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Out of the PF Act Club and Into the Cold: When Would a Cayman Private Fund Be De-Registered?

February 3, 2023 | Issue No. 209

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As the Fontainebleau once again prepares for an influx of fund finance professionals to its restaurants and nightclubs, we got to thinking about another kind of club (those funds registered with CIMA under the Private Funds Act) and what it might take for one of those funds to have the equivalent of a Dwayne "The Rock" Johnson-sized bouncer come and take them out of that club (CIMA being the relevant 300lb bouncer here!).

Throughout all of the discussions from 2020 up until the present day, in relation to the Cayman Islands PF Act one of the common questions from lenders looking to analyse their risk was: "*What does a de-registration of a private fund by CIMA look like and when could it happen?*"

As with all questions relating to how and when a regulator might take action there is rarely an easy or conclusive answer, but this note attempts to provide some guidance on the issue based on our extensive experience advising clients in more heavily regulated sectors (such as the banking, (re)insurance and investment management/advisory sectors) regarding CIMA scrutiny and enforcement actions.

Prudential Regulation in Cayman – A (Very) Short History

One of the well-understood themes about Cayman funds (both hedge funds and private funds) is that the regulator (CIMA) has always taken a prudent but unintrusive approach to registration, regulation and de-registration of Cayman funds. This very much continues to be the case, but the global tide of increased regulation has also landed on Cayman's shores in the past years and shows no sign of retreating. Accordingly, the likelihood of reviews by the regulator of funds and corresponding administrative fines or regulatory actions occurring has increased significantly in the past five years. While the PF Act remains a relatively new addition to the regulatory landscape and private funds have not yet featured in the more involved reviews by CIMA, if CIMA's interactions with other sectors over the past few years is to be used as a litmus test then it is safe to say that private funds will face increased focus in coming years regarding compliance with their continuing obligations under the PF Act.*

Why Does All of This Matter to Fund Finance Lenders?

As anyone who has had a Cayman fund in the middle of one of their deals over the past few years will be aware, Cayman private funds that are in-scope of the PF Act are required to be registered with CIMA in order to accept capital contributions. Given the ability to call for capital contributions from LPs is the core pillar of a lender's collateral package

in a subscription finance deal, any regulatory issue that may render a call for capital contributions technically difficult or illegal (such as CIMA de-registering a fund for non-compliance and the fund then being unable to accept capital contributions) is of course pertinent to the lender's risk. As a result of this, almost all credit agreements with a Cayman nexus now contain an affirmative covenant of the borrowers to maintain the registration of the applicable Cayman funds together with a linked event of default if de-registration occurs while such a fund remains in-scope of the PF Act.

When Would CIMA De-register a Private Fund?

As noted above, there are no hard or fast rules for this, but the PF Act does specifically empower CIMA to cancel the registration of private funds that are failing to comply with the PF Act. In practise, however, the reality is that before de-registration by CIMA of a private fund would occur there would likely be an opportunity for such a fund to right the ship as, assuming CIMA follow the same process they do in other sectors, they would likely first issue a "breach notice" to the GP of the fund setting out the compliance failures and the timeline in which such failures must be corrected. Accordingly, in most scenarios in our experience, it would require a sustained pattern of non-compliance and/or failure to engage with CIMA in respect of breach notices before de-registration occurred. The easiest examples to give of issues that might lead to de-registration are: (i) failure to pay annual fees to CIMA over multiple years; and (ii) failure to file annual audited accounts or returns with CIMA on time or over a number of years. These are just the most obvious examples, however, and with the expansion of regulatory obligations for private funds that the PF Act introduced, it is entirely foreseeable that in the future other areas of focus may become as important to the regulator and as such be factors in a potential de-registration action.

Conclusion

The global tide of increased regulatory oversight of private funds has not missed the Cayman Islands, and we expect to see this theme continue in the coming years. While the PF Act is still a relatively new addition to the Cayman landscape and regulatory actions by CIMA to de-register a private fund are not something that is likely to be a common occurrence for now, the future focus of any regulator is hard to predict, and so we continue to advise our clients on the importance of comprehensive ongoing covenants in credit agreements regarding PF Act compliance.

*****_As a result of the increased regulatory scrutiny in other sectors (and predicted increased scrutiny in the private funds world) one of the more interesting developments to observe locally in Cayman over the past few years has been the proliferation of a new species to Cayman (being the regulatory lawyer). A decade ago the idea of a regulatory lawyer would have been about as useful as a Cayman ERISA or tax specialist, whereas now most large firms have at least one attorney focused solely on this area (at Conyers, we now have an entire group comprised of regulatory lawyers and compliance professionals who focus solely on advising our clients on these issues!)._