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Private Equity 2021

Cayman Islands: Trends & Developments
Julian Ashworth, Iain Anderson, Alex Howard and
Oliver Quarmby
Maples Group

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Trends and Developments

Contributed by:

Julian Ashworth, Iain Anderson, Alex Howard and

Oliver Quarmby

Maples Group see p.9

Private Equity Trends and Developments in the Cayman Islands

Private equity activity in the Cayman Islands has been extremely active during the first half of 2021, with enhanced levels of entity formations reflecting significant fund formation and transactional activity.

Sponsors are continuing to be responsive to this demand, structuring and offering certain products that provide strategies tailored to the current environment and investor demand, including credit opportunities, market dislocation and special situations opportunities funds and products with regional or focused investment mandates, including environmental, social and governance (ESG) strategies. Similarly, there has been robust deal flow and several private equity firms have sponsored various special purpose acquisition company (SPAC) launches with the Cayman Islands being the preferred domicile for SPAC entities intending to seek a target outside the United States.

The Cayman Islands has been well-positioned to respond to a volatile and challenging global environment and retain its pre-eminent offshore position due to its legislative and regulatory framework, tax neutral status, flexible structuring options, respected legal system developed from English common law and experienced and responsive service providers coupled with broad market familiarity with Cayman Islands structures.

Regulatory developments

The most notable regulatory developments in the Cayman Islands during the last 12 months has

been the introduction and implementation of the Private Funds Act, which provided for registration of closed-ended collective investment vehicles with the Cayman Islands Monetary Authority (CIMA). Approximately 13,000 investment funds are now registered under the Private Funds Act. Cayman Islands regulation is, generally, fund-level focused and there is no requirement for a non-Cayman Islands manager of a private fund domiciled in the Cayman Islands to be regulated in the Cayman Islands. Most managers of private funds are not domiciled in the Cayman Islands and are regulated by various onshore regulators such as the US Securities and Exchange Commission, the UK's Financial Conduct Authority, the Hong Kong Securities and Futures Commission or the Japanese Financial Services Agency. A Cayman Islands-registered manager would be subject to oversight by CIMA and be required to have sufficient substance in the Cayman Islands with reference to its business activities.

Within this regulatory framework, sponsors, allocators and investors are able to legislate their own contractual arrangements, which is particularly helpful as strategic investors seek alternatives to traditional co-mingled fund structures and vehicle types.

Alternative structures and the Cayman Islands

The Cayman Islands' offering is also well-positioned for alternative structures; ranging from separate accounts, funds of one through "permanent capital" strategic transactions, end-of-life liquidity options and GP minority equity stake deals.

While the Cayman Islands is most commonly associated with private equity fund establishment, whether main, feeder/blocker, parallel, alternative investment or co-investment vehicles, there continues to be increasing demand for Cayman Islands structures in transactional contexts, particularly buy-out and secondary transactions, including as management holding vehicles.

The nature, scope and volume of work being undertaken in the Cayman Islands gives rise to a number of trends and developments which reflect emerging technologies and work practices, a mature funds industry and the multi-jurisdictional dimension of offshore practice.

Fund Structuring

A key reason for the jurisdiction's success is the range of Cayman Islands vehicles which are available to sponsors/managers, enabling them to structure closed-ended fund products in a manner which meets the diverse profile of investors domiciled in geographically disparate regions.

The most popular Cayman Islands-domiciled vehicles for structuring investment vehicles are:

- exempted limited partnerships (ELPs);
- exempted companies; and
- limited liability companies (LLCs).

There has also been increased interest from Japan in unit trusts that are tailored for private equity purposes. It is also now possible to form and register a Cayman Islands limited liability partnership (LLP).

Limited liability companies

The Cayman Islands limited liability company, similar to the Delaware variant, was introduced in mid-2016. Since then, there have been in excess of 4,000 Cayman Islands LLCs registered.

The LLP has been available for registration since November 2020. An LLP combines the flexible features of a general partnership but has the benefit of separate legal personality and affords limited liability status to all its partners. This provides an additional structuring option and may be suitable for general partner, fund of funds or holding partnerships.

The popularity of exempted companies and ELPs has been unaffected by the introduction of LLCs. By way of illustration, there has been consistent year-on-year growth in the number of ELPs registered, averaging over 10% per annum.

There are, however, nuanced regional differences in the types of vehicles being used for private equity mandates.

North American and European markets

In the North American and European markets, most primary, feeder, parallel, alternative investment and co-investment vehicles are typically formed as an exempted limited partnership unless a tax blocker is required.

In onshore-offshore fund structures, the ability to provide symmetry between the offshore fund vehicles and their equivalent onshore counterparts (notably Delaware and Luxembourg limited partnerships) can lead to greater ease and cost efficiency of fund administration, pass-through tax treatment and has helped to better align the rights of investors between the different vehicles in a fund structure.

The exempted company is less regularly employed as a fund vehicle other than with respect to certain types of target investors and with reference to certain assets. Its key feature - being a corporate vehicle with separate legal personality - lends these vehicles to being most commonly used as general partner, manager,

blocker or holding vehicles (although one of the exempted company variants, the segregated portfolio company, can be an attractive option for managers targeting certain Middle Eastern-based or family office investors).

The LLC has been an appealing alternative for general partner, upper tier, manager and co-investment vehicles. The absence of share capital (and the absence of the need to maintain a share register), combined with the ability to intuitively track and record the capitalisation of an LLC and its distributions, has also led to LLCs being attractive for blocker, aggregator and holding vehicle applications. Because a member is not required to make a contribution but may benefit from profit allocations, the LLC has been adopted for certain employee award and grant schemes.

Japan

In a Japanese context, a unit trust structure may offer tax and other regulatory related benefits to certain types of Japanese investors when compared to a limited partnership vehicle. The unit trust is also more familiar to many Japanese investors and it can be customised to incorporate characteristics of a traditional private equity fund, including capital call features, claw-backs and defaulting investor provisions.

Private equity is proving increasingly popular with Japanese mega banks, pension funds, life insurers and, more recently, a number of the regional banks who are rebalancing their portfolios and shifting assets into private equity in the search for higher yields. These factors have contributed to a surge in the establishment of private equity type unit trusts in recent years.

Global structures

A number of managers will utilise a mix of parallel fund vehicles to maximise the global distribution of their funds and manage downstream assets.

By way of example, managers targeting investors in multiple regions, including Europe, may look to offer parallel Cayman Islands, Delaware and Luxembourg fund options or a variation on that arrangement, such as a master-feeder fund structure with a Cayman Islands closed-ended fund vehicle operating as a feeder fund into a European (such as an Irish or Luxembourg) master fund. Similarly, a Cayman Islands closed-ended fund vehicle may set up holding or trading vehicles in various European jurisdictions (such as Ireland or Luxembourg) to facilitate its investment objectives.

Regulatory

A sophisticated legislative and regulatory framework has enabled the Cayman Islands to respond to the challenges and opportunities arising out of evolving, and often conflicting, regulatory developments. The other key regulatory developments in the recent years include the following.

- The implementation of the Private Funds Act in 2020, a regime that requires closed-ended funds to register with CIMA, introduced a proportionate regulatory overlay for closed-ended funds with several benefits, was responsive to recommendations by international partners and reflects the Cayman Islands' commitment as a co-operative jurisdiction as affirmed by various international organisations. It covers similar ground to existing or proposed legislation in a number of other jurisdictions.
- The Cayman Islands has implemented the comprehensive automatic exchange of information (AEOI) regimes of both the Organisation for Economic Co-operation and Development's Common Reporting Standard (OECD) and the US Foreign Account Tax Compliance Act (FATCA). Reporting financial institutions have customer due diligence, annual reporting obligations in the Cayman Islands and the

recent new annual requirement to file a CRS Compliance Form. Reports, as well as the annual CRS Compliance Form, are made to the Cayman Islands Tax Information Authority (TIA) administered by the government's Department for International Tax Cooperation. The TIA in turn provides account information automatically to the tax authorities of over 100 jurisdictions.

- The maintenance of beneficial ownership information and, since 2017, a requirement for a beneficial ownership register. Subject to any available exemptions, exempted companies and LLCs are now required to complete and maintain a beneficial ownership register at their Cayman Islands registered office with a licensed corporate service provider with information made available by the Cayman Islands government to certain law enforcement agencies upon legitimate request.
- The Cayman Islands introduced the Tax Information Authority (International Tax Compliance) (Country-by-Country Reporting) Regulations in 2017. In summary, these regulations implement in the jurisdiction the model legislation published under the OECD's Base Erosion and Profit Shifting Action 13 Report (Transfer Pricing Documentation and Country-By-Country Reporting).
- The Cayman Islands continue to review and revise its AML Regulations and related guidance to ensure they remain in line with current Financial Action Task Force (FATF) recommendations and global practice from time to time. The requirements of the AML Regulations include the appointment of natural persons as AML officers to entities carrying on "relevant financial business" (which includes Cayman Islands investment funds vehicles) to oversee the effective implementation of AML programmes carried out by or on behalf of such entities. The Cayman Islands' latest technical compliance assessment was published by the Caribbean FATF on 19 February

2021, which rated the Cayman Islands as compliant or largely compliant with 39 out of the 40 FATF recommendations and the Cayman Islands continues to enhance its AML/CFT regime, including by applying sanctions, including administrative penalties, that are intended to be effective, proportionate and dissuasive.

- In further response to and compliance with OECD Base Erosion and Profit shifting standards, in December 2018, the Cayman Islands brought into force the International Tax Co-Operation (Economic Substance) Act (As Revised) and associated regulations and guidance. This law introduced reporting and economic substance requirements for certain Cayman Islands-domiciled entities (which, from June 2021, includes Cayman Islands partnerships) undertaking certain activities, with reporting made to the TIA. The economic substance regime incorporates certain exemptions, specifically for vehicles that fall within the statutory definition of an investment funds.
- The Data Protection Act (As Revised) (DPL) came into force in late-2019. This law imposes certain obligations on Cayman Islands vehicles that handle personal information relating to an individual with respect to that information. The DPL data protection principles are equivalent to those in force under other comparative legislation, such as GDPR in Europe.
- The Cayman Islands continues its dialogue with a number of international partners and governing regulatory bodies, including the OECD and the FATF, to ensure the jurisdiction maintains a robust and proportionate regulatory framework which is implemented in an effective manner to meet internationally accepted best practice standards.

At the establishment stage, these regulatory matters are being reflected in more detailed dis-

closures in offering and subscription documents. By way of example, investors are being required to make disclosures which pertain to AML and tax transparency considerations and sponsors are addressing data protection and sanctions obligations together with economic considerations, such as pertaining to the costs which will be allocated to the fund as fund expenses as opposed to incurred by the manager.

These are dynamic and ongoing obligations, the nature of which is reflected in fund documents and Cayman Islands notification and reporting obligations of the nature described above.

Fair disclosure and compliance

There is also an emphasis on fair disclosure. During a fund's life cycle, as in key onshore jurisdictions, sponsors engage in ongoing dialogue with investors and advisory boards to ensure key matters, notably conflicts, are fairly disclosed, including in the context of fees (which has been an area subject to well-publicised onshore regulatory enforcement actions).

The scope for conflicts can be particularly acute at the end of a fund's life, for example where liquidity is sought, or value optimised, by way of a general partner-led secondary transaction or a term extension. In those instances, a sponsor may receive new material information in the midst of an all-partner consent process, or prior to a deal being consummated, which the sponsor (and/or general partner) must disclose so that investors are able to make an informed decision with reference to those revised particulars.

Given that the regulatory framework is evolving quickly and becoming more complex and multi-layered, an increasing number of sponsors look to outsource compliance functions, such as AML/KYC verification and tax transparency reporting obligations, to third-party specialists. This allows management companies to dedicate

more resources to their core investment-focused activities and more clearly delineate between fund and house expenses.

Geographic Factors Impacting Cayman Islands Private Equity Trends

The Cayman Islands product has broad global appeal although several trends are dictated by geographic factors.

Fundraising

The North American fundraising market remains active with a range of vehicles from small bespoke sidecar funds to mega-funds being established in the Cayman Islands. The broad flexibility of the Cayman Islands' offering ensures there is wide appeal among mid-market and start-up managers as well as allocators and investors to establish Cayman Islands vehicles intended to fulfil a wide range of purposes.

The European private equity market, including new fund formations, buyouts and exits, has continued to grow over the last few years. Following the temporary slowdown at the onset of the pandemic in the spring of 2020, industry quickly adapted to the new environment of working from home and undertaking virtual due diligence and this saw activity return strongly in the second half of the year. This trend has continued into 2021 despite the uncertainty caused by the end of the Brexit transition period and intermittent lockdowns throughout Europe. Against this growth in the European private equity markets, demand for Cayman Islands private equity fund structures from European sponsors has remained consistent, in particular, where targeting non-European money.

Managing the impact of the pandemic

There is also continued demand to structure downstream investments through Cayman Islands aggregator, alternative investment vehicles and holding vehicles as sponsors look to

deploy capital in what has become a highly competitive deal market as sponsors seek to exploit opportunities created by the pandemic.

European managers have continued to adapt strategies across all asset classes in order to reflect the disruption caused to businesses and market uncertainty, with private credit funds remaining popular, and also an increased investor focus on ESG considerations. Secondary activity has also been strong as investors and sponsors have looked to restructure their portfolios.

The Cayman Islands continued to be a popular jurisdiction for UK managers looking to establish offshore private equity funds, especially where there is a transatlantic nexus. Increased fund oversight and investor protection through the implementation of the Private Funds Act and the strengthening of CIMA's regulatory powers has, together with certain other recent legal and regulatory developments, served to more closely align Cayman Islands private funds with the regulated framework that European private equity fund managers and investors are used to operating in under AIFMD.

The slowdown of Chinese investment during 2019 continued into early 2020. As the pandemic started to ease later in the year in the region, Chinese GPs quickly got back to closing deals which had been put on hold. Robust deal-making helped Asia-Pacific assets under management rise.

Global landscape

Despite the challenges of COVID-19 and the ongoing US-China trade tensions which have made the environment for fundraising difficult, for new managers, sponsors from the Asia region continue to take a robust view, resulting in a spike in fund launches over the first six months of 2021 compared to 2020. The Cayman

Islands continues to be the dominant jurisdiction of choice for sponsors and investors alike in the Asia region, being favoured for investment funds launched across different disciplines ranging from traditional private equity, to real estate and credit funds.

Continued growth

There are record levels of dry powder in the Asia Pacific region. According to one survey, GPs' largest concern is high valuations. This dry powder is somewhat mitigating the effects of lower fundraisings in the previous year.

As noted above, there is increasing appetite in Japan for exposure to private equity with many Japanese investors expanding into the asset class.

South East Asia has seen continued growth in private equity with large funds turning a focus on the region both for fund-raising and deal-flow. There are a number of large private equity fund launches taking place with Singapore domiciled managers. The venture capital space in particular has seen a number of new and upcoming launches with the recent spate of unicorns and potential upcoming unicorns in the region proving attractive.

The investment funds market in Asia is also witnessing a convergence of traditional private equity funds with hedge funds, leading to the uprising of hybrid funds. To this end, traditional hedge fund managers are now accustomed to investing into private companies through side pockets or co-investment vehicles with the aim or potentially greater returns over the longer term while traditional private equity fund managers are also launching hedge funds to provide their investors with greater levels of liquidity in the secondary market. These are all welcomed developments for the private equity industry, showing constant innovation and developments of the industry

CAYMAN ISLANDS TRENDS AND DEVELOPMENTS

*Contributed by: Julian Ashworth, Iain Anderson, Alex Howard and Oliver Quarmby, **Maples Group***

with the use of the Cayman Islands structures at the centre of such initiatives.

Looking Ahead

It is anticipated that, given the expectation that volatility in global markets will continue, investors will continue to allocate a significant portion of their investment capital to alternatives.

Against this backdrop, and notwithstanding such volatile macro-economic landscape, the Cayman Islands remains well placed to maintain its position as the principal offshore jurisdiction for private equity given the flexible structuring options, investor familiarity with Cayman Islands structures and a proportionate regulatory framework that continues to adapt in a robust and responsive manner to the needs and expectations of sponsors, investors and international partners.

Maples Group advises global financial, institutional, business and private clients on the laws of the British Virgin Islands, the Cayman Islands, Ireland, Jersey and Luxembourg through its leading international law firm, Maples and Calder. With offices in key jurisdictions around the world, the Maples Group has specific strengths in the areas of corporate commercial, finance,

investment funds, litigation and trusts. Maintaining relationships with leading legal counsel, the Group leverages this local expertise to deliver an integrated service offering for global business initiatives. The authors would like to thank Tim Dawson for his contribution to the chapter.

AUTHORS



Julian Ashworth is a partner in the Cayman Islands' funds and investment management team at Maples and Calder, the Maples Group's law firm. His practice focuses on private

equity, hybrid and hedge fund structures and downstream transactions, including financing and security agreements, secondary transactions and fund restructurings. He advises sponsors and management companies on profit sharing and funding arrangements and Cayman Islands regulatory matters. Julian is also involved in corporate finance matters, including M&A transactions, joint ventures, co-investments and restructuring matters.



Iain Anderson is a partner in the funds and investment management team at Maples and Calder, the Maples Group's law firm, in the Singapore office. He specialises in fund

formations, downstream fund transactions, including acquisitions, co-investments and joint ventures, and general partner arrangements and fund regulatory work. His clients include large global and regional private equity and hedge funds, boutique managers, smaller start-up funds and investee companies.

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Contributed by: Julian Ashworth, Iain Anderson, Alex Howard and Oliver Quarmby, Maples Group



Alex Howard is an associate in the funds and investment management team at Maples and Calder, the Maples Group's law firm, in the Cayman Islands. He specialises in the

establishment and maintenance of private equity funds and other alternative investment funds. Alex also advises on the regulatory aspects of Cayman Islands investment vehicles.



Oliver Quarmby is an associate in the London funds and investment team at Maples and Calder, the Maples Group's law firm. He practises Cayman Islands law, advising on the

establishment and maintenance of all types of investment funds, in particular private equity and hedge funds. Oliver has over 15 years' experience in the funds industry.

Maples Group

Ugland House
South Church Street
PO Box 309
Grand Cayman
KY1-1104
Cayman Islands

Tel: +1 345 949 8066
Fax: +1 345 949 8080
Email: info@maples.com
Web: www.maples.com

