

FUND FINANCE FRIDAY

The Cayman Islands Private Funds Bill, 2020 – Are Fund Finance Deals Impacted?

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On January 8, 2020 the Cayman Islands Government published the Private Funds Bill, 2020 (the “Bill”). The Bill builds upon the reputation of the Cayman Islands as a co-operative and transparent jurisdiction and introduces for the first time a requirement for private funds to register with the financial regulator in the Cayman Islands – the Cayman Islands Monetary Authority (“CIMA”).

While the introduction of the Bill is an important step in the evolution of the Cayman Islands as a leading jurisdiction for the formation of private funds vehicles, it will result in significant changes to the supervision, regulation and registration requirements of such vehicles in the Cayman Islands and so is of immediate 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 will fall within the definition of a "private fund" under the Bill.

Many alternative investment vehicles within such structures will also be caught within the definition of "private fund" and, while they will be required to register with CIMA, such vehicles will be exempted from certain provisions of the Bill (most notably, annual audit).

The Bill applies to each "private fund" which is defined as any company, unit trust or partnership whose principal business is the offering and issuing of its investment interests (which carry an entitlement to participate in the profits or gains of the fund and are not

redeemable at the option of the investor), the purpose or effect of which is the pooling of investor funds with the aim of spreading investment risks and enabling investors to receive profits or gains from such entity's acquisition, holding, management or disposal of investments; where:

- the holders of such interests do not have day-to-day control over the acquisition, holding, management or disposal of the investments; and
- the investments are managed as a whole by or on behalf of the operator of the private fund, directly or indirectly, for reward based on the assets, profits or gains of the private fund.

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 Bill.

What is the current position and how does the Bill change this?

At present, closed-ended funds are exempted from the requirement to register with CIMA. Accordingly, most private equity and venture capital funds that are established in the Cayman Islands are currently not subject to any CIMA registration or regulatory requirements.

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

What does this mean for lenders in fund finance transactions?

The short answer is that, subject to a lender conducting due diligence to its satisfaction that a fund is in compliance with the new requirements, the Bill should not materially affect a "standard" subscription line fund finance transaction involving Cayman Islands borrower vehicles.

Some of the required due diligence will necessitate further consideration as the Bill comes into effect and guidance on its application is issued by CIMA, but below is a list of matters which may need to be factored into fund finance transactions:

Registration

The Bill provides that a private fund shall not accept capital contributions from investors in respect of investments until it is registered by CIMA.

As the core of a subscription line facility will usually be the ability of the general partner (or the lender in its place) to draw down investor capital commitments, it will be vital that any Cayman private fund vehicle that is party to a credit facility is registered with CIMA ahead of the initial credit extension.

If a borrower is claiming that one or more of its Cayman Islands vehicles that is a party to a credit facility is not within the scope of the Bill, the lender should require sufficient documentary comfort to confirm that this is the case.

Existing Private Funds

CIMA has not yet issued guidance prescribing by when existing private funds will be expected to register. If a Cayman Islands fund that is party to an existing credit facility misses the deadline to register with CIMA, then the lender's security over the call rights of such fund will be potentially unenforceable until the registration occurs (as an attempt to call capital during such period could be contrary to law). Accordingly, compliance with the CIMA registration deadline (once it is confirmed) by Cayman Islands funds that are party to a credit facility will be of the utmost importance from a lender perspective.

Alternative Investment Vehicles

As noted above, alternative investment vehicles ("AIV") (a term which has not yet been defined in the Bill) will be required to register with CIMA but will not need to comply with the annual audit, valuation, safekeeping, cash monitoring or securities identification requirements.

However, the prohibition on receipt of capital contributions until the AIV is registered with CIMA will still apply. As a result, to the extent that undrawn commitments of AIV investors will form part of the security package, the same approach as above should be considered (confirmation that the entity is registered or sufficient documentary comfort of its out-of-scope status).

The Bill also contains reference to "restricted scope private funds," but CIMA has not yet issued guidance prescribing which funds will fall within this definition.

Ongoing Requirements and CIMA Information Requests

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

Accordingly, lenders should require each Cayman Islands private fund that is party to a credit facility to notify the lender of any material correspondence (to be negotiated) from CIMA in order for the lender to remain informed and act accordingly in respect of any potential regulatory queries that CIMA may have.

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 CIMA of material changes to the information submitted as part of its registration application. Lenders may wish to require that copies of such annual returns and audited accounts are provided as part of ongoing reporting for both information purposes and also to ensure that they are being prepared and filed with CIMA in accordance with the private fund's obligations.

The Bill 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). Again, to the extent that asset valuations and cash in accounts are independently verified, it may be prudent to require that such reports are also provided to the relevant lender for informational purposes.

CIMA Regulatory Actions

In addition to the powers that CIMA has to request documents and information mentioned above, CIMA 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 circumstances, CIMA 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.

As any of the above regulatory actions could be troublesome to a lender's position, consideration should be given to whether any additional protections should be built into credit agreements – for example, the inclusion of an event of default to cover a situation where any regulatory actions are taken by CIMA.

Do lenders need to take any immediate action?

Lenders do not need to take any immediate action in respect of facilities where Cayman Islands private funds are part of the borrower fund structure.

Lenders should, however, begin to consider whether there are particular changes to their standard loan documents or credit processes that they wish to implement upon enactment of the Bill (the Bill is not yet law in the Cayman Islands and will be considered for enactment at the 30 January 2020 meeting of the Cayman Islands Legislative Assembly (and remains subject to revision until formally enacted)).

For existing private funds that will be required to register, there will be a transitional period within which to comply. Once this date is known, and the registration deadline approaches, lenders should check in with Cayman Islands borrowers as to progress and to confirm that they will meet the registration deadline (or that they view certain entities within the existing structure as out of scope).

Following the enactment of the Bill, it is expected that newly formed private funds will immediately fall within the scope of the Bill and so additional consideration should be given as to how this might impact the timeline for launching Cayman Islands private funds and the putting in place of subscription line facilities.

Conclusion

While the introduction of a new regulatory regime for Cayman Islands private funds 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 Bill will serve largely to codify existing practices in governance and operations of such vehicles.

Accordingly, although a borrower's requirement to register its Cayman Islands private funds with CIMA (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, we do not expect the Bill to be a deciding factor in the inclusion of Cayman Islands vehicles in private fund structures and transactions.

As a positive to lenders to such structures, they will have the added benefit of being able to take comfort from the additional regulation of such vehicles but, from a lender perspective, the

primary lesson that should be taken from this article is that more robust diligence procedures will need to be implemented as Cayman Islands private funds move into the regulated sphere.