

How a change in strategy is putting Cayman on the map for Japanese institutional investors

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As offshore funds counsel in the Cayman Islands, it may come as no surprise that, for me, the last few years have seen a distinct rise in requests to establish bespoke private equity and real estate funds for US managers and sponsors who have been successful in attracting investments from large Japanese institutional investors.

An announcement in early 2017 by the world's largest pension fund, Japan's Government Pension Investment Fund, of its desire to allocate to alternative investments mainly outside of Japan, seems to have heralded a new, modestly riskier era for Japanese institutional investors as more pension funds look to follow in GPIF's footsteps and allocate to alternative investments.

Driven by a thirst for higher-yielding assets after years of poor growth, it seems Japanese institutional investors are turning to US managers to assist them develop an international, diversified portfolio. And US managers and sponsors are welcoming them with open arms, often establishing bespoke, heavily tailored and carefully negotiated funds of one (the closest equivalent in the Cayman Islands to a managed account). Other managers have been successful in raising capital for more traditional hedge funds, often offering daily liquidity, established specifically for the Japanese market.

Whilst Japanese institutional investors may be stepping outside of their comfort zone in terms of investment strategy, they seem content to keep the investment structure as traditional as possible. The Cayman Islands unit trust has always been, and remains, the most popular structure for these investors, given the similarity to the Japanese domestic investment trust and the associated historical tax benefits. Investors gain some comfort from the perceived benefits associated with having an independent professional trustee responsible for the oversight of the fund and the fact that an independent fiduciary will hold the legal title to the fund's assets (rather than a newly incorporated company) and will be responsible for controlling the governance of the fund (rather than directors, whose appointments are usually under the

control of the investment manager or one of its affiliates). However, I have seen a few instances in which a traditional Cayman Islands exempted limited partnership has been the preferred fund vehicle, either unitised or not, so it seems there is still some room for structural variation.

Many US managers and sponsors are not overly familiar with the Cayman Islands unit trust, traditionally having used corporate or partnership structures. It is perhaps, therefore, easiest to consider what is a unit trust by comparison to a corporate structure.

Unlike a company, a unit trust has no separate legal personality, rather it is a relationship which relies on the trustee enforcing contractual obligations entered into by the trustee on behalf of the trust. The trustee is responsible for the overall business and affairs of the unit trust and has a duty to act in the best interests of the beneficiaries. Most importantly, the trustee holds legal title to the trust property. The trustee is required to deal with the trust property separately from property which is owned and held by the trustee as his own personal property and such trust property is held by the trustee for the benefit of the beneficiaries of the trust (i.e. the fund investors).

Given trustees hold legal title to the trust property, trustees are generally seen as owing a higher standard of prudence in protecting the interests of the beneficiaries than would be reasonable to impose on a director of a commercial company. The trustee's responsibility is directly owed to the beneficiaries (i.e. investors) collectively, in contrast to a corporate structure where the directors owe duties to the company as a whole.

The trustee of a Cayman Islands unit trust will typically be a corporate trustee in the Cayman Islands and will therefore be required to be licensed as a trust company under the Banks and Trust Companies Law (Revised) or as a mutual fund administrator under the Mutual Funds Law, irrespective of whether or not the unit trust is regulated under the Mutual Funds Law. The Cayman Islands trustee will thus be regulated and supervised by the Cayman Islands Monetary Authority.

As compared to a corporate structure, unit trusts offer a certain amount of additional flexibility. For example, distributions to unitholders are unrestricted, whereas distributions to shareholders are subject to certain restrictions as set out in the Cayman Islands Companies Law.

Once a decision has been made to use a unit trust, the next question will be whether to use a standalone unit trust or an umbrella trust. A standalone trust, as the name implies, is a single trust established under a single trust instrument and is most appropriate where the trust fund is used to pursue a single investment strategy. An "umbrella" unit trust is, on the other hand, a structure whereby the trustee holds different pools of investments which are each allocated to separate "sub-trusts".

The umbrella structure is most popular with managers who intend to roll out different strategies or who are building a platform for use by different managers (generally their affiliates).

In an umbrella structure, a master trust instrument is entered into to establish the master trust and this is supplemented from time-to-time to establish one or more sub-trusts by way of a supplemental trust deed. The master trust instrument will provide that each sub-trust is a separate and distinct trust; this is intended to segregate the assets of each sub-trust into separate funds. Therefore, the investors in one sub-trust will only have an interest in the property held by the trustee in respect of that sub-trust and the trustee, as trustee of that sub-trust, will only be entitled to an indemnity out of the assets of that sub-trust.

Another decision for managers to make is whether to themselves become party to the unit trust instrument; more commonly, unit trust instruments are a declaration of trust made by the trustee only. My experience has been that US managers are wary of being party to the trust instrument, this stems from a fear that they may be deemed to be a co-trustee or be subject to the same fiduciary duties as trustees. In reality, this may be more of a perceived, than a real, risk given the manager will not hold legal title to the fund assets and so it is unlikely it could be held to be a co-trustee. Further, recent case law suggests that depending on the precise nature and scope of its role, the manager may owe fiduciary duties to a unitholder regardless of whether or not they are a party to the trust instrument.

For any US manager setting up a Cayman Islands unit trust there will no doubt be a learning curve as they get to know and understand how this structure works, but to many this seems a fair price to pay to attract capital from some of the wealthiest investors in the world.

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