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The Cayman Islands Private Funds Law and its impact on fund finance

Derek Stenson & Michael O'Connor
Conyers

The Cayman Islands Private Funds Law, 2020 (the “PF Law”) was enacted in February 2020 and introduced for the first time a requirement for Cayman Islands private funds to register with the financial regulator in the Cayman Islands, being the Cayman Islands Monetary Authority (the “Authority”).

The introduction of the PF Law builds upon the reputation of the Cayman Islands as a co-operative and transparent jurisdiction and is an important step in the evolution of the Cayman Islands as a leading jurisdiction for the formation of private fund vehicles. The PF Law’s introduction is also indicative of increased regulatory oversight of the investment management industry globally, and while this can be seen as a positive development (notwithstanding the short-term growing pains as the regime is implemented), the PF Law has resulted in significant changes to the supervision, regulation and registration requirements of such vehicles in the Cayman Islands and so is of relevance to sponsors, service providers and lenders to private funds.

What is a private fund?

Almost all Cayman Islands fund vehicles that are commonly seen within private equity and venture capital structures (including alternative investment vehicles) fall within the definition of a “private fund” under the PF Law, with the notable exception being single investor vehicles.

The PF Law applies to each “private fund”, which is defined as a “*company, unit trust or partnership that offers or issues or has issued investment interests, the purpose or effect of which is the pooling of investor funds with the aim of enabling investors to receive profits or gains from such entity’s acquisition, holding, management or disposal of investments, where:*

- (i) the holders of investment interests do not have day-to-day control over the acquisition, holding, management or disposal of the investments; and*
- (ii) the investments are managed as a whole by or on behalf of the operator of the private fund, directly or indirectly”.*

A company, unit trust or partnership will not be a private fund if it falls within the list of “non-fund arrangements” in the schedule to the PF Law.¹

What was the previous position and how does the PF Law change this?

Prior to the introduction of the PF Law, Cayman Islands private equity and venture capital funds were outside of the scope of registration with, and regulation by, the Authority by virtue of being closed-ended vehicles (whose limited partners could not withdraw from the fund vehicle at their own option).

Following the introduction of the PF Law, this position has changed and such vehicles are now required to register with the Authority and will be subject to the supervisory measures of the Authority. Additionally, such funds will need to comply with various governance and filing requirements set out in the PF Law. Once registered, a private fund will be required to pay an annual registration fee, comply with annual return and local audit requirements, inform the Authority of material changes to the information submitted as part of its registration application, and retain appropriate accessible records.

Amongst the more notable changes the PF Law has introduced are the following:

Registration

The PF Law provides that a private fund shall apply to register with the Authority within 21 days from its acceptance of capital commitments but that a private fund shall not accept capital contributions from investors in respect of investments until it is registered by the Authority.

Ongoing requirements and the Authority's information requests

The Authority has a broad range of powers under the PF Law, including that it may request a private fund to provide the Authority with such documents, statements or other information in respect of a private fund as the Authority may reasonably require in connection with its functions.

Annual audit and return and valuation provisions

Once registered, a private fund will be required to comply with annual return and local audit requirements and inform the Authority of material changes to the information submitted as part of its registration application.

The PF Law also contains requirements for valuations of fund assets and cash monitoring to be undertaken in each case by independent third parties or by the operator (in which case any potential conflicts of interest must be properly identified, managed, monitored and disclosed to the investors of the private fund).

The Authority's regulatory actions

In addition to the powers that the Authority has to request documents and information mentioned above, the Authority may also take more robust actions in certain circumstances (e.g. if a private fund is unlikely to meet its obligations as they become due or is carrying on business fraudulently). In such circumstance, the Authority may take a number of actions, including cancelling the private fund's registration or appointing a person to assume control of the affairs of the private fund. It is worth noting that the Authority now also has the power to levy administrative fines for non-compliance with the PF Law.

What is required for a private fund to “register” with the Authority?

The registration process for private funds to register with the Authority is very straightforward. A private fund simply authorises its Cayman Islands legal counsel to upload the following documents to the Authority's secure online system (known as “REEFS”) along with submitting the required application fee:

- REEFS Application Form.
- Certificate of Incorporation/Registration (as applicable).
- Constitutive Documents (Memorandum & Articles of Association/Trust Deed/Declaration of Partnership, as applicable).
- Offering Memorandum/Summary of Terms/Marketing Material (as applicable).

- Auditor's Letter of Consent.
- Administrator's Letter of Consent (if applicable).
- Structure Chart.

What happens next? How long does it take for a private fund to register with the Authority?

The application is reviewed by the Authority and, assuming all of the documents, information and fees required have been provided, the private fund can expect its application to be approved and the private fund to be formally "registered" within a number of days.

Is a private fund automatically registered by making a submission to register as a private fund with the Authority?

No. The *submission* of an application to the Authority does not mean the private fund is automatically registered. The application needs to be processed and approved by the Authority prior to their registration of the private fund. Accordingly, a private fund is not "registered" for the purposes of the PF Law (nor is it able to accept capital contributions from investors in respect of investments under section 5(6) of the PF Law) until its registration has been confirmed by the Authority.

What does this mean for lenders in fund finance transactions?

As noted above, the PF Law provides that a private fund shall "*not accept capital contributions from investors in respect of investments until it is registered*" by the Authority. Given that the central pillar of the security covering a subscription line facility is the ability of the general partner (or the lender in its place) to draw down investor capital commitments unimpeded in an event of default, it is important that any Cayman Islands private fund vehicle that is party to a credit facility is registered with the Authority ahead of the initial credit extension (or the joinder of a Cayman private fund to an existing facility).

As a result of the importance of this point to the security package, if a borrower has specified that one or more of its Cayman Islands vehicles that is a party to a credit facility is not within scope of the PF Law, the lender should require sufficient documentary comfort to confirm that this is the case and it would be prudent to consult with its Cayman Islands counsel to verify the analysis.

Effects on loan documents – past and present PF Law credit agreement provisions

For transactions that arose from February 2020 through July 2020 (new subscription lines or amendments to existing facilities), most lenders sought to directly address the implications of the PF Law and require that applicable Cayman Islands credit parties register on a set timeline (e.g. 60/30/15 days in advance of the registration deadline under the PF Law – being 7 August 2020 for funds in existence before this date). This primarily occurred via the addition of affirmative covenants or other contractual provisions to the loan documents in respect of the requirement for private funds to register with the Authority.

As 7 August 2020 (the deadline for PF Law registration) has passed, the above covenant requiring registration ahead of a set deadline has been replaced in the market with:

- a condition precedent to closing (or joinder of an additional borrower vehicle) requiring that the lender be provided with evidence that each credit party that is required to be registered with the Authority pursuant to the PF Law is registered. This evidence

is generally provided by screenshots of the Authority website online register and/or the provision of the Certificates of Registration, letters or other documentary evidence issued by the Authority confirming the registration;

- an affirmative covenant requiring that each credit party that is required to be registered with the Authority pursuant to the PF Law shall register and duly maintain such registration in accordance with the PF Law; and
- an event of default which, depending on lender preference, can be immediate in the event that an entity becomes de-registered (on the basis that significant failings would have to occur for a private fund to become de-registered on a non-voluntary basis) or subject to a cure period for de-registration.

What is the net result of the PF Law for market participants?

The short answer is that, subject to borrowers registering their Cayman Islands private fund vehicles as required by the PF Law in a timely manner ahead of seeking to close a financing transaction (which is firmly in their interest from a legal and regulatory perspective, and so not something that should prove problematic) and lenders conducting due diligence to their satisfaction that a fund is in compliance with the new requirements, the PF Law should not materially affect a “standard” subscription line fund finance transaction involving Cayman Islands credit parties. In a number of respects, the PF Law arguably makes the use of Cayman Islands vehicles in private fund structures even more attractive. For example:

- **sponsors** will now be able to point prospective or current investors to the regulatory enhancements which now apply to Cayman Islands vehicles, but the day-to-day operation of Cayman Islands funds is largely unchanged. Additional service providers may be brought in to deal with the added regulatory burden (i.e. annual audit sign off in the Cayman Islands) but aside from this, the normal operation of Cayman vehicles continues;
- **investors** will now be able to take comfort that they are investing in a regulated fund vehicle which benefits from the oversight of an internationally recognised financial regulator; and
- **for lenders**, despite a tumultuous 2020 of document negotiations over certain contractual provisions relating to the PF Law, there is of course the silver lining that, given that borrowers are now, in many cases, subject to prudential supervision, including annual audits and continuing obligations under the PF Law, such entities are arguably more desirable from a risk/credit perspective now that they have emerged into the regulated space.

Conclusion

While the introduction of the PF Law heralds a new chapter in the regulation of private funds in the Cayman Islands, it should also be noted that, for many funds, the requirements of the PF Law will serve largely to codify existing practices in the governance and operations of such vehicles.

Accordingly, although a borrower’s requirement to register its Cayman Islands private funds with the Authority (and a lender’s due diligence to ensure that borrowers are compliant in this regard) will require additional actions in the process of closing funds and fund finance facilities, it is not anticipated that the PF Law will be a material factor in determining whether or not to include Cayman Islands vehicles in private fund structures and fund finance transactions.

As the PF Law settles in, further enhancements can be expected to the regime. While it is hoped that some of these will address lender- and creditor-relevant concerns in the PF Law, the “new normal” for Cayman Islands private fund vehicles is not materially different to the “old normal”, and so, from an overall perspective, the “PF Law Storm” can now be said to have passed, and normal business has resumed with the PF Law resulting in nominal changes to a standard fund finance transaction.

* * *

Endnote

1. Being: (a) pension funds; (b) securitisation special purpose vehicles; (c) contracts of insurance; (d) joint ventures; (e) proprietary vehicles; (f) officer, manager or employee incentive, participation or compensation schemes, and programmes or schemes to similar effect; (g) holding vehicles; (h) individual investment management arrangements; (i) pure deposit-based schemes; (j) arrangements not operated by way of business; (k) debt issues and debt-issuing vehicles; (l) common accounts; (m) franchise arrangements; (n) timeshare and long-term holiday product schemes; (o) schemes involving the issue of certificates representing investments; (p) clearing services; (q) settlement services; (r) funeral plan contracts; (s) individual pension accounts; (t) structured finance vehicles; (u) preferred equity financing vehicles; (v) a fund of whose investment interests are listed on a stock exchange (including an over-the-counter market) specified by the Authority by notice in the *Gazette*; (w) occupational and personal pension schemes; (x) sovereign wealth funds; and (y) single family offices.

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