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A Refresher on Broker-Dealer Expense Sharing Agreements

By Garth Puchert

Like many securities firms, broker-dealers incur various costs, such as real estate, technology, and back-office expenses, while running their businesses. These expenses are often borne by third parties, typically the broker-dealer’s parent company or other affiliate. The Securities and Exchange Commission ("SEC" or the "Commission") and Financial Industry Regulatory Authority ("FINRA") expect broker-dealers to execute and implement expense sharing agreements with such third parties, and meet related net capital requirements.

All broker-dealers should be aware of these requirements, as auditors and regulators have increased their scrutiny on even the smallest expenses impacting financial statements. Both the SEC and FINRA have outlined the relevant expectations of broker-dealers.

In October 2003, FINRA (then the NASD) issued guidance on expense-sharing agreements for its member firms in Notice to Members ("NTM") 03-63. The main driver behind NTM 03-63 was a concern by regulators that broker-dealers were not properly recording expenses and liabilities on their financial statements, a concern that remains today. Pursuant to Rule 17a-3(a)(1) and (a)(2) of the Securities Exchange Act of 1934, NTM 03-63 requires a broker-dealer to make a "record reflecting each expense incurred relating to its business and any corresponding liability, regardless of whether a third party has agreed to assume the expense or liability." NTM 03-63 also states that such expenses or liabilities assumed by third parties must be maintained in the broker-dealer’s records, regardless of the accounting treatment or impact to the firm’s net capital.

NTM 03-63 outlines some basic principles when drafting expense sharing agreements:

1. Allocations of recorded expenses to third parties must be reasonable, and applied on a consistent basis, and broker-dealers must be prepared to provide evidence of the reasonableness of the allocation to FINRA.
2. Expenses should include those which the broker-dealer receives a direct or indirect benefit for and/or the broker-dealer would be responsible for paying if the third party did not assume the expense.
3. Expenses typically covered in these agreements include but are not limited to: rent, communications, compensation of registered personnel, technology costs, and back office services (e.g., compliance, legal, operations).
4. Arbitration awards against a broker-dealer may not be satisfied by a third party.

NET CAPITAL IMPLICATIONS

With respect to net capital issues, NTM 03-63 states that expenses and liabilities assumed by third parties must be liabilities for the broker-dealer for purposes of net capital unless:

1. The third party has agreed in writing that the broker-dealer is not responsible for the expense or liability (for vendor payments, the vendor agrees that the broker-dealer is not responsible).
2. No evidence indicates that the broker-dealer is responsible for the expense or liability.
3. The broker-dealer does not incur the liability under GAAP.
4. The broker-dealer can evidence that the third party maintains resources, independent of the broker-dealer, to pay the expenses.

Regarding the last issue, the SEC amended its broker-dealer net capital and financial responsibility rules in 2013 to address the assumption of broker-dealer liabilities and expenses by third parties. Specifically, the Commission’s amendments to Rule 15c3-1 of the Exchange Act included the requirement for "a broker-dealer to adjust its net worth when calculating net capital by including any liabilities that are assumed by a third-party if the broker-dealer..."
cannot demonstrate that the third-party has the resources, independent of the broker-dealer’s income and assets, to pay the liabilities.” The Commission’s primary concern stemmed from instances where the third parties lacked sufficient resources, independent of the broker-dealer, to assume such liabilities or expenses thereby misrepresenting the broker-dealer’s true financial condition. In adopting this rule, the SEC advised broker-dealers to maintain records demonstrating the third party’s ability to cover liabilities and expenses in expense-sharing agreements. Such evidence may include the third party’s most recent audited financial statements, tax returns or regulatory filings.

**WHAT SHOULD BROKER-DEALERS DO?**
The FINRA and SEC guidance and rules provide a clear path for broker-dealers to follow in executing and implementing expense-sharing agreements with any third parties. Some basic steps to take in preparing for audits or regulatory exams include:

1. Execute the expense sharing agreement between the broker-dealer and the third party assuming broker-dealer expenses.
2. Itemize the list of expenses assumed by the third party.
3. Prepare supporting documentation for each expense, regardless of the amount or materiality.
4. Clearly document the rationale and methodology for expenses allocated to third parties, and demonstrate the consistency and reasonableness of the allocation percentage.
5. Prepare evidence of the third party’s ability to assume liabilities and expenses for the broker-dealer.
6. Periodically review (at least annually) the expense sharing agreements, allocation methodologies, and expenses or liabilities within the scope of the agreements, and update as needed based on business, operational, or regulatory changes.
7. Perform periodic testing of the effectiveness and implementation of the expense sharing agreements, and remediate as needed.
8. Continuously confirm that the broker-dealer is meeting related net capital requirements.

Garth Puchert is a partner at EisnerAmper LLP. He can be reached at 212.891.4091 or garth.puchert@eisneramper.com.

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**The Fund Administrator’s Perspective:**
**Real Estate Funds Poised for Robust Growth**

*By Jorge Hendrickson, SVP, Head of Sales and Marketing, Opus Fund Services*

Real estate funds are on track for robust growth and continued demand and will require operational changes to satisfy investor requests and industry best practices. In the first quarter, of the new client engagements that Opus received, 10% were dedicated to real estate, private equity and venture capital. This includes new launches and existing managers who were bringing on a fund administrator for the first time. See chart below.
In general, the increase in closed-end launches was most noticeable and significant in the first quarter compared to previous quarters.

A closed-end fund typically invests in assets that are not freely transferable nor traded on an established market or exchange and are not marked to market, as in an open-end fund. The illiquid nature of the portfolio holdings dictates the fund structure. An additional influence on structure is the time and process needed for managers to raise capital, identify investment opportunities and deploy capital. In many cases, these funds will have a limited life cycle (e.g., seven years) that is correlated to the portfolio holdings and investment thesis. Managers will raise money during an initial closing period and will then draw-down on investor commitments via a capital call process to fund investments as needed.

Investor appetite for private equity, private debt, venture capital and real estate investments remains strong, as returns amongst these managers have been and continue to be attractive. Recent volatility in the equities markets, rate hikes, and the possibility for inflation growth may also be contributing to investor demand for high quality fund managers that are raising capital for a specific deal, private loans (e.g., small business, factoring), or an investment into physical assets or real estate.

Real estate funds, for example, are launching to invest in areas such as residential (e.g., flips, rentals), commercial (e.g., office, retail), industrial, land and lending (e.g., bridge loans, hard money loans). Beyond the potential realized returns at the end of the fund life cycle when holdings are liquidated, investors in real estate funds may also receive income via preferred returns or distributions which are tied to the fund’s operating activity, such as rental or interest income. Distributions can be paid out monthly, quarterly or at varying frequencies depending on the underlying activity of the fund.

From an entity formation perspective, we are seeing many real estate funds launch in a Series LLC structure. This allows for each underlying investment to sit within its own separate LLC entity, which has benefits from liability, operational, and accounting perspectives. This structure works particularly well for funds buying physical properties, such as buildings or housing. The performance of each LLC rolls up into the fund NAV, where investors sit. Some structures also allow for investors to customize their allocations and pick which LLC they want exposure to.

While real estate funds have often handled many of these operational and accounting tasks internally, we are seeing more funds adapt to investor requests and industry best practices by hiring a third-party fund administrator. There is also an increase in the number of existing funds converting away from self-administration. We predict this trend will continue to gain significant momentum over the next 12-24 months.

I recently spoke with an investor who has traditionally invested in hedge funds, where using a third-party fund administrator is standard practice. This investor receives independent investor statements from the fund administrators of those hedge funds. However, in his due diligence process with several real estate funds, he discovered that this was not always the standard practice. Receiving performance and investor reporting directly from the managers carries obvious risk and operational due diligence concerns. The administrator will independently calculate NAVs, process investor transactions and reporting, perform AML/KYC, process capital calls and distributions, prepare annual financial statements and support the audit/tax process. For a modest monthly fee, an administrator is typically a fund expense that investors are happy to assume.

In our view, the real estate and greater closed-end fund community will continue to grow and evolve quickly under current market conditions. This growth will also positively impact how funds operate, interact with investors and leverage their service providers.

Jorge Hendrickson is senior vice president, head of sales and marketing at Opus Fund Services. Questions? He can be reached at 646.470.6957 or jhendrickson@opusfundservices.com.
Technical Corrections Provisions Impact Partnership Audit Rules

By Richard Shapiro and Aninda Dhar

Over recent months, taxpayers, professional tax advisors and commentators have rightfully focused on the provisions of the 2017 Tax Cuts and Jobs Act ("TCJA"), perhaps the most significant tax legislation in the last 30 years. However, other legislation enacted during this period has also contained important tax provisions – namely, the Consolidated Appropriations Act, 2018. While the focus of that bill was the continuation of funding of U.S. government programs through September 30, 2018 (the federal government’s fiscal year-end), it contained overdue technical corrections (the “Technical Corrections”) to legislation that previously overhauled partnership audit rules. With the exception of one provision dealing with the taxation of grain cooperatives, the Technical Corrections do not address the myriad of provisions in the TCJA that need correction; that will require another legislative vehicle.

BACKGROUND – BIPARTISAN BUDGET ACT OF 2015
As we have previously reported, the partnership audit rules were substantially overhauled in 2015 as part of the Bipartisan Budget Act of 2015 (the “BBA”). Generally effective for taxable years beginning after December 31, 2017, the BBA repealed the Tax Equality and Fiscal Responsibility Act of 1982 and electing large partnership rules and replaced them with a single set of rules for auditing partnerships and partners at the partnership level. As enacted in the BBA, the IRS will examine a partnership’s items of income, gain, loss, deduction, credit and partners’ distributive shares for a particular year of the partnership year (the “reviewed year”), with adjustments taken into account by the partnership in the year the audit or judicial review is completed (the “adjustment year”) rather than the reviewed year. Any tax deficiency arising from the partnership level adjustment (the “imputed underpayment”) is calculated using the maximum statutory individual and corporate income tax rates.

However, the imputed underpayment may be reduced (a) to the extent partners voluntarily file amended returns for the reviewed year, the returns take into account all adjustments properly allocable to such partners and any tax due by such partners for the reviewed year is paid with the returns or (b) if the partnership demonstrates that a portion of the imputed underpayment is allocable to partners that are tax-exempt or are taxed at lower than the maximum corporate or individual tax rate used in computing the imputed underpayment.

In lieu of taking adjustments at the partnership level, the partnership can elect (the “push-out” election) to issue adjusted Form K-1s to the reviewed year partners. Those partners then take their share of any adjustments into account on their individual returns in the adjustment year, together with interest and penalties running from the reviewed year.

Meanwhile, partnerships with 100 or fewer partners are able to elect out of the new regime for any tax year provided that each partner is an individual, a C corporation, certain foreign entities, an S corporation or an estate of a deceased partner.

THE TECHNICAL CORRECTIONS
Following are key highlights of the Technical Corrections made to the partnership audit rules.

- As previously noted, the provisions, as originally enacted, applied to “items of income, gain, loss, deduction or credit.” Instead, the Technical Corrections refer to adjustments to “partnership-related items.” That is generally defined as any item or amount with respect to the partnership which is relevant in determining the income tax liability of any person, without regard to whether the item or amount appears on the partnership’s return and including any imputed underpayment and any item or amount relating to partnership transaction, basis or liability. It also includes any partner’s distributive share of any such
amount or item. This is clearly a significant expansion of scope. For example, because a partnership-related item includes an item or amount relating to any transaction with the partnership, an item or amount relating to a partner’s transaction with a partnership other than in his capacity as a member of the partnership is a partnership-related item for this purpose.

- The Technical Corrections clarify that the partnership audit rules do not apply to any tax imposed or withholding required under the self-employment tax, the net investment income tax, the nonresident alien and foreign corporation withholding provisions or FATCA withholding. However, a partnership adjustment with respect to income tax is taken into account for purposes of determining the tax under these provisions. So, for example, if a partnership adjustment results in a change in the amount of income of an individual from a partnership, the change is reflected as required in the calculation of the individual’s net earnings from self-employment with respect to the partnership, and the self-employment tax may be collected through a process outside the partnership audit rules.

- In determining the amount of the imputed underpayment, items of different character, either capital or ordinary, may not be netted together to determine an imputed underpayment. This netting rule may result in higher imputed underpayments.

- The Technical Corrections address the situation of a partnership (or an S corporation) that is a direct or indirect partner of an audited partnership (i.e., a tiered structure) which has elected to push-out adjustments of partnership-related items to partners (or S corporation shareholders). The provision sets forth applicable requirements and the time frame for satisfying these requirements.

- New “pull-in” procedure: The Technical Corrections provide an alternative procedure to filing amended returns. Under this pull-in procedure, the IRS determines the partnership’s imputed underpayment as reduced by the portion of the adjustments to partnership-related items that direct and indirect reviewed-year partners take into account and with respect to which those partners pay the tax due, provided the requirements of the pull-in procedure are met.

Under this procedure, reviewed-year partners pay the tax that would be due with amended returns, make binding changes to their tax attributes for subsequent years and provide the IRS with the information necessary to substantiate that the tax was correctly computed and paid. However, partners do not file amended returns. As noted in the Joint Committee on Taxation technical explanation, “[t]hus, there are generally not corollary effects on the partners’ returns beyond the effects on tax attributes, in other taxable years, of the adjustments to partnership-related items.

“Pull-in” is available generally to direct and indirect reviewed-year partners, in the case of tiered partnerships. And, it does not require the participation of all direct and indirect reviewed-year partners of the partnership.

- The interest rate on amounts owed, after an assessment, upon a partnership’s failure to pay an imputed underpayment within ten days after the IRS provides notice and demand, is increased to the federal short term rate (determined monthly) plus five percentage points (from three percentage points). An S corporation and its shareholders are treated like a partnership and its partners under this provision. A partner is liable for no more than the partner’s proportionate share of the imputed underpayment, interest and penalties, measured on the basis of the partner’s distributive share, with the aggregate proportionate shares totaling 100%. The distributive shares set forth in the partnership agreement, or as determined for purpose of Schedule K-1, may serve as a measure of a partner’s proportionate share. Partner payments under this provision reduce the partnership’s liability to pay. However, the partnership’s liability is not reduced by partner payments made after the date on which the partnership pays. For purposes of
this provision, an S corporation and its shareholders are treated in same manner as a partnership and its partners.

Tax, interest and penalties on the proportionate share of each partner (as of the close of the adjustment year of the partnership) can be assessed without regard to normal deficiency procedures generally applicable to income tax. However, assessment may not be made (or proceeding in court without assessment) after the date that is two years after the date on which the IRS provides notice and demand.

• Before the due date for payment of an imputed underpayment, a partnership (or in certain specified cases a partner) may make a cash deposit to suspend the running of interest. The deposit is not treated as a tax payment.

With the calendar well into 2018, the new partnership audit rules are now a reality. It is incumbent on existing partnerships and partnerships under consideration to evaluate the impact of these rules on their operations and documentation and to take all appropriate actions.

Richard Shapiro is a tax director in EisnerAmper’s Financial Services and Corporate Tax Groups and Aninda is a senior manager in the firm’s International Tax Services Group. Questions? Richard can be reached at 212.891.6926 or richard.shapiro@eisneramper.com and Aninda can be reached at 212.891.8065 or aninda.dhar@eisneramper.com.

### Alternative Investment Industry Outlook for Q2 and Beyond

**By Elana Margulies-Snyderman**

Despite flat hedge fund performance in the first quarter of 2018 due to market volatility, investors globally including various institutions, family offices and high net worth individuals are on track to continue allocating this quarter and through the rest of 2018. Due to the volatility, along with concerns about a possible correction, allocators appear to favor macro strategies to provide downside protection. In addition, they continue to eye a handful of other strategies, including quantitative, Asia-based, and sector-focused long/short equity managers, particularly in health care and financials. However, the continued investor interest doesn’t go without ongoing pressure for managers to accommodate limited partners by lowering their fees and creating customized offerings.

**INVESTOR OUTLOOK**

**HEDGE FUND SPOTLIGHT**

EisnerAmper has heard from both clients and prospects that investors have been paying more attention to hedge funds this quarter to capitalize on the market volatility.

“Last year, people were wondering why they were paying all this money to a hedge fund when they could simply buy an ETF,” said Phil DeRosa, managing director of EisnerAmper’s Connecticut office. “With all this volatility, you just might want someone who can trade around these markets. Investors are now looking for hedge funds and investment vehicles that engage in a wide range of trading, including making bets that markets will fall, to actually live up to their names and offer protection, or hedges, against falling stock markets. That could mean, for example, buying stocks that didn’t benefit from the bull market and thus are less likely to fall as sharply as the broader index.”

Capital introductions professionals from both boutique and top-tier brokerage firms also confirmed that macro funds appear to be a favorite amongst investors due to market volatility. Besides the general consensus on macro funds, along with quantitative, Asia, and long/short sector managers, they noted strategy preferences amongst allocators on various continents.

Here are a few favorites from investors across the globe:

• U.S. investors like equity quant, credit distressed, relative value, volatility arbitrage and niche strategies in the emerging manager space. There has also been an uptick in conversation around ESG investing.

• Europeans are looking at managers that run European, Asian and emerging markets strategies with a focus on directional equity. They also favor niche strategies and
UCITS structures.

- Finally, in Asia, Japanese family offices -- who typically rely on their private banker or brokerage house for allocating -- are investing in low-volatility products through the bank’s platform. Additionally, smaller Japanese family offices who use their brokers’ “wrap” accounts, are investing into daily liquidity multi-asset products to ensure full discretion on their investments. Typically, these smaller family offices have between 10-30% of their assets in hedge funds. Meanwhile, Singapore investors continue to add hedge funds to their portfolios and are seeking to diversify across asset classes since many were over-allocated to equities.

PRIVATE EQUITY SPOTLIGHT
In addition to hedge funds, investors are also paring back their long-only exposure in both equities and fixed-income in favor of private equity, private credit and real estate.

EisnerAmper has observed that insurance companies are one investor group that is increasing its allocation of capital to private equity.

“Across our client base we have seen large insurance companies make significant commitments to private equity funds, and I’m sure we will continue to see more of this,” said Anthony Minnefor, a partner in EisnerAmper’s Financial Services Group based in New Jersey.

ALLOCATOR PRESSURES
Continuing since the first quarter of this year and even the last few years, investors continue to pressure managers to lower their fees. Hence, managers accommodate them by creating customized offerings including separately managed accounts and funds of one to protect their bottom line.

Jeffrey Parker, partner in EisnerAmper’s Financial Services Group, said the firm is seeing more mini-master structures than in the past due to lower operating costs and also because hedge fund managers face fee pressure from investors.

“There is more pressure on fees,” he said. “Fees are often lower than in the past. Some launches offer reduced fees for higher investment amounts. We are also seeing models that seek to align managers and investors, such as more of an incentive fee and less of a management fee.”

CONCLUSION
With the first half of 2018 almost behind us, hedge fund investors and managers alike are anticipating more volatility looking ahead and are positioning their portfolios accordingly. In addition, managers will continue to succumb to fee pressures from allocators and create customized structures to satisfy their demand. Meanwhile, looking ahead at private equity and less liquid investments, these funds are expected to thrive mainly due to investor demand.

Elana Margulies-Snyderman is a senior manager in EisnerAmper’s Financial Services Group. Questions? She can be reached at 212.891.6977 or elana.margulies-snyderman@eisneramper.com.
GDPR: How Asset Managers Can Comply by May Deadline

By Louis Bruno

On January 28, 2018, the world celebrated the official Data Privacy Day. Every year on this day, businesses recognize their responsibility to protecting the privacy of their clients and employees.

Firms understand their responsibility to protect an individual’s right to privacy; however, many of these organizations continue to be challenged with the ability to effectively identify, classify and safeguard their data.

Regulators continue to express their concern and develop rules that require firms to dedicate more time and resources to solve the problem. The European Union, for example, has issued the General Data Protection Regulation or “GDPR” which imposes strict data protection requirements on firms established in the EU as well as on all firms that control or process European personal data.

Asset Managers and Private Funds are struggling to understand the complexity of GDPR and how the permutations of rules may apply to their data. The definitions are broad, but asset managers that have office locations in the EU, employ EU nationals or market to European investors realize they are considered to be “controllers” or at least “processors” of EU personal data under the GDPR.

To assess the exposure and the ability to comply with the GDPR, asset managers should be able to answer:

- **Do we capture EU data?** – Personal data that is subject to the regulation is broader than an individual’s contact details and the information may not always be easily identifiable in offering documents, LP agreements, client and vendor documents or other related files.

- **Where does the data reside?** – GDPR expects firms to be able to identify and classify EU personal data that is stored internally or with a third-party administrator. The ability to identify and map the flow of personal data supports the GDPR requirements to provide specific rights to an individual, which include rights associated with access, rectification, erasure, portability and processing of personal data.

- **Can we collect the required consent?** – Fund managers will be required to establish a lawful basis for processing personal data and document consent from the data owner, which may include current and prospective investors, sub-advisors, and other participants.

  - **Are the current policies and controls sufficient?** – Asset managers may not have the requisite data governance and security control framework to support the GDPR requirements. A comprehensive framework should define controls for internal processing data, transferring data outside of out of the European Economic Area (“EEA”) and activities conducted by external third parties.

  - **What happens in the event of a data breach?** – Although many firms have implemented cybersecurity and data protection controls, many of these detective measures are not able to identify the impact of the data breach and allow management to report the event to the relevant authorities within 72 hours as required by the GDPR.

Asset managers that are subject to GDPR will need to implement a data governance and control framework to effectively comply with the regulations. The framework is supported by multiple functions throughout the organization and should be able to identify personal information that is captured for each business activity, explain how the information is used internally and externally by third parties (e.g., marketing agents, distributors, administrators, depositaries etc.) and identify the specific storage locations.

All firms that are subject to GDPR must comply by May 25, 2018. Many firms will not be ready to comply with the requirements by the end of the month and it’s unclear if supervisory authorities will provide any reprieve for partial compliance with the regulation. The inability to comply could bring about the imposition of significant fines (up to 4% of the previous year’s annual global turnover or €20 million, whichever is greater). The penalties are significant; however, given the global focus on an individual’s right to privacy, asset managers realize that the reputational impact associated with non-compliance can cripple a business which may outweigh any regulatory fine.

Louis Bruno is a principal with EisnerAmper’s Global Compliance and Regulatory Solutions. Questions? He can be reached at 212.891.6095 or louis.bruno@eisneramper.com.
Considerations for Establishing an Investment Fund in the Cayman Islands

By James Lewis, Partner, EisnerAmper Cayman

The Cayman Islands is recognized worldwide as an international financial center and is the jurisdiction of choice for the establishment of offshore hedge funds. Industry experts have cited the following reasons why: tax neutrality, reputation, central time location, reliable legal system, proportionate regulation by Cayman Islands Monetary Authority (“CIMA”) and no exchange controls in place.

Some important factors to consider when setting up a hedge fund are outlined below:

ORGANIZATIONAL STRUCTURE

Funds are established utilizing a range of structures depending on the needs of the investors and promoters. Typical structures include:

• **Stand-alone**: Under this structure, investors purchase equity interests in a single vehicle.

• **Multi-Class or Umbrella**: Multi-class funds have shares or units split into a number of different classes. Each class would have a different investment objective.

• **Side-by-Side**: The establishment of a stand-alone onshore fund and a stand-alone Cayman Islands fund. The two funds will make identical investments in assets managed by the same investment manager.

• **Master/Feeder**: The establishment of an onshore feeder fund, an offshore (Cayman Islands) feeder fund and an offshore (Cayman Islands) master fund. The two feeders will invest in the master fund which will acquire a pool of assets. You can also choose not to have an offshore feeder and have those investors invest directly into the master fund.

INVESTMENT FUND VEHICLES

A synopsis of the most common types of vehicles and their features are outlined below:

**Exempted Companies**

- Established under the Companies Law.
- Must have at least one shareholder.
- No minimum capital requirement.
- Must have a registered office in Cayman Islands.

- May obtain a 30-year tax exemption from the Cayman Islands Government.

**Segregated Portfolio Companies**

- Established as an exempted company under the Companies Law.
- Seeks to segregate separate pools of assets and liabilities to specified shareholders or creditors.
- Must have a registered office in Cayman Islands.
- Assets and liabilities attributed to a particular portfolio are legally separated from the assets and liabilities of the Company’s general account and all other segregated portfolios.

- Useful for multi-strategy vehicles.

**Unit Trusts**

- Established under the Trusts Law.
- Constituted under a trust deed that provides the terms on which the trustee holds the trust’s assets for unit holders.
- Must have a place of business in the Cayman Islands, approved by CIMA, which will be its principal office.
- Multi-class unit trusts can be created without cross-class liability issues arising.
- If registered as an exempted unit trust, they may obtain a 50-year tax exemption from the Cayman Islands Government.

**Exempted Limited Partnership**

- Established under the Exempted Limited Partnership Law.
- Must have at least one general partner.
- Must have a registered office in Cayman Islands.
- Partnerships are not separate legal entities and, as such, all contracts are entered into by the GP.
- Formed by one or more GPs and one or more limited partners entering into a limited partnership agreement.
• May obtain a 50-year tax exemption from the Cayman Islands Government.

**Limited Liability Companies**

• Established under the Limited Liability Companies Law.
• Must have at least one member at all times.
• Must have a registered office in Cayman Islands.
• Members enjoy limited liability without the company being limited by shares or guarantee.
• May obtain a 50-year tax exemption from the Cayman Islands Government.

**REGULATORY FRAMEWORK FOR INVESTMENT FUNDS**

The regulation of investment funds established under Cayman Islands law is largely governed by the provisions of the Mutual Funds Law (“MFL”) and is supervised by CIMA. The MFL defines a mutual fund as a company, trust or partnership, incorporated or established in the Cayman Islands which issues equity interest redeemable or repurchaseable at the option of the investor.

If a fund has less than 15 investors and has the power to appoint and remove directors, they may be exempted from regulation. A close-ended fund, whose equity interests are not redeemable at the option of the investor, is not regulated under the MFL.

Primary statutory obligations of a registered fund:

• CIMA registration: Complete the appropriate mutual fund form along with the prescribed documents.
• Minimum capital requirement: Includes an initial investment of KYD$80,000 which approximates US$100,000 per investor unless the fund is registered on a recognized stock exchange.
• Annual audit requirement: Must submit audited financial statements to CIMA within six months of the fund’s financial year-end, and the auditor must be a CIMA approved auditor.
• Fund annual return: completed by the fund operator and electronically submitted by the fund’s auditor of record.
• Pay an application fee and an annual fee each January.

**Key Service Providers for Investment Funds**

• **Lawyer:** Used in preparing the offering document of the fund and assisting with registering the fund with CIMA.

• **Investment manager:** The precise role can range from managing the fund’s assets or simply acting in an advisory capacity to the directors. No Cayman Islands residency is required, but it is common in order to obtain a tax deferral on part of the management and performance fees granted.

• **Administrator:** Usually responsible for preparing the NAV but also may be responsible for other functions as would be outlined in the administration agreement.

• **Custodian:** Appointed by the fund to hold the assets pursuant to the relevant custodian agreement.

• **Auditor:** Usually appointed by fund, but in a regulated fund situation, they must appoint a local CIMA approved auditor.

• **Directors:** The MFL imposes on a regulated fund that at least two directors are appointed and at least one of which be approved by CIMA. These should generally be individuals, but can be a corporation if they are established in the Cayman Islands and are well known to CIMA.

Establishing an investment fund in the Cayman Islands involves many considerations. Each fund is unique and its purpose and strategies are unique. The above should provide some insights into the decisions that will need to be made when considering the establishment of a Cayman Islands investment fund.

*James Lewis is a partner with EisnerAmper Cayman. Questions? He can be reached at 345.945.5889 or jlewis@eisneramper.ky.*