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Private Equity 2022

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Cayman Islands: Trends & Developments

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CAYMAN ISLANDS

Trends and Developments

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Place to Invest

With a backdrop of market uncertainty and a higher than normal inflationary environment, private equity activity in the Cayman Islands has nonetheless continued to be active during the first half of 2022, with sustained levels of entity formations reflecting healthy levels of fund formation and transactional activity.

As a response to this demand, sponsors continue to structure and offer certain products that provide strategies tailored to the current environment and investor demand, which include credit opportunities, market dislocation and special situations opportunities funds and products with regional or focused investment mandates, including environmental, social and governance (ESG) strategies.

While in 2021, the Cayman Islands saw a dramatic increase in special purpose acquisition company (SPAC) related transactions, such transaction flow slowed in Q1 and Q2 of 2022, reflecting a cooling of interest in the SPAC market generally as a result of economic and regulatory factors.

The Cayman Islands continues to be 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 expe-

rienced and responsive service providers coupled with broad market familiarity with Cayman Islands structures.

Regulatory developments

The most notable 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-ended collective investment vehicles with the Cayman Islands Monetary Authority (CIMA). Approximately 14,679 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 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 alterna-

tives to traditional co-mingled fund structures and vehicle types.

Alternative structures and the Cayman Islands

The Cayman Islands also offers alternative structures, such as 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 an increasing demand for Cayman Islands structures in transactional contexts, particularly buyout 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 that are available to sponsors/managers, which enable them to structure closed-ended fund products in a manner that meet the diverse profiles 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).

As a flexible structuring vehicle, Cayman Islands LLCs have gained popularity in recent years. Over 4,300 Cayman Islands LLCs have now been registered, similar to the Delaware variant introduced in mid-2016.

The Cayman Islands Limited Liability Partnership (LLP), which has now been available for registration since November 2020, 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 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 registered, averaging over 10% per annum.

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 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 counter-

parts (notably Delaware and Luxembourg limited partnerships) can lead to greater ease and cost efficiency of fund administration, pass-through tax treatment and has improved investor rights alignment between the various vehicles of 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. Because of their key feature – being corporate vehicles with separate legal personalities – these vehicles are primarily used by general partners, managers, blockers and holding companies. However, the segregated portfolio company, one of the exempted company variants, 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 can often offer tax and other benefits to many Japanese investors when compared to a limited partnership vehicle. It is possible to structure the unit trust to incorporate characteristics of a traditional private equity fund, including commit-

ment and capital call features, claw-backs and defaulting investor provisions.

Private equity is proving increasingly popular with Japanese banks, pension funds, life insurers and other institutional investors who are increasingly rebalancing their portfolios 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 recent years include the following.

- In 2020, the Private Funds Act was implemented, requiring closed-ended funds to

register with CIMA, introducing a proportionate regulatory overlay for closed-ended funds that resulted in several benefits. This was in response to recommendations made by international partners and is evidence of the Cayman Islands' commitment to co-operative jurisdiction, as affirmed by a variety of 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 (OECD) Common Reporting Standard (CRS) 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 a requirement for a beneficial ownership register. Subject to any available exemptions, exempted companies and LLCs are 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 Anti-Money Laundering (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. 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.
- 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 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 funds.

- 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 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 disclosures in offering and subscription documents. By way of example, investors are being required to make disclosures pertaining 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 has continued to grow over recent years, despite the pandemic and the end of the Brexit transition period. However, sentiment in 2022 has so far largely been dominated by market uncertainty, inflation, war in Ukraine and recent political instability in the UK and elsewhere in continental Europe. The European private equity markets have seen a slowdown in fundraising, although demand for Cayman Islands private equity fund structures from European sponsors continues to be healthy, in particular, where targeting non-European money.

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 is now a highly competitive deal market.

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 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.

According to one survey, Asia Pacific's share of global assets under management (AUM) rose to 30% at the end of 2021. Over the past decade, AUM focused on this region grew 2.4 times

faster than for North America and 3.0 times faster than for Europe (which Asia Pacific passed for second place in 2018). Despite the rise of "onshore" fund jurisdictions in Asia, Cayman Islands entities continue to remain the vehicle of choice, particularly for large global managers.

Global landscape

Despite the ongoing challenges of COVID-19, the global slowdown and the ongoing US-China trade tensions, which have made the environment for fundraising difficult for new managers, sponsors from the Asia region continued to take a robust view into early 2022. There is, however, some evidence of a slowing in new fund launches as we move later into the year, which may relate to ongoing concerns about a recession and concerns around the Russian invasion of Ukraine.

A number of potential headwinds have arisen in Asia Pacific as we move into late 2022. Global investors are concerned about China's slowing economic growth and increasing investment risk given rising geopolitical tensions and tighter industry regulations. Political and economic uncertainty cast a shadow over the region's exit market and the closing of the US IPO exit route for Chinese companies has significantly reduced the number of Chinese firms listing in the US. Additionally, global macro factors, including the war in Ukraine and the potential US recession 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.

Continued growth

According to one survey, the amount of dry powder – committed but unallocated capital waiting to be invested – in Asia Pacific-focused funds reached a new high of over USD650 billion, a level that should fuel investment activities in the region for years to come.

As noted above, there is increasing interest from Japanese institutional investors in private equity with many Japanese investors now expanding into the asset class or increasing allocations.

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. Tech and “Unicorn” investments continue to be a major focus in the South-East Asian region. 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.

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 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 may 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.

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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

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CAYMAN ISLANDS TRENDS AND DEVELOPMENTS

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