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The cover features several large, dark green leaf-like shapes scattered across the background, creating a natural, organic feel. The leaves vary in size and orientation, with some pointing upwards and others downwards.

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Private Equity

Cayman Islands: Trends & Developments
Maples Group

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Trends and Developments

Contributed by Maples Group

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the Maples Group has specific strengths in the areas of corporate commercial, finance, investment funds, litigation and trusts. The Group maintains relationships with leading legal counsel, and leverages this local expertise to deliver an integrated service offering for global business initiatives.

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Anthony B. Webster is the head of the Private Equity practice in Asia at Maples and Calder, the Maples Group's law firm. He has acted for a wide variety of sponsors across the region, having advised on the Cayman and BVI aspects of more than 300

funds (including many for the best-known private and state-sponsored Chinese promoters of offshore funds). He also has extensive experience of downstream corporate and finance transactions backed by private equity managers.

Private equity continues to be an attractive and dynamic asset class in light of geo-political, macro-economic and broader regulatory developments. The Cayman Islands prevails as the principal offshore jurisdiction servicing this sector.

The Cayman Islands fundraising market remains particularly buoyant as investors seek more attractive returns and longer maturity periods than many other asset classes offer, particularly given dovish central bank monetary policies and low or negative bond yields.

While the Cayman Islands are most commonly associated with private equity fund establishment opportunities, there is also increasing demand for Cayman Islands structures in transactional contexts, particularly buyouts and secondary transactions.

The Cayman Islands remains the primary offshore jurisdiction in which to domicile private equity funds in light of 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.

There is also no requirement for a non-Cayman Islands manager of a fund domiciled in the Cayman Islands to be regulated in the Cayman Islands. Indeed, most managers of private equity funds are not domiciled in the Cayman Islands and are regulated by relevant onshore regulators, such as the US Securities and Exchange Commission, the UK's Financial Conduct Authority or the Japanese Financial Services Agency. A Cayman Islands registered manager would be subject to oversight by the Cayman Islands Monetary Authority.

This framework enables sponsors and allocators/investors alike to legislate their contractual arrangements freely, which is particularly helpful as strategic investors seek alternatives to traditional co-mingled fund structures and vehicle types.

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.

This broad landscape has given rise to a number of trends and developments linked together by a core overarching theme; the nature of offshore practice has become more complex, involved and multi-jurisdictional due to global developments including onshore tax and policy reform, geo-political trends, complex and, at times, conflicting regulatory frameworks, emerging technologies and a mature funds industry.

Fund Structuring

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

The most popular Cayman-domiciled vehicles by which to structure investment vehicles are exempted limited partnerships (ELPs), exempted companies, and limited liability companies (LLCs). There has also been increased interest in Japan in unit trusts that are tailored for private equity purposes.

The Cayman Islands limited liability company, similar to the Delaware variant, was introduced in mid-2016. There have been in excess of 2,300 Cayman LLCs registered since then.

The popularity of exempted companies and ELPs has been unaffected by the introduction of LLCs. 2018 formation levels for both exempted companies and ELPs were at historic highs, with registration numbers trending at similar levels in the first half of 2019. By way of illustration, almost 5,000 new ELPs were registered in 2018, which was approximately 30% higher than equivalent registrations in the previous year.

There are some nuanced regional differences in the vehicles being used for private equity mandates. In the North American and European markets, primary fund and parallel private equity vehicles, feeders and AIVs are typically formed as exempted limited partnerships, 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 and pass-through tax treatment, and has helped to better align the rights of investors between the different vehicles in the 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 of being a corporate vehicle with separate legal personality leads to these vehicles 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 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. As 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.

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

This development is in response to traditionally risk-averse Japanese institutions recalibrating their investment portfolios and allocating to private equity in a search for yield. As with many western states, Japanese Government bond yields have been stuck at, or near, 0%. The opportunity in the Japanese market is illustrated by institutions such as the Global Pension Investment Fund (the world's largest pension fund, with a USD1.42 trillion portfolio) publicly stating its intention to increase its allocation to alternatives from 0.07% at the end of 2016 to a target of 5%. Japan Post Bank, with an even larger USD1.8 trillion portfolio, has similarly announced plans to increase its alternatives allocation to 3%. More broadly, approximately 96% of Japanese institutional

investors intend to invest in alternatives in the year ahead, with a particular focus on private equity.

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 Delaware, Cayman Islands 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, Luxembourg or the Netherlands) to facilitate their investment objectives.

Regulatory

A robust legislative and regulatory framework and engaged legislators and regulators have enabled the Cayman Islands to respond efficiently and effectively to the challenges and opportunities arising out of ongoing regulatory developments. The key regulatory developments in the past few years include the following:

- The Cayman Islands has adopted comprehensive automatic exchange of information (AEOI) regimes, and reporting financial institutions have both due diligence and annual reporting obligations in the Cayman Islands, the method by which in-scope vehicles comply with their international obligations. Both the Organisation for Economic Co-operation and Development's Common Reporting Standard (OECD) and the US Foreign Account Tax Compliance Act (FATCA) have mandatory application in the jurisdiction. Notifications are made to the Cayman Islands Tax Information Authority (TIA), administered by the Government's Department for International Tax Co-operation.
- In 2017, the Cayman Islands introduced a new 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.
- Also in 2017, the Cayman Islands introduced the Tax Information Authority (International Tax Compliance) (Country-by-Country Reporting) Regulations, 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).
- Following an enhancement of its anti-money laundering (AML) and terrorist financing regulations (the AML

Regulations) in 2017, Cayman has continued to revise and update its AML Regulations and related guidance to ensure it remains in line with current Financial Action Task Force recommendations and global practice. The AML Regulations have been expanded in scope to apply to a wider range of Cayman Islands-domiciled entities, to require the appointment of natural persons as AML officers, and to clarify principles of delegation and/or reliance in the context of outsourcing the administration of the AML Regulations.

- In further response to and compliance with OECD base erosion and profit shifting standards, in December 2018, Cayman published the International Tax Co-Operation (Economic Substance) Law, 2018 and associated regulations. This new law introduces reporting and economic substance requirements for certain Cayman Islands-domiciled entities, with reporting made to the TIA.
- The Data Protection Law, 2017 (DPL) is due to come into force on 30 September 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 that the jurisdiction maintains a robust and proportionate regulatory framework that meets internationally accepted best practice standards.

At the establishment stage, these regulatory matters are being reflected in longer and more detailed disclosures in offering and constitutional documents. By way of example, investors are being required to make disclosures that pertain to AML and tax transparency considerations, and sponsors are addressing data protection and sanction obligations together with economic considerations, such as those pertaining to the costs that 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.

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.

As the regulatory framework is evolving quickly and becoming more complex and multi-layered, an increasing number of sponsors are looking 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 to 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.

The North American fundraising market remains active, with a significant number of mega-funds being structured in the Cayman Islands. The broad flexibility of Cayman's offering, however, 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, continued to grow within the last two years. This is despite the noticeable uncertainty that has prevailed in the UK private equity market since the Brexit referendum. Against this backdrop of continued growth in the European private equity markets, demand for Cayman Islands private equity fund structures from European sponsors increased in 2018 where targeting non-European money.

There is also increasing demand to structure downstream investments through Cayman Islands aggregator and holding vehicles as sponsors look to deploy capital in a competitive deal market. There have been a number of macro-economic factors affecting market confidence and deal levels globally. By way of example, in the UK, the Brexit referendum has had a significant effect on both the private equity market and UK

managers alike. Deal activity has declined amid the tumultuous geo-political environment, and most UK managers have had the added burden of restructuring their internal management structures in preparation for Brexit. At the time of writing, Brexit and the likely shape of the UK's future relationship with Europe remains unknown, and it is anticipated that deal activity will only accelerate once there is greater certainty in this regard. Notwithstanding the challenges facing the UK private equity market, the Cayman Islands continues to be a popular jurisdiction for UK managers looking to establish offshore private equity funds.

As noted above, there is increasing appetite in Japan for exposure to private equity, and a number of managers are expanding into the asset class. By way of illustration, local managers who have only raised local Japanese Yen funds are starting to expand and establish offshore structures for the first time. This is having a positive effect on the broader private equity environment, with Japanese banks interested in getting into the fund financing space and Japanese conglomerates starting to spin off non-core businesses to private equity-backed purchasers, including the sale of Toshiba Memory and Panasonic's healthcare business.

In the mainland China market, there has been a noticeable slowdown in the pace and volume of fundraising by Chinese GPs, which is primarily attributable to the US-China trade dispute. This slowdown became apparent at the beginning of 2019 and has intensified as recent developments bring sharper focus to the sustainability of the one country, two systems model. Chinese investment into the United States (that has traditionally made use of Cayman structures) has slowed down dramatically.

There is also renewed interest in Cayman private equity fund structures from the South Korean market, after the South Korean parliament passed legislation overturning a very unhelpful decision of the South Korean Supreme Court (which elected to treat Cayman partnerships as separate legal persons for Korean tax purposes). Korean managers, however, appear to have struggled to raise significant amounts of international capital for investment into South Korea.

Looking Ahead

The Cayman Islands is well placed to maintain its position as the principal offshore jurisdiction for private equity, notwithstanding various macro-economic challenges and an evolving regulatory framework that both affect the industry.

The Cayman Islands' government and private sector have approached these developments in a robust and responsive way that ensures the jurisdiction's legislative and regulatory environment, tax-neutral status, flexible structuring options and local service providers can cater to a diverse profile of sponsors and investors who are operating in an increasingly complex, competitive and multi-jurisdictional context.

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