

The Islamic Finance and Markets Review – the Cayman Islands

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| Legislative and regulatory framework

Legislative and regulatory regime

The Cayman Islands are a British overseas territory of the United Kingdom. They were also a dependency of Jamaica for administrative purposes between 1863 and 1962. Cayman law is therefore a common law system largely based on English common law and statutes, with some influences from Jamaica.

The legal system has not diverged far from that of England and Wales. Many of the divergences are a result of the Cayman Islands being an international financial centre (**IFC**). Companies and partnerships established in IFCs are commonly used in structuring financial transactions, including Islamic finance transactions. Accordingly, many of the divergences between Cayman and English laws have arisen because of the Cayman Islands' legislature's desire to facilitate, and provide confidence around, financial transactions. For example, there is no restriction on a Cayman company giving financial assistance for the purposes of the acquisition of its own shares or shares of a holding company.

The financial services industry in the Cayman Islands is regulated by the Cayman Islands Monetary Authority (**CIMA**).

The relevant legislation is summarised below.

Banking

Banking business is a regulated activity. Section 2 of the Banks and Trust Companies Act (**Bank Law**) defines banking business as "the business of receiving (other than from a bank or trust company) and holding on current, savings, deposit or similar account money that is repayable by cheque or order and may be invested by way of advances to customers or otherwise".

The Monetary Authority Law and the Bank Law give CIMA the responsibility for both licensing and regulating banking business. In relation to licensing, CIMA may issue the following categories of banking licences: a Category A banking licence, a Category B banking licence and a Restricted Category B banking licence.

The Category A licence is the broadest and permits domestic business with residents of the Cayman Islands as well as offshore business. The Category B licence permits only business conducted outside the Cayman Islands. The Restricted Category B licence is subject to the same limitations as the Category B licence, but the licensee is further restricted to a pre-approved customer base and CIMA will typically not allow that customer base to exceed six persons or entities.

CIMA further categorises each type of bank into two further categories – home-regulated banks and host-regulated banks. CIMA's policy has different requirements for each type of entity. Home-regulated banks are banks incorporated in the Cayman Islands and are financially regulated by CIMA. Host-regulated banks are usually branches of a foreign parent bank that are subject to regulation by the parent's home regulator. CIMA's approach to the licensing (and continuing regulation) of home-regulated banks is stricter, including in relation to:

- capital adequacy requirements
- financial resources
- information required to be provided to key shareholders
- financial resources of key shareholders
- audit requirements
- a bank's local presence in the Cayman Islands

While Section 17(1) (a) of the Bank Law states that it is the duty of CIMA to maintain a general review of the banking practice, Cayman statute does not regulate the type of banking products that can be offered by licensee banks. Accordingly, there is no regulation in relation to Islamic banking products.

In addition to the regulation of banking business, money services business is also regulated by CIMA. The Money Services Act defines money services business as including:

- a. money transmission
- b. cheque cashing
- c. currency exchange

- d. the issuance, or sale or redemption of, money orders or travellers cheques

Capital markets

The Securities Investment Business Act (**Securities Law**) provides for the regulation of persons carrying on securities investment business, including market makers, broker-dealers, securities arrangers, securities advisers and securities managers in or from the Cayman Islands.

Securities are broadly defined in Schedule 1 of the Securities Law as including:

- a. shares
- b. debentures, bonds and certificates of deposit
- c. warrants
- d. options
- e. futures
- f. certain types of swaps

Regulated activities are set out in Schedule 2 of the Securities Law and include:

- a. dealing in securities
- b. arranging deals in securities
- c. managing securities
- d. advising on securities

No distinction is made in the Securities Law between Islamic securities and other securities.

Under the Securities Law, a person (being either a Cayman entity or a person who has established a place of business in Cayman) who engages in securities investment business must hold a securities investment business licence or be registered with CIMA unless exempted under Schedule 3 – Excluded Activities or Schedule 2A – Certain Categories of Persons who do not need to register with CIMA (non-registrable persons).

Excluded activities include where a company is dealing in securities on its own account or providing finance to enable a person to deal in securities. Non-registrable persons include individuals who are:

- a. carrying on a securities investment business only in the course of acting in certain capacities

(e.g., as a director, partner, liquidator, receiver or executor) where the individuals are not separately remunerated for carrying on that business and either do not hold themselves out as carrying on such business or are acting on behalf of a company, partnership or trust that is licensed or exempted from licensing; or

b. conducting a securities investment business as a single family office

The classes of persons who can be registered with CIMA (rather than hold a securities investment business licence) include:

a. a company carrying on securities investment business exclusively for companies within the same group;

b. a person carrying on securities investment business exclusively for sophisticated persons or high-net-wealth persons; or

c. a person who is appropriately regulated by a recognised regulatory authority in the jurisdiction where the securities investment business is being conducted

Offering of securities

In relation to the specific issue of the offering of securities:

a. if the issuer of securities is a Cayman exempted company, pursuant to Section 175 of the Companies Act, it is prevented from offering its securities to members of the public in the Cayman Islands unless it is listed on the Cayman Islands Stock Exchange

b. if the issuer of securities is not incorporated or established in the Cayman Islands, it can offer its securities to investors established or operating in the Cayman Islands, but subject to the provisions of the Securities Law

Again, there is no distinction between Islamic securities and other types of securities.

Insurance

Engaging in insurance business is also a regulated activity. Section 2 of the Insurance Law defines insurance business as ‘the business of accepting risks by effecting or carrying out contracts of insurance, whether directly or indirectly, and includes running-off business including the settlement of claims’.

The Insurance Law gives CIMA the responsibility of regulating insurance business in the Cayman Islands. This includes licensing, ongoing supervision and enforcement. The day-to-day regulatory oversight of the sector falls to CIMA’s insurance supervision division.

Similarly to the Bank Law, the Insurance Law focuses on the licensing requirements for insurers

and their continued monitoring (particularly in relation to capital requirements, solvency, reporting and risk management).

Also similarly to the Bank Law, the Insurance Law does not stipulate what insurance products (be they Islamic or otherwise) a licensee may provide. However, Section 23(1) of the Insurance Law does state that CIMA may direct a licensee, in relation to a policy, a line of business or the licensee's entire business, to refrain from conduct that constitutes unsafe or unsound practice.

Funds

There are two principal pieces of legislation in relation to investment funds and whether such investment funds need to be registered or licensed with CIMA – the Mutual Funds Act (**MF Law**) and the Private Funds Act (**PF Law**). Both laws apply to fund entities that are incorporated or established in the Cayman Islands.

MF Law

In general terms, the MF Law applies to open-ended funds whose interests are redeemable at the option of the investor and that do not qualify or elect for exemption or other exclusion. We shall refer to funds to which the MF Law applies as mutual funds. As a general rule, mutual funds tend to be hedge funds and in the form of a Cayman exempted company.

Under the MF Law, a mutual fund must not carry on business in or from the Cayman Islands unless registered with CIMA. There are four categories of registrable mutual funds:

- a. a fund registered under Section 4(3) of the MF Law (s4(3) fund): this is by far the most common form of mutual fund. The principal requirement is that the minimum initial investment purchasable by a prospective investor is US\$100,000;
- b. a fund registered under Section 4(4) of the MF Law (s4(4) fund): this is a mutual fund with 15 or fewer investors, a majority of whom are capable of appointing or removing the operators of the mutual fund. A s4(4) fund is not subject to the minimum initial investment requirement of a s4(3) fund; nor is an offering document required to be filed with CIMA;
- c. an administrative fund: this requires a licensed mutual fund administrator in Cayman to agree to provide the fund's principal office and to apply to CIMA on the fund's behalf. The primary advantage is that the US\$100,000 minimum initial investment requirement also does not apply to administered funds. However, the additional role and responsibilities of the administrator may increase administration fees and limit choice; and
- d. a licensed fund: this is designed to be suitable for retail funds and as such involves a more prescriptive and iterative process with CIMA

The MF Law also imposes on registered funds a number of continuing obligations, including:

- a. to file with CIMA material amendments to the current offering document within 21 days
- b. to have its accounts audited annually by an auditor approved by CIMA and to file those accounts with CIMA within six months of the end of its financial year
- c. to pay an annual filing fee
- d. to have appointed to its board of directors at least two directors at any one time

Generally, these should be individuals.

If CIMA is satisfied that a registered fund:

- a. is or is likely to be unable to meet its obligations as they fall due
- b. is carrying on or attempting to carry on business or is winding up its business voluntarily in a manner that is prejudicial to its investors or creditors
- c. has not been directed and managed in a fit and proper manner
- d. has a person holding a position as a director, manager or officer who is not a fit and proper person to hold that position

then, CIMA may:

- a. cancel the fund's registration
- b. require the substitution of any promoter or operator of the fund
- c. appoint a person to advise the fund on the proper conduct of its affairs
- d. appoint a person to assume control of the affairs of the fund

PF Law

The MF Law applies equally to Islamic and non-Islamic funds. However, the majority of Islamic funds tend to be closed-ended private equity or property funds, which are structured either as exempted limited partnerships or exempted companies to which the PF Law applies.

With the introduction of the PF Law, close-ended funds (ie funds that offer non-redeemable investment interests) are also registrable with CIMA. The result is that, with some limited exceptions, all fund vehicles that are incorporated or established in Cayman need to be registered with CIMA.

In addition to the requirement to register, the PF Law imposes on registered funds a similar set

of continuing obligations as those set out in the MF Law.

Regulatory and supervisory authorities

As discussed in Section I.i, CIMA is the principal regulator in the Cayman Islands. As discussed above, each governing statute gives CIMA certain powers in relation to the particular regulated sector and lists the measures that CIMA may take, as regulator. CIMA's principal functions are set out in the Monetary Authority Law. Its regulatory functions not only include regulating and supervising financial services business, but also monitoring compliance with money laundering regulations. CIMA's regulatory handbook sets out the policies and procedures to be followed by CIMA. In particular, the handbook describes the policies and procedures for giving warning notices to persons affected adversely by proposed actions of CIMA; giving reasons for CIMA's decisions; and receiving and dealing with complaints against CIMA's actions and decisions.

The handbook further states that CIMA is to have due regard to international standards governing banking, insurance and securities supervision.

The handbook also describes CIMA's approach to:

- a. licensing approval and cancellation -including for the banking, insurance and funds sectors
- b. reviewing licensees' financial statements and onsite inspections of licensees' premises
- c. anti-money laundering procedures to be followed by licensees
- d. enforcement - including applying for court orders

The handbook is binding on all CIMA's committees and officers.

Also worthy of mention is the Cayman Islands General Registry. The primary function of this government department is to develop and implement policies and procedures for all registers under its administration to ensure their continued effective contribution to the financial services industry and the public. The registers maintained by the General Registry include the register of Cayman companies and Cayman partnerships. As discussed below, Cayman companies and partnerships are widely used in Islamic finance transactions.

Common structures

Islamic transactions

As described in Section I.i, the Cayman Islands is an international financial centre. The benefits of companies incorporated in IFCs have been well documented, including:

- a. stable legal systems (typically based on English law)

- b. low costs and efficient company incorporation
- c. little or no taxation, no exchange control
- d. trusted court systems
- e. sophisticated professional infrastructure (with an array of experienced professional service providers)

Accordingly, Cayman exempted companies are used as the issuer (often described as the trustee) in many Islamic financing transactions, including *sukuk*, *wakalah* and *ijarah*. Exempted companies are the most common type of company incorporated in the Cayman Islands and are formed to conduct business outside the Cayman Islands. Exempted companies are similar in structure to companies formed in other common law jurisdictions: shareholders' liability is limited (typically by shares) and the directors manage the business of the company. Specifically, the Cayman company is set up as an 'orphan' special purpose vehicle (SPV). The company is referred to as an SPV because it is formed solely for the purpose of the relevant financing transaction.

The SPV is referred to as an orphan because the beneficial interest in the shares of the SPV, rather than being held by a parent company, is held by a trustee (either pursuant to a charitable trust or Cayman STAR Trust) [1] for charitable or other specific purposes. As a result of the trust structure, the SPV is not part of the company group that is the ultimate borrower in the financing transaction. In that way, in the event of the insolvency of the borrower, a court is unlikely to find that the SPV should be included within the assets of the borrower's insolvent estate. The SPV is also made bankruptcy-remote under its constitutional documents or the transaction documents, or both, because it is prohibited from undertaking any activities other than the financing transaction. In that way, the SPV is unlikely to be liquidated, with a view to the transaction remaining intact and the lenders being repaid.

The *sukuk* structure essentially works as follows:

- a. the Cayman SPV issues certificates to investors
- b. the proceeds are used by the Cayman SPV to purchase an asset from the borrower. The asset is then leased back to the borrower
- c. the borrower pays rent to the Cayman SPV so that the SPV may pay principal and coupon payments on the certificates
- d. if specific events of default occur, the borrower is obliged to repurchase the asset at a certain exercise price so that the SPV may redeem the certificates

Closed-ended funds

As discussed in Section I.i, both open-ended and close-ended funds are typically regulated by CIMA. Open-ended funds are usually hedge funds established in the form of Cayman exempted companies.

On the other hand, closed-ended funds (ie funds whose interests are not redeemable at the option of investors) typically include private equity and property funds and are often established as Cayman exempted limited partnerships (ELPs) under the Exempted Limited Partnership Act.

The structure of an exempted limited partnership is essentially as follows:

- a. the general partner (GP) is solely responsible for the management of the Limited partners (LPs) are excluded from the management
- b. any debt or obligation incurred by the GP in the conduct of the business of an ELP is a debt or obligation of the ELP
- c. to meet such debts or obligations, the GP may call on the capital commitments of the LPs. That is, under the terms of the ELP agreement, each LP will agree to contribute amounts to the ELP up to a certain fixed amount (ie its total capital commitment)

The Cayman ELP is one of the most commonly used investment vehicles in the world, both for Islamic and non-Islamic funds. Islamic funds are established in compliance with applicable *shariah* principles. For example, an Islamic fund may only invest in industries or properties that comply with Islamic law, but will be established using an ELP, similarly to a conventional fund.

Taxation

As the area is an IFC, there is little taxation. The Cayman Islands have no form of income or capital gains tax, nor do they have any estate duty, inheritance tax or gift tax. Where transaction documents are executed in, or taken into, the Cayman Islands, stamp duty will generally be payable. In most cases, the stamp duty will be nominal. However, *ad valorem* stamp duty will be payable where a transaction involves a transfer of, or security over, Cayman real property or shares in a Cayman company that holds Cayman real property. In relation to transfers, stamp duty is payable at a rate of 7.5% on the purchase price or market value of the property, whichever is higher. In relation to security, stamp duty is payable on a sliding scale of 1 to 1.5% depending on the amount secured by the mortgage. The Cayman Islands is not party to any double tax treaties. The tax position is the same for both Islamic and other types of finance transactions.

Insolvency

Rescue procedures

Adopted to address the needs of the Cayman Islands as an international financial centre, the Cayman insolvency regime focuses on the rights of creditors. The Cayman insolvency regime has rescue procedures aimed at resuscitating near-insolvent companies, notably:

- a. provisional liquidation: a company itself or its creditors or shareholders may apply for a provisional liquidator to be appointed. The objective is usually to preserve or protect the company's assets until the hearing of the winding-up petition. However, a provisional liquidator may give the company time to restructure its business or to obtain financing
- b. appointment of a restructuring officer: a company may petition the court for the appointment of a restructuring officer on the grounds that it is or is likely to become unable to pay its debts and intends to present a compromise or arrangement to its creditors
- c. schemes of arrangement: the objective is to allow the company to enter into an agreement with its shareholders or creditors, or both, to either:
 - restructure its affairs while solvent so that it can continue to trade and avoid liquidation
 - reach a compromise or arrangement with shareholders or creditors, or both, after liquidation proceedings have commenced

A scheme of arrangement requires the sanction of the Grand Court for it to be binding on the company and its creditors.

Liquidation

In relation to liquidation proceedings, a company may be wound up:

- a. compulsorily by the court
- b. voluntarily
- c. under the supervision of the court: this is in the scenario where the company voluntarily appoints a liquidator but it becomes clear that:
 - the company is or is likely to become insolvent
 - court supervision will facilitate a more effective, less expensive or quicker liquidation.

Creditor protection

The insolvency regime is friendly to creditors in a number of ways:

- a. there is an express provision that secured creditors may enforce their security without the permission of the court or reference to the liquidator;
- b. there are provisions dealing with fraud in anticipation of the winding up, with criminal penalties applying; and
- c. the court may require liquidators to assist in the criminal investigation of liquidated companies

The Cayman insolvency regime applies equally to Islamic and non-Islamic transactions.

Judicial framework

The Cayman Islands (Constitution) Order establishes the Grand Court, the Court of Appeal and an independent judiciary. The Grand Court has five divisions to manage cases: the Admiralty, Civil, Criminal, Family and Financial Services. The majority of commercial cases are held in the Financial Services Division.

The Court of Appeal sits as a three-judge bench. Final appeal lies to the Judicial Committee of the Privy Council, in London.

In the absence of specific Cayman decisions, relevant decisions of the superior courts of England and Wales and of the countries of the Commonwealth, while not strictly binding, are highly persuasive. There have been no significant cases in relation to Islamic finance products or structures.

Outlook

In recent years, there has been a development in Cayman law that may affect the type of Cayman entity used in Islamic Finance transactions: the Limited Liability Companies Act has created a new class of Cayman entity – a limited liability company (LLC), which is similar to a Delaware limited liability company. Going forward, these LLCs may be used as hedge fund vehicles, orphan SPVs or as GPs of ELPs, rather than Cayman exempt companies, particularly where transactions are structured in jurisdictions that are familiar with Delaware LLCs.

The advantages of an LLC include flexible treatment of profits and losses free from capital maintenance rules and the ability to stipulate, in the LLC agreement, that a person appointed to the board by a particular member may act in the interests of that member, rather than the LLC.

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1 A STAR Trust is a form of statutory trust which can be established for persons, purposes (charitable and non-charitable) or both. The STAR Trust statutory provisions only apply where the trust instrument expressly states that they are to apply.

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