Client Memorandum

Commentary on the Cayman Islands Monetary Authority ("CIMA") - Private Sector Consultation Paper on Corporate Governance

February 2013

Summary

The CIMA paper on proposed corporate governance expresses the intention that it will "enhance and clarify corporate governance standards and provide greater transparency in the financial services market". The expression "transparency" carries no particular meaning and so the question of what is available to an investor under current law must first be answered. What must be ignored are the pleadings of irrelevant third parties, including journalists who seek to erode the legitimate right to confidentiality between commercial parties. On the subject of greater transparency, certain benefits of the immediate CIMA proposals appear helpful if of marginal benefit, but with respect to corporate governance standards it neither enhances nor clarifies the existing position. It seeks to provide a "governance lite" set of guidelines useful only to those who are not aware of the current applicable legal principles and which in several notable areas conflict with those principles. There appears no recognition of the argument that governance of an institutional fund may be a matter best left to discussion between investors and the board prior to investment.

Furthermore, CIMA is required in Section 6(3) of the Monetary Authority Law ("**MAL**") to implement standards that are proportionate to the anticipated benefits. At no point does CIMA establish that the proposed regulation relates to a regulatory failure in the Cayman Islands. Rather at paragraph 6, CIMA relies entirely on commentary for increased regulation by international regulatory bodies, without recognizing that it was the failure of pre-existing regulation suggested by those bodies or their sponsors that led to the financial crisis. Only the most extreme of blame deflecting Eurocrats asserts that hedge or mutual funds or offshore insurance companies were implicated in the causes of the financial crisis. CIMA should have given no credence to that suggestion. Lord Turner of the FSA did not. However CIMA repeats the convenient heresy of certain international regulatory bodies that "deficiencies in corporate governance practice" led to the financial crisis. There is no evidence for this in the Cayman Islands financial services industry. It should be noted that during the financial crisis no Cayman Islands financial institution failed and no evidence is presented that Cayman Islands' governance, or its absence thereof, was in any way a cause of the crisis. It is disappointing that CIMA assumes a contrary position. And not merely disappointing, possibly a position without capacity. By Section 6(3)(c) of the MAL, CIMA may only apply internationally applied standards in so far as they are "relevant and appropriate to the circumstances of the Islands".

CIMA also leans heavily on the fact that in other jurisdictions regulatory authorities have been persuaded to amend corporate governance codes and/or regulations, and assumes that these will modernize the corporate governance standards in the Cayman Islands. But CIMA undertakes no independent analysis of the position in the Cayman Islands, and relies entirely on an erroneous assumption that the Cayman Islands governance standards require modernizing. In fact, what is proposed would create an alternative governance regime, which neither improves nor corresponds in all respects with current law and best practice.

1 Transparency

1.1 There is no analysis by CIMA of the current obligations with respect to a Cayman Islands mutual or hedge fund in relation to transparency. The Mutual Funds Law ("**MFL**") when introduced in 1993, codified common law, in that it required an offering document to contain all such material information in relation to the offering as would enable an investor to make a fully informed decision. Furthermore, any change in that information requires a revised offering memorandum to be filed with CIMA. There is no doubt that such obligation, as a matter of law, requires full information to be disclosed in connection with the directors and all service providers, and indeed, that is the practice. Furthermore,

the offering memorandum in question will have to comply with stringent disclosure requirements imposed by United Kingdom, United States, Japanese or Hong Kong law if circulated in those jurisdictions.

1.2 It may thus be concluded that under current law all investors have available to them full information in relation to:

1.2.1 their share rights,

1.2.2 the identity of the directors and their history,

1.2.3 the investment objectives of the fund, risk parameters and investment restrictions, and

1.2.4 conflicts of interest and fees.

1.3 Any prospective investor can make full enquiry of the fund as to the number of directorships held by any director and determine to invest, to invest subject to conditions, or not to invest at all. Invariably Cayman Islands investors are institutional or high net worth, and undertake their own sophisticated due diligence as part of the investment process. Even in circumstances where the investor decides to take non-voting shares he can determine to redeem at any time, thereby voting with his feet. The real question which remains unanswered save in one respect (see below at paragraph 4) is: "How are the current proposals intended to improve on that position?"

1.4 The database suggested at paragraph E2 does nothing to enhance the quality or extent of the information contained in the offering memorandum, revised from time to time as it may be, but may offend a legitimate commercial right to privacy. In any event it should be noted that the information contained in the database is to be provided by the same directors who approve the offering document. But no good reason is suggested for making this database public. It should be limited to investors only.

2 Companies Management Law

2.1 The extension of the Companies Management Law provisions at paragraph E3 to individuals acting as a director in the manner suggested is sound and overdue.

3 E4 Directors registration

3.1 One of the fundamental attractions of the MFL has been the ability to locate directors in the most convenient or time zone attractive jurisdiction, in relation to the operations of the fund. Furthermore, promoters will necessarily favour the appointment of directors with specialist knowledge not available in the Cayman Islands. There has been no previous requirement to pre-approve directors, and that has facilitated the immediate registration of a fund pursuant to section 4(3). Any suggestion that clients may not have freedom of choice with regard to directors, or that a pre-approval process will delay the establishment of a fund pursuant to Section 4(3) procedure, would cut across one of the fundamental attractions of the Cayman Islands fund regime, on which its success was built and will therefore fail the test laid down in Section 6(3)(c) of the MAL, which requires CIMA to recognize "the necessity of maintaining the competitive position of the Islands". It will also cut across Section 6(3)(e) of the MAL, in that it will contradict the "innovation in financial services business" established by Section 4(3) of the MFL.

4 E5 corporate governance survey

4.1 The most essential, and perhaps only area, where concern has been legitimately expressed in relation to the corporate governance in the Cayman Islands is deferred for further consideration pending a survey to be undertaken by Ernst & Young. However, there is little doubt that the lack of self-restraint shown by certain corporate director services providers in the private sector in terms of the number of directorships accepted per person is giving rise to genuine governance concerns. There seems little doubt, notwithstanding the illogicality of the numerical limitation now suggested by CIMA, that some mandatory restraint must now be imposed. Possibly this may be higher than the 25 per

person cap imposed by some jurisdictions, but certainly lower than 75 per person which common sense dictates is a maximum. (Relief could be given for group companies where the issues that arise may correspond.) This may be a crude solution, but in the absence of any evidence of reasonable restraint in the private sector, no other alternative appears available. Without wishing to predict the outcome of the Ernst and Young survey, the publication of the number of directorships per person in a public register, would be one of the few positive moves available to establish greater meaningful transparency, in an area where legitimate concern has been expressed.

5 Statement of guidance corporate governance

5.1 In Appendix B, CIMA proposes guidelines on corporate governance which are designed to establish the principles by which a board of directors should operate. This poses the following immediate questions:

5.1.1 What is the effect of these guidelines and how is CIMA to monitor them, and with what sanction?

5.1.2 To the extent the guidelines establish a separate regime for corporate governance distinct from current law - to what extent is the distinct regime intended to interact with current law?

5.1.3 What is the effect of the fact that the guidelines do not, as currently drafted, correspond with current law?

5.2 It is recognized that any endeavor to précis the law must necessarily provide an incomplete analysis, but the guidelines do not simply précis the law, they deviate from it. Thus:

5.2.1 Paragraph 3.1 requires the board to have the "ultimate responsibility for effectively managing the affairs of the regulated entity". This mis-states the position as a matter of law, and that which, as a matter of practice, applies to the great majority of Cayman Islands hedge and mutual funds in which the role of the board of directors by way of permitted delegation is supervisory only. Weavering refers. Thus, the ultimate responsibility of the board as a matter of law, and therefore the scope of each director's duty, may be limited, not to effective management, but to mere supervision.

5.2.2 In paragraph 3.2.1 the board is required by the guideline to undertake "effective, prudent and ethical oversight of the regulated entity." The word "ethical" is without certain meaning, and whilst it may appear attractive to some, does not correspond with any requirement of law, save to the extent that the directors by the fiduciary duties are required by law to act honestly and in good faith in the interests of the Company. That well understood term of law, however, does not in all cases connote a course of action would correspond in everyone's eyes with the word "ethical".

5.2.3 In paragraph 3.5 the requirement that service directors must attend at board meetings where necessary, is impractical, due to the multi-national nature of funds' structuring. It should be clear that attendance may be by telephonic or other means.

5.2.4 In paragraph 4.1 the legal obligations of a director with regard to the duties of skill, care and diligence are correctly stated. However, in paragraph 4.2 the fiduciary duties are incorrectly stated in that the word "openly" is introduced. This has no certain legal meaning, and furthermore may well imply a contradiction in that the duties of the directors are to the company, as a matter of law, and that investors have limited or no rights in the normal course of matters to enquire as to the conduct at directors' meetings.

5.2.5 Paragraph 4.4 confuses the strict legal position, which is that the duty to act in what the director believes to the best interests of the company is owed to the company, and not to the shareholders or investors as suggested.

5.2.6 In paragraph 4.7 it is not clear that the duty may be reduced as matter of law to a supervisory function of the delegated function only.

5.2.7 Paragraph 4.8 is unclear and may contradict long-established law, which indicates that a director need not have specific knowledge in relation to the conduct of the business affairs of the company, which may be attended to by way of delegation, and indeed contradicts the more recent statement of the subjective and objective nature laid down in recent English case law and as described in paragraph 4.8.1.

5.2.8 In paragraphs 6.1 and 6.2 (whilst an admirable aspiration of a Regulator) the duties of the board of directors to the Company, may in certain circumstances, supervene obligations owed to CIMA and the extent of disclosure to a regulator may well be a matter for specific legal advice on the facts, particularly in the event of prospective litigation.

5.2.9 Paragraph 7.2 does not put sufficient weight on the fact that the risk profile will be disclosed in the relevant offering document, which will govern risk management procedures. It will be the role of the directors to supervise the application of the risk principles by the Investment Manager.

5.2.10 Paragraph 7.3.3 suggests a distinction between executive and non-executive directors, which does not exist as a matter of Cayman Islands corporate law, although it may arise on the basis of the specific provisions of the constitutional documents of the regulated entity.

5.2.11 Paragraph 7.3.5 would contradict the customary practice of delegating executive decision making to a sole director as a matter of expediency.

Conclusion

The foregoing points require consideration in light of the intention (as yet unexpressed) of the effect of any such corporate governance guidelines and their relationship to any relevant legal proceedings and the sanctions that CIMA may intend to impose for their breach. The answers to these questions are still as yet unresolved and it is hoped will form the basis of further consideration during the consultative process.

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