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Private Equity 2024

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Cayman Islands: Trends and Developments

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



CAYMAN ISLANDS



Trends and Developments

Contributed by:

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

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Authors



Julian Ashworth is a partner in the Cayman Islands' funds and investment management team at Maples and Calder, 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, 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.



Alex Howard is a partner in the Cayman Islands' funds and investment management team at Maples and Calder, Maples Group's law firm. 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.

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



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

establishment and maintenance of all types of investment funds, particularly 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



Private Equity Trends and Developments in the Cayman Islands

The first half of 2024 has seen private equity capitalising on the strong recovery of the financial markets following a period of prolonged market volatility, sustained high interest rates and continued inflationary pressures, with the second quarter of 2024 seeing the highest level of private equity activity in two years. The significant surge in the number of deals, and deal value, reflects confidence in the financial markets and a clearer macroeconomic outlook, which is driving portfolio growth.

During this period of growth, sponsors have continued to look to the Cayman Islands when structuring and offering private equity products that provide strategies tailored to the current market environment, including technology, infrastructure, credit opportunities, market dislocation and special situations opportunities funds and products with regional or focused investment mandates, including environmental, social and governance strategies.

The Cayman Islands continues to be well-positioned to respond to the fast-paced and growing private equity sector, and to 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 investment fund-related regulatory development in the Cayman Islands in recent years has been the introduction and implementation of the Private Funds Act, which provided for registration of closed-end collective

investment vehicles with the Cayman Islands Monetary Authority (CIMA). More than 17,000 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, the Monetary Authority of Singapore or the Japanese Financial Services Agency. A Cayman Islands-registered manager would be subject to oversight by CIMA and 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 well-positioned for alternative structures, ranging from separate accounts and funds-of-one through to "permanent capital" structures and other strategic transaction structures, such as end-of-life liquidity options, continuation vehicles and general partner minority equity stake deals.

While the Cayman Islands is most commonly associated with the establishment of private equity funds, whether main, feeder/blocker, parallel, alternative investment or co-investment

vehicles, there continues to be a strong 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 that 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 that are available to sponsors/managers, enabling them to structure closed-end fund products in a manner that satisfies 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).

The use of Cayman Islands LLCs, similar to the Delaware variant, introduced in mid-2016, has continued to be popular as a flexible structuring vehicle, with more than 5,150 Cayman Islands LLCs now being registered.

The Cayman Islands Limited Liability Partnership (LLP), available for registration since November 2020, possesses the flexible features of a general partnership but has the additional benefit of a separate legal personality and affords limited liability status to all its partners. This vehicle 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 generally continues to be unaffected by the introduction of LLCs and LLPs. By way of illustration, there has been consistent year-on-year growth in the number of ELPs in existence.

There are, however, nuanced regional differences in the types of vehicles being used for private equity mandates. By way of example, the preferred investment vehicle for many Japanese investors continues to be the Cayman Islands unit trust.

North American and European markets

In the North American and European markets, most primary, feeder, parallel, alternative investment and co-investment vehicles are formed as an ELP 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, as well as 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. The key feature of being a corporate vehicle with a separate legal personality has led to this type of vehicle being most commonly used as a general partner, manager, blocker or holding vehicle (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 the Japanese context, a unit trust structure can often offer tax and other benefits to many Japanese investors when compared with a limited partnership vehicle. It is possible to structure the unit trust to incorporate the characteristics of a traditional private equity fund, including commitment and capital call features, claw-backs and defaulting investor provisions.

Private equity has proved popular with Japanese banks, pension funds, life insurers and other institutional investors seeking to rebalance their portfolios into private equity in the search for higher yields over a number of years, including foreign private equity. This is despite a continued weakening of the Yen against the US dollar in recent years, which has put pressure on Japanese investors to fund US dollar-denominated commitments and, in some cases, has led to reduced commitment sizes or increased selectivity on funds targeted.

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-end fund vehicle operating as a feeder fund into a European (such as an Irish or Luxembourg) master fund. Similarly, a Cayman Islands closed-end 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. Several key regulatory developments in recent years are outlined below.

The private funds regime

The Private Funds Act (As Revised) came into force in 2020 and provides a regime for the regulation of closed-end funds (private funds) by CIMA. The new regime introduced a proportionate regulatory overlay for private 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.

Furthermore, in April 2023 CIMA released a series of updated and new regulatory measures

for regulated entities (including private funds), which included the Statement of Guidance on Corporate Governance for Mutual Funds and Private Funds, the purpose of which is to provide guidance on the minimum expectations for the sound and prudent governance of regulated funds. It sets out the key corporate governance principles pertaining to the operators of regulated funds as a guide to CIMA's expectations with regard to governance. CIMA also issued the (i) Rule and Statement of Guidance – Internal Controls for Regulated Entities, which requires regulated entities (including private funds) to establish, document and maintain an adequate and effective system of internal control; and (ii) The Rule – Corporate Governance for Regulated Entities, which requires regulated entities (including private funds) to establish, implement and maintain a corporate governance framework commensurate with their size, complexity, nature of business, structure, risk profile and operations.

Automatic exchange of information (AEOI)

The Cayman Islands has implemented the comprehensive AEOI regimes of both the Organisation for Economic Co-operation and Development's (OECD) Common Reporting Standard (CRS) and the US Foreign Account Tax Compliance Act (FATCA). Reporting financial institutions have customer due diligence and annual reporting obligations in the Cayman Islands, and an annual requirement to file a CRS Compliance Form. Reports, as well as the annual CRS Compliance Form, are filed with 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.

Tax Information Authority (International Tax Compliance) (Country-by-Country Reporting) Regulations, 2017

The Cayman Islands introduced the Tax Information Authority (International Tax Compliance) (Country-by-Country Reporting) Regulations in 2017. 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).

Anti-money laundering (AML) regulations

The Cayman Islands continues to review and revise its AML regulations and related guidance from time to time, to ensure they remain in line with current Financial Action Task Force (FATF) recommendations and global practice. 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. As a result of the Cayman Islands' continued enhancement of its AML/CFT regime, including by way of introducing administrative penalties and sanctions that are intended to be effective, proportionate and dissuasive, the FATF has determined that the Cayman Islands has the highest compliance rating with respect to all 40 FATF recommendations relating to AML and countering the financing of terrorism, and that it has satisfied all of the FATF's recommended actions for the jurisdiction, recognising that the Cayman Islands has a robust and effective AML and counter-terrorist financing regime.

Beneficial ownership and transparency

The Beneficial Ownership and Transparency Act (As Revised) (BOTA), the Cayman Islands' new

beneficial ownership regime, was brought into force on 31 July 2024.

BOTA modifies the beneficial ownership regime that had been in place in the Cayman Islands since 2017 in a manner that aligns with equivalent regimes in other jurisdictions, such as the US Corporate Transparency Act. BOTA extends the reach of the beneficial ownership regime to most Cayman Islands entities and removes most of the exemptions previously relied upon.

The new regime applies to all “legal persons”, which includes companies, LLCs, LLPs, limited partnerships, ELPs, foundation companies and certain other legal persons prescribed in regulations, with such persons being required to complete and maintain a beneficial ownership register at their Cayman Islands registered office with a licensed corporate service provider. Cayman Islands trusts and non-Cayman Islands vehicles, including foreign entities that are registered in the Cayman Islands, are out of scope of BOTA.

The regime also provides certain legal persons with an alternative route to compliance (meaning the legal person would not be required to report their beneficial owners or establish a beneficial ownership register, but rather report limited “required particulars”). This route is available to a legal person who is: (i) listed on the Cayman Islands Stock Exchange (CSX) or an approved stock exchange (including subsidiaries of a listed entity) or (ii) licensed under certain Cayman Islands regulatory laws.

Additionally, an investment fund registered with the CIMA under the Private Funds Act (As Revised) or the Mutual Funds Act (As Revised) may choose to comply with BOTA by either satisfying obligations under the default regime (as highlighted above) or availing itself of an invest-

ment fund-specific alternative route to compliance.

A registered investment fund that elects to pursue the alternative option will not be required to maintain a register of its beneficial owners. Instead, Cayman Islands-domiciled investment funds registered with CIMA as mutual or private funds that rely upon the alternative route to compliance will be required to supply the contact details of certain Cayman Islands service providers, such as its registered office services provider or a licensed fund administrator. That contact person will be required to provide beneficial ownership information, on behalf of the registered investment fund, to the competent authority on request within 24 hours (or such longer period as may be specified in the competent authority’s request).

The regime provides that the Cayman Islands government may make further regulations in due course, empowering the Cayman Islands registrar to provide public access to certain required particulars of registrable persons (such as persons who meet a “legitimate interest test”), which may include access to organisations that have a genuine role in preventing or combating money laundering and terrorist financing.

The International Tax Co-Operation (Economic Substance) Act

In further response to and compliance with OECD base erosion and profit-shifting standards, in December 2018, the Cayman Islands brought the International Tax Co-Operation (Economic Substance) Act (As Revised) and associated regulations and guidance into force. This law introduced reporting and economic substance requirements for certain Cayman Islands-domiciled entities and 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 fund.

Data protection

The Data Protection Act (As Revised) (DPA) 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 DPA data protection principles are equivalent to those in force under other comparative legislation, such as General Data Protection Regulation in Europe.

Continuing dialogue

The Cayman Islands continues to have 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 is implemented in an effective manner to meet internationally accepted best practice standards.

Impact on offering and subscription documents

At the establishment stage, these regulatory matters are being reflected in more detailed disclosures in offering and subscription 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 sanctions 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 the costs 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 that 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 continuation fund, 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 multilayered, 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 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.

Fundraising

Following the soft North American fundraising market of 2023 resulting from the difficult economic and political environment, private equity fundraising looks to have slightly rebounded in the first half of 2024. While fund sizes are still slightly smaller than those seen in 2022, fundraising timelines have significantly accelerated. In light of this renewed growth, there continues to be consistent demand for the establishment of Cayman Islands structures, with a range of vehicles including small bespoke sidecar funds, mega-funds and downstream structuring vehicles. 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, in establishing Cayman Islands vehicles intended to fulfil a wide range of purposes.

The European private equity market has been impacted in recent years by global market uncertainty, inflation, the conflict in Ukraine and, latterly, the Israel-Gaza war. Fundraising in Europe held up relatively well amongst the larger buyout firms; however, it remained a challenging environment for deal-making.

The Cayman Islands continues 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 have, together with certain other recent legal and regulatory developments, in particular with regards to corporate governance and internal controls rules, 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 the Alternative Investment Fund Managers Directive.

Owing to pandemic disruptions, geopolitical uncertainties and regulatory clampdowns, fundraising in the region proved difficult throughout 2022 and continuing into 2023. Despite the rise of "onshore" fund jurisdictions in Asia, Cayman Islands entities continue to remain the vehicles of choice, particularly for large global managers.

Global landscape

A number of potential headwinds continue in Asia-Pacific as we move into late 2024: global investors remain concerned about China's economic growth and increasing investment risk given rising geopolitical tensions and tighter industry regulation. Political and economic uncertainty casts a shadow over the region's exit market, and the closing of the US IPO exit route for many Chinese companies has significantly reduced the number of Chinese firms listing in the US. Additionally, global macro factors, including the war in Ukraine, high inflation, still-high interest rates and US political uncertainty, may be negatively impacting investor sentiment.

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. In the Southeast Asian market, there has been an increase in the number of structures using both Cayman and Singapore vehicles; for instance, a Cayman feeder partnership into a Singapore variable capital company (VCC) master fund has been popular in the VC fundraising space.

Continued growth

As noted above, there is a continued interest from Japanese institutional investors in private equity, with many Japanese investors continuing to diversify by allocating funds to the asset class or increasing allocations. Tech investments continue to be a major focus in South-East Asia. With many valuations coming down, this may lead to increasing deal flow, although this may be tempered by a “risk-off” approach being adopted by investors given global macro factors.

Looking Ahead

If the financial markets continue to recover from the significant macroeconomic disturbances seen in recent years, private equity is well situated to capitalise on the emergence from the prolonged market uncertainty through an innovative and robust approach to investment strategies and value growth.

Against this backdrop, 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 proportionate regulatory framework that continues to adapt in a robust and responsive manner to the needs and expectations of sponsors, investors and international partners.

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