



## Economic Substance — Should a Lender Care?

### A Cayman Perspective

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There has been much written about the new economic substance legislation being introduced in a number of offshore jurisdictions. The Cayman Islands introduced the International Tax Co-Operation (Economic Substance) Law, 2018 (ES Law) in January 2019. Though regulations and guidance notes were issued in February 2019, the guidance remains subject to change. The ES Law requires certain entities incorporated or registered in the Cayman Islands and carrying on “relevant activities” to have “adequate substance” in the Cayman Islands. A high-level summary of entities that are potentially in scope of the ES Law and of “relevant activities” for the purpose of the substance test is included at the end of this article.

So, why should a lender care about economic substance? Akin to an entity failing to be in good standing, failure to comply with the requirements of the ES Law may ultimately lead to an entity being struck off the register of companies. This creates obvious consequences for an in scope debtor or pledgor entity in a financing transaction—potentially a Cayman Islands corporate borrower or pledgor that is not covered by the definition of “investment fund,” or a Cayman Islands corporate blocker vehicle (particularly in a cascading security structure where funding obligations are meant to flow through a chain of entities).

Given that a number of entities are currently out of scope of the ES Law, we do not believe that it will necessarily have a wide-ranging effect on fund finance facilities at this stage. However, we would recommend that lenders monitor compliance with the ES Law by Cayman obligors in a fund financing.

It would be prudent to: (i) ask a fund manager or general partner to confirm whether any Cayman entities in a fund financing are subject to the ES Law and, if so, how such entities are meeting the ES Law requirements, and (ii) consider whether additional comfort should be included in transaction documents to cover off any related risks.

#### High-Level Summary

The ES Law applies to “relevant entities” that conduct any “relevant activity.” Such entities must establish “adequate substance” in the Cayman Islands and will be subject to administrative penalties and, ultimately, strike off for failure to comply.

#### What are relevant entities?

Relevant entities include (i) Cayman companies (including exempted companies and limited liability companies), (ii) limited liability partnerships, and (iii) non-Cayman companies that are registered in Cayman (which would include a foreign company that acts as a GP of a Cayman ELP (Foreign GP)), but *exclude* (x) investment funds, and (y) entities that are tax resident outside of the Cayman Islands. Exempted limited partnerships, which continue to be the most commonly used Cayman investment fund vehicle, are currently out of scope. Limited liability partnerships are not commonly used as vehicles in this space.

While all “relevant entities” as set out above are required to declare their ES Law status in their annual filing, only those entities that are carrying on “relevant activities” are required to comply with economic substance requirements.

#### What are relevant activities?

There are nine relevant activities under the ES Law, the most relevant for our purposes being “holding company business” and “fund management business.”

#### Practical Relevance for Fund Finance Transactions

We expect Cayman corporate blocker entities or corporate vehicles that are not classified as investment funds and not otherwise tax resident outside of the Cayman Islands to be subject to the economic substance requirements. A corporate vehicle carrying on “holding company business,” which is defined as “pure equity holding business”—*i.e.*, only holding equity participations in other entities and only earning dividends and capital gains—is in scope, but is subject to a reduced economic substance test. In practice, this should be met by its ongoing compliance with existing statutory obligations. Compliance by other corporate vehicles should, however, be initially assessed and all corporate vehicles should be monitored on an ongoing basis for continued compliance with the ES Law.

A foreign corporate GP registered in the Cayman Islands would be considered a “relevant entity” but would not likely be carrying out a “relevant activity” such as “fund management business” (except in unusual situations). As such, while it would need to declare its status in its annual filing, it would not be required to actually comply with economic substance requirements.

## Subscription Finance in The Wall Street Journal

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On May 5, 2019, *The Wall Street Journal* published an article titled “Pensions Don’t Always Track How Much is Borrowed Against Their Names.” The article, like much of the press coverage before it, seems to lack a complete understanding of how the subscription facility product functions. It suggests that investors do not track their exposure to subscription facilities, insinuating that the investors do not know how much they have to fund. For example, the article states, “But if investors don’t track their exposure to this debt, they could find themselves short of cash when they have to pay the bill.”

Reading that, you can almost hear a collective sigh from the Fund Finance market. This is sort of like saying a 5k runner might not be able to finish the race if they don’t know where along the course their spouse is standing to cheer for them. Where the spouse is standing, of course, has no bearing on the length of the race. Just like the balance on the subscription facility has no bearing on the maximum amount an investor is obligated to fund. Investors track their uncalled capital commitments to their funds. They always know exactly how much they owe. Subscription line lenders never loan more than the uncalled capital commitments of the investors. The insinuation in the article that investors may not know their funding obligation is unfortunate. (We are, however, super sympathetic to the fact that it is very hard to fully understand the nuances of a niche market when one does not actively practice in the space.) The article is available [here](#).

## The Small Fund Business Is Getting Smaller

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By **Chris van Heerden**  
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The trend towards greater concentration of capital at the top sponsors is a reoccurring theme in *Fund Finance Friday*. *Pitchbook's* quarterly *US PE Breakdown*, published this past week, again underscored the theme with renewed clarity.

During the first quarter, 29 funds closed, raising \$45.5 billion. The average fund size of \$1.57 billion represents a nearly 70% increase from 2018. Since 2013, funds of under \$1 billion consistently accounted for about a quarter of the dollars raised, but in Q1 these funds raised only 14% of the total.

It's not just a story about the rise of the megafunds skewing the average. The small fund business is getting smaller. The \$6.5 billion raised by sub-\$1 billion funds in Q1 sets an annualized pace of \$25.9 billion. If this rate holds, it would represent the least dollars raised by funds under \$1 billion since 2009. Sub-\$1 billion funds raised \$38.3 billion in 2018, down from a yearly average of \$46.6 billion in the five preceding years.

Brookfield's acquisition of a majority stake in credit specialist Oaktree Capital receives attention in the report. Through the combination, the two firms have been able to join complementary strategies on a larger scale platform. *Pitchbook* suggests the transaction may also become a template for similar deals as founders seek to monetize their GP stakes.

The *Pitchbook* [report](#) and accompanying data are both well worth the read. Larger fund sizes point to larger facility sizes and challenge lenders of all stripes to adapt to an increasingly concentrated market.

## Fund Finance Association's Next Generation Hosts 'NAVigating Fund Finance Facilities'

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By **Rob McClean**  
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The Fund Finance Association's Next Generation network hosted its second European event at Vinson & Elkins' offices in the Walkie Talkie building in London on May 2.

Over 80 up-and-coming professionals from across the fund finance industry gathered to hear from senior experts at MV Credit, BlueBay Asset Management and Investec on "NAVigating Fund Finance Facilities."

Murtaza Merchant from MV Credit, Ivo Keltner from BlueBay and Ian Wiese from Investec shared their experiences of NAV facilities, subscription facilities and hybrids in an insightful fireside chat with Charlotte Lewis-Williams from Vinson & Elkins.

After the talk, guests and speakers enjoyed an evening of networking over drinks and canapés with unobstructed views of the City.

The Fund Finance Association's Next Generation is a forum for junior professionals in the fund finance industry, offering educational, networking and mentorship opportunities within the field. Please contact Billal Malik or Rob McClean if you are interested in being involved.





## On the Move—Fund Finance Tidbits

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### On the Move

Bank of Ireland Corporate Banking in the UK has appointed Nick Armstrong as Head of its Subscription Finance business. Nick is based in the Bank's UK head office in London. He is responsible for building a portfolio of private equity business, with the aim of developing long-term relationships with these customers. Nick's appointment furthers Bank of Ireland's strategy of building its Corporate Banking footprint in the UK by establishing niche, industry-focused teams.

Nick will lead a growing team of industry experts managing a portfolio of non-bank financial institutions (NBFI) customers, including private equity, real estate and infrastructure closed-ended funds. The offering allows funds to move swiftly, when making investments, by providing short-term liquidity lines secured against investor capital.

Prior to joining Bank of Ireland, Nick spent over 11 years as a financial institutions banker in RBS's corporate and investment banking divisions, where he was responsible, most recently, for originating and structuring debt facilities for a range of listed and unlisted alternative asset funds. These loans included subscription/capital call financings as well as NAV-backed facilities and liquidity facilities to the general partners of these funds.

Bill Greaves, Head of Bank of Ireland Corporate Banking UK, said: "The appointment of a Subscription Finance team builds upon our Northern expansion in 2018 with the launch of our Manchester office and follows superb results for Corporate Banking in the UK throughout 2018. Nick will be joined by Helen Hoang, an external recruit, and Harriet Castle, an internal appointment."



## See You in San Fran Next Wednesday

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Cadwalader, Simpson Thacher and the Maples Group are co-sponsoring a fund finance event in San Francisco next Wednesday, May 15. Cocktails and hor d'oeuvres will follow introductory remarks on the state of the market. The event begins at 6 p.m. in a private room at Wayfare Tavern, 558 Sacramento Street. To register, click [here](#).

