

Fund Finance Friday



Back to Business (as Usual) for Cayman Vehicles — But What Is ‘BAU’?

August 7, 2020 | Issue No. 89



By **Kurt Oosterhouse**
Partner | Fund Finance



By **Derek Stenson**
Partner | Conyers



By **Michael O'Connor**
Partner | Harneys

For those of us who have been lawyers for a while, certainly you have heard or used the answer “tax reasons” or something to that effect to explain the unexplainable. This, of course, is the quick and easy answer when it comes to explaining why entities are formed in the Cayman Islands, which is unfortunately reinforced reasonably regularly by script writers for Netflix**. “Tax reasons” is, of course, a gross oversimplification of the complex cocktail of ingredients that make the Cayman Islands the financial center it has become, and why so many companies and partnerships are formed in the Cayman Islands (as opposed to other jurisdictions).

We wanted to use this opportunity to take a step back, to look at the history behind Cayman’s growth and to consider, following the recent introduction of the Private Funds Law (“PF Law”), whether those same underlying, historical reasons still apply and what “business as usual” may look like going forward.

***Our strong recommendation is not to seek, receive or act upon tax or legal advice from Netflix!*

When did Cayman become such a big thing?

With the risk of sounding a little like a Ron Burgundy quote (although we do have a few “leather-bound books”), the history of the Cayman Islands as a tax-neutral jurisdiction can be traced in local folklore back to the brave actions of local inhabitants in saving the lives of shipwrecked sailors on one of Cayman’s many coral reefs in 1794. This allegedly resulted in a grant of immunity from Crown taxes as a thank-you to the Islands’ people.

In reality, however, the Cayman Islands financial services sector, as we know it today, really came into existence from the 1960s forward when political instability in neighboring British overseas territories (namely, Jamaica and the Bahamas) led a number of financial services professionals to identify the Islands as a politically stable and forward-thinking jurisdiction, with the benefits of oversight and support from the British government, and to assist the Cayman Islands government in developing its legal framework to facilitate the offshore banking and financial services sectors.

The 1990s brought the introduction of the Mutual Funds Law and the Exempted Limited Partnership Law, and the resulting increased use of the Cayman Islands in North American fund structures. While the business conducted in the Islands today (which is almost entirely institutional-level work and heavily weighted towards investment funds and international finance vehicles) is unrecognizable from the work done in the 1970s and 1980s (when descriptions of Cayman accounts and Swiss levels of privacy may have been more apt), the key drivers of success from the early days remain true today.

These reasons are simple, but often overlooked: (1) Cayman is a politically, economically and socially stable jurisdiction which uses English common law principles; (2) Cayman has an advanced regulatory framework which meets international best practices; and (3) Cayman has a deep bench of experienced and responsive financial services professionals who understand international and cross-border financial transactions (as well as many attorneys in the Cayman Islands who will have first trained and worked at some of the best-known commercial law firms in the world before leaving the cold winters behind in search of a sun tan!).

Why do sponsors form Cayman vehicles?

The Cayman Islands exempted limited partnership is a globally known and understood fund vehicle for both investors and their advisors, and has over time become the “gold standard” in choosing an investment vehicle for many international managers and their investors. It’s also true to say that Cayman is chosen for “tax reasons,” but not for the reasons you might think. The fact that Cayman levies no tax on profits, capital gains or income of its own means that Cayman Islands vehicles can be used to co-mingle capital of various groups of investors without such investors paying tax on two levels (*i.e.*, their home jurisdiction and also in the Cayman Islands).

This ability to group together certain investors (who may be subject to different taxes or administrative filings in their home jurisdiction) or segregate certain groups from one another in separate tax-neutral vehicles allows for administrative efficiency and avoids any possible contagion of taxation, legal or regulatory issues from one type of investor to another. The capital of such vehicles can then be invested directly or in the main fund vehicle while keeping intact the various administrative differences between investors.

What about the Private Funds Law? Does it change anything?

The introduction of the PF Law in February of this year brought Cayman Islands private equity funds into the sphere of regulation by the Cayman Islands Monetary Authority (“CIMA”) for the first time. The introduction of the PF Law (and the July amendments) may have left many of us shouting (or screaming) at our computers, but now that August 7 is upon us and the registration deadline has passed, what does the PF Law change?

In short, it changes very little and, in a number of respects, makes the use of Cayman 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 vehicles, but the day-to-day operation of Cayman funds is largely unchanged. Additional service providers may be brought in to deal with the added regulatory burden (*i.e.*, annual audit sign-offs 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 recognized financial regulator;
- **For lenders**, despite a tumultuous summer of document negotiations and heartburn 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, annual audits, and continuing obligations under the PF Law, such entities could be said to have become more desirable from a risk/credit perspective now that they have emerged into the regulated space.

One of the key aspects to the success of Cayman as a fund domicile has always been its “speed to market.” This ease of formation of Cayman vehicles (which can be achieved within 24 hours) will not be affected in any way by the PF Law and, while the added step of CIMA registration is now required for certain funds, it is fully expected that once the initial deluge of registrations is complete, turnaround times for registration will be extremely fast and will not impact on the ability of sponsors to form and utilize Cayman vehicles for investors or close financings for such funds in the same expeditious manner that has always been the case.

So it’s back to business as usual for Cayman then?

The PF Law has certainly challenged the ability of the industry to deal with large-scale changes over a short period of time but, despite the growing pains of undertaking such a large project in a post-apocalyptic “working from home” world, things are now already returning to normal.

The enhancements to the regulatory regime remain, as do the reasons why sponsors use the Cayman Islands. From a fund finance perspective, the days of heated battles over credit agreement wording are now also behind us (for the

most part!), to be replaced by an additional condition precedent and enhanced covenant protection in respect of PF Law compliance, which are quickly becoming boilerplate.

Summer 2020 will always remain, as described by one unnamed Cadwalader associate, as the “Summer of Cayman.” But even though the hurricane season continues, the PF Law storm is quickly passing and, following some celebrations on August 8, 2020, it's back to business as usual for Cayman.