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DIRECTORS AND OFFICERS

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

By [Sabrina Foster](#), [Athena International Management](#)

The role of professional independent directors in the alternative investment funds industry in the Cayman Islands has greatly evolved over the past 20 years. The demand by both regulators and investors for better governance and increased independent oversight over the management and administration of investment funds has been driven by high-profile fraud cases, as well as key changes in U.S. and global economic cycles.

This two-part series explains how to establish a best-in-class governance framework for Cayman funds. This second article analyzes board meetings, service provider reports and board self-assessments. The [first article](#) explored board selection and composition, as well as on-boarding directors.

See “[Corporate Governance Best Practices for Cayman Islands Hedge Funds](#)” (Jan. 19, 2012).

Phase III: Board Meetings and Reports

Once the fund’s board has been established, the next step is to determine the board’s frequency of meetings and level of reporting from the various service providers to the fund.

Meeting Frequency and Location

Quarterly scheduled board meetings are recommended for best-in-class governance, and in many robust frameworks, an additional special meeting is scheduled for the review and approval of the annual audit. In limited cases, semi-annual meetings may be acceptable. The board of a regulated fund, however, should not meet any less than semi-annually. Factors that may influence the frequency of meetings may include the size of the fund; nature of the investment strategy and complexity of the fund; the number and type of investors and their locations; and the structure and operational infrastructure of the fund (e.g., emerging manager or fund of funds platform).

Another important factor is the lifecycle of the fund and the particular issues that the fund may be facing. For example, the launch phase will include the onboarding of service providers, development of marketing plans and investor onboarding negotiations. During the growth phase, there may be new or additional service providers; cross trades and fee allocation issues; or the negotiation of side letters, which should not be signed without the approval of the board. During the wind-down phase, there may be liquidity, asset realization or valuation issues, all of which demand the attention of the board of directors and may

drive the frequency of communications and meetings between the board and the investment manager. Therefore, it is critical that the board be involved as soon as there is any thought of winding up the fund.

Other factors – such as market dislocations, vendor performance issues, errors, valuation issues and black swan events – can also play a part in meeting frequency. It is important to remember that the frequency of meetings should not be a fixed number – it should be determined and reassessed by the board as issues and circumstances dictate and demand.

Regardless of how often the board meets, it is best practice for at least one of its meetings to be held in person in the absence of extenuating circumstances. The location of board meetings should be discussed with the fund's legal and tax advisors to mitigate the risk of adverse tax consequences to the fund.

Meeting Records

Establishing a best-in-class governance framework requires the board of directors to ensure that full, accurate and clear records of board meetings are kept. The [Statement of Guidance for Regulated Funds - Corporate Governance](#) published by the Cayman Islands Monetary Authority suggests that records should include:

- the agenda items and supporting documents circulated;
- a list of attendees, indicating whether they attended in person, by phone or by video conference;
- the matters considered and the decisions made as to those matters; and
- the information requested from and provided by service providers and advisers to the fund.

Unless the fund manager has its own experienced governance team in place to organize meetings, distribute agendas and take accurate minutes, best practices include the retention of professional board support services to manage meetings and ensure proper recordkeeping.

See our two-part series “A Roadmap to Maintaining Books and Records”: [Compliance With Applicable Regulations](#) (Nov. 2, 2017); and [Document Retention and SEC Expectations](#) (Nov. 9, 2017).

Service Provider Reports

The effectiveness of the board of directors will also be influenced by the information and reporting that the board receives. In addition to attendance at meetings, the various reports by service providers are paramount to ensuring adequate supervision by the board of the fund's service providers. A best-in-class governance framework includes quarterly reporting from the administrator and the anti-money laundering (AML) officers; monthly or quarterly performance reporting (depending on the investment strategy) from the investment manager; and annual reporting from the fund's auditor. In addition, it is recommended that legal counsel be invited to attend semi-annual meetings of the board to provide legal and regulatory updates on applicable laws.

The topics that the reports and board meeting presentations by key service providers to the fund should cover are discussed in detail below.

Administrator

In addition to the administrator, if any regulatory issues (such as AML or Foreign

Account Tax Compliance Act (FATCA)/Common Reporting Standards (CRS) compliance) are outsourced to a service provider other than the administrator, that service provider should also report, as appropriate.

The administrator's report should cover:

1. Investor/AML Overview:

- update on any outstanding AML matters;
- update on FATCA/CRS compliance and reporting;
- confirmation that all investors invested in the fund meet the fund's eligibility requirements and that AML documentation is up to date;
- confirmation that the fund/administrator is complying with applicable AML regime(s);
- summary of all capital activity during the reporting period;
- confirmation that cumulative investments from benefit plans do not exceed 25 percent;
- confirmation that there have been no investor complaints during the reporting period;
- summary of all exceptional items approved during the reporting period, such as late or below-minimum subscriptions; and
- any other matters that need to be brought to the board's attention.

See "[What Impact Will FATCA Have on Offshore Hedge Funds and How Should Such Funds Prepare for FATCA Compliance?](#)" (Feb. 1, 2013).

2. Administrative Performance Update:

- details of any errors, omissions or breaches of service level agreements;
- timeliness of shareholder statement issuance;
- details of any material changes in the administrator's personnel, systems, structure or operations, particularly as to AML officers if the administrator is providing that function; and
- any legal actions or inquiries pending against the administrator.

3. NAV and Reporting Overview:

- most recent net asset value (NAV) report to shareholders and discussion of NAV process;
- total NAV for the fund as of the latest valuation date;
- confirmation that the NAV has been calculated in accordance with the administration agreement, private placement memorandum and the fund's valuation policy; and
- commentary on NAV calculation or valuation issues, if any, during the reporting period, including details of any stale pricing, hard-to-value securities or securities that have not been independently valued and disclosure of any material exceptions to the process.

Investment Manager

The investment manager's report should cover:

1. Overview of Performance and Operations:

- current assets under management (fund and firmwide);

- current staffing of investment manager;
- portfolio composition (geographic and sector);
- investment performance (attractors/detractors, micro/macro outlook);
- use of leverage;
- liquidity issues and confirmation of sufficient liquidity to meet potential redemptions;
- investor base;
- shareholder and potential investor or operational due diligence feedback;
- adverse press; and
- any other matters that need to be brought to the board's attention.

2. Risk Review:

- risk management and controls (monitoring of investment guidelines; market, liquidity, counterparty and operational risk);
- internal control environment;
- business continuity planning, disaster recovery planning and cybersecurity; and
- annual compliance review.

3. Review of Fund and Investment Manager Marketing Efforts:

- growth targets and capacity;
- sources and means of growth;
- any changes in focus or exposure to new asset classes, geography, capital structure or strategy; and
- any other marketing initiatives or future plans.

4. Confirmation of Compliance With:

- offering documents and articles of association;

- investment parameters and restrictions;
- risk management limits;
- regulatory requirements for the fund and the investment manager, including all Cayman Islands regulatory requirements; and
- [side letters](#) and side letter notification trigger events.

5. Review of Counter-Party Exposure and Service Provider Oversight:

- custodians;
- ISDA counterparties; and
- vendor on-site visits and performance in accordance with service level agreements.

Auditor

The auditor's report should cover:

- overview of the audit process;
- focus and key risks;
- level of testing conducted;
- existence and valuation of investments;
- process around testing of Level 3 investments, including any differences or adjustments;
- any limits on the scope of the audit;
- any restrictions imposed on the auditor by management;
- cooperation from the administrator and investment manager;
- any disagreements with management;
- any unadjusted differences;
- any evidence of misstatements or deficiencies;
- any evidence of fraud, weakness in internal controls or non-compliance with regulatory requirements; and
- any other matters that need to be brought to the board's attention.

See [“Advisers Must Ensure Their Auditors Are Appropriately Competent and Capable”](#) (Mar. 26, 2020).

AML Officer

The AML officer’s report should cover:

- fund risk assessment;
- fund risk rating;
- administrator risk assessment;
- investment activity AML risk analysis;
- review of the fund’s AML policies and procedures;
- “know your customer” status of investors;
- politically exposed persons or high-risk investor reporting;
- suspicious activity reports;
- AML training; and
- regulatory updates.

See our two-part series “How Fund Managers Can Navigate U.S. and Cayman Islands AML Requirements”: [Part One](#) (Jul. 25, 2019); and [Part Two](#) (Aug. 1, 2019).

Phase IV: Board Self-Assessments

Board self-assessments are not new to the world of corporate governance, but it is an exercise that is growing in popularity and practice for many alternative investment fund boards. The role of board self-assessments is to look at the board’s effectiveness and performance as a whole, as well as the performance of committees and individual directors.

This process may be carried out internally by the completion of self-assessment

questionnaires or, more ideally, by an external facilitator, the results of which should be reviewed and discussed by the board as a whole at least annually to ensure that the board is considering its effectiveness in the discharge of its duties and obligations. It is important to avoid a “check-the-box” exercise, which will ultimately yield little value for the fund’s governance framework. Boards that adopt good self-assessment practices will have a greater advantage when creating a good governance culture and will be better equipped to deal with any changes that the fund’s governance program may demand from time to time.

See [“White Paper Links Robust Fund Governance to Fund Longevity”](#) (Mar. 22, 2018).

Conclusion

The foregoing characteristics promoting good governance are essential elements for consideration in constituting a fund’s board and establishing a best-in-class governance framework.

Sabrina Foster serves as an independent director and general counsel with Athena International Management, an award-winning provider of experienced independent directors to the international alternative investment community. Foster has over 20 years’ experience in the financial services industry, having practiced law in the Cayman Islands for over 16 years and served as an independent director since 2013.