter. When a split board is used (i.e., independent directors who are not affiliated with one another), the directors would typically expect and request that their remuneration be the same or within a reasonable range of one another.

A director's annual fees will normally be a fixed amount, which covers attendance at quarterly board meetings and reasonable time spent for director engagement in other meetings held in the ordinary course of business. Some directors may stipulate a maximum number of hours in the director services agreement, while others may simply include provisions that allow the director to charge for time on an hourly basis should the time demands and workload related to the appointment increase, such as due to threatened or potential litigation or other contentious situations that demand significant time and attention.

Directors will also generally expect to be entitled to recover reasonable expenses for travel and other miscellaneous expenses, such as telephone, printing and courier expenses.

## Director Indemnification

It is common practice for directors to seek to be indemnified for losses and claims as a result of serving as a director of a fund. It is also customary for a Cayman Islands company to include provisions in its articles of association indemnifying the directors against personal liability that each may incur as a result of acting as a director.

It is important to note that the scope of indemnification generally cannot exceed that contemplated in the articles. Therefore, in the initial stages of fund set-up, the directors and the investment manager must determine the

liability and exculpatory provisions to be included in the articles of association, which is most commonly "actual fraud and willful default." The indemnification and exculpatory provisions in the articles of association are then typically mirrored in the director services agreement to memorialize the terms by contract and avoid any mismatch between those documents.

See "[Recent Cayman Grand Court Decision Signals That Fund Managers Should Review Indemnification Provisions in Governing Documents](#)" (Apr. 11, 2019).

## D&O Liability Insurance

Increasingly, professional independent directors are making D&O liability insurance coverage a prerequisite for serving as a director. That coverage should include all existing, past and future directors of the fund. Directors may also request that additional "tail coverage" be included to preserve the period of coverage for at least one year in the event of the termination of the D&O policy. Although professional directorship-service-provider firms, which are licensed by CIMA, will hold their own professional indemnity insurance (PII), that PII coverage is usually a secondary coverage for the relevant director, with the fund's D&O policy being the primary first recourse policy in the event of a claim.

The level of coverage typically depends on the fund's assets under management but is usually not less than \$5 million (USD) in coverage. In some cases, the investment manager's policy can be extended to include the directors of the funds managed by it, but that should be confirmed with the fund's insurance provider.

In addition, the independent directors will need to be satisfied as to the adequacy of the nature, amount and scope of coverage.

See "[Hedge Fund D&O Insurance: Purpose, Structure, Pricing, Covered Claims and Allocation of Premiums Among Funds and Management Entities](#)" (Nov. 17, 2011).

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