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UPDATE

What's in Store for Cayman Funds in 2020 - Pragmatic Considerations

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The current coronavirus (COVID-19) pandemic has given rise to a series of unique circumstances and challenges to society as a whole. The measures taken to minimize the impact of the virus, including quarantine requirements and restrictions on travel and social gatherings, have also given rise to both social and economic uncertainty. Whilst the overall impact of COVID-19 is yet to be fully understood, a summary of some of our general observations on the funds market are provided, as well as some thoughts on the pragmatic considerations that may be immediately relevant to funds that are established in the Cayman Islands.

General Market Observations

1 Immediate Reaction of Funds in General

As the COVID-19 pandemic continues to have a huge impact on the economies and markets around the globe, the immediate impact of it is felt by investment funds at every stage in their life cycle.

Funds Currently Raising Capital

For funds that are actively fundraising, we have seen fund managers looking to expedite closings as soon as possible. In addition, we are also seeing new funds being raised on a vastly accelerated timetable. This is particularly true for some of the larger global private equity sponsors and also for other managers with strategies designed to capitalize on the current market dislocation. There are a number of potential reasons for this course of action, including:

- Fund managers may see this as a buying opportunity – they may wish to ensure they have sufficient dry powder available to deploy when assets are seen as good value (thus allowing them to be opportunistic and take advantage of attractive distressed assets when the timing is right);
- GPs who are worried about potential LP defaults may wish to ensure that a process for drawing capital is implemented as quickly as possible to help mitigate this concern; and
- Fund managers may be cognizant that potential investors may start to lose interest/look to reduce their allocation to private equity. As a result, there might be a sentiment that fundraising will become difficult in the period following an economic slowdown, particularly with the expectation of the 'denominator effect'and also a decrease in distributions from funds already invested in. That said, it appears that many institutional LPs are looking to learn from their experience from the last financial crisis and have adjusted their allocation policies to ensure that they don't miss out on potential opportunities. Institutional LPs are acutely aware that many funds raised during the last crisis have proved to be some of the most successful vintages.

From a timing perspective, Cayman legislation is already conducive to handling remote closings with urgency. For example, the Electronic Transaction Law (2003 Revision) generally recognizes electronic signatures as reliable (provided that the e-signature meets certain requirements, such as being linked to, and within control of the signatory and without alterations). .

Existing Funds

For existing funds that are not actively fundraising, the main area of focus is likely to be on the health of the companies in their existing portfolio. It seems likely that investors will look very closely at how GPs deal with this crisis. Interestingly, there is a sense that being seen to 'do the right thing' by portfolio companies and their employees could be of critical importance to many institutional investors.

This in turn also ties into the issue of optics and LP messaging – GPs are likely considering exactly what message to convey to their LPs regarding the status of their portfolio and potential projections, while still maintaining investor confidence. To this end, we are seeing GPs looking to provide regular communications to LPs and, in some cases, telegraphing capital calls by giving greater notice than they are contractually obliged to give under the fund documentation.

2 Potential Market Outlook and Investment Opportunities

Should the market turn, as suggested, it would be unsurprising if the sudden availability of certain types of assets created a shift in the types of funds established in a post-COVID-19 environment.

Namely, we may see an increase in:

- Special Situation Funds: given the potential availability of underpriced distressed assets, funds specifically focused on this asset class may have significant investment opportunities, as well as be more likely to generate investor traction than funds with other investment strategies.
- Credit Funds: similarly, given the likely increase in distressed debt becoming available as a result of a downturn, GPs may start thinking of how they could capitalize on lending. Credit Funds may also step into fill any lending gap if the banks becoming unwilling (or unable) to provide financing (e.g. to help finance portfolio company acquisitions).
- Secondaries: in a similar vein, other investment funds who may be in distress following a market turn may now be looking to sell off all or a portion of their portfolios – this is particularly relevant for the Asian market, which has seen a recent maturity in this space, and may now have the infrastructure to capitalize on such opportunities missed during the 2008 global financial crisis.

In addition to the above, the restrictions imposed on the general population giving rise to the 'new normal' has also created room for niche strategies such as telecommunications infrastructure. This could not only create a strong basis for future investment strategies, but also provide for more favourable immediate returns.

General Concerns and Immediate Steps for Cayman Funds

General Concerns

A negative impact on the global economy resulting from COVID-19 could also raise a number of commercial and legal concerns for fund managers. Areas of immediate focus may be on issues such as potential LP defaults, as well as the possibility of existing portfolio companies suddenly becoming under financial stress. This could, in turn, create a knock-on strain on the time and attention of fund managers, who would then be forced to try to mitigate the impact of these distressed LPs/investments whilst simultaneously attempting to put money to work.

In the longer term, fund managers may be concerned about issues such as potential manager liability, as well as the potential implications of the COVID-19 constraints on their ability to meet regulatory and tax compliance obligations.

Immediate Steps

While there is currently no way of assessing whether any of the longer term concerns outlined above are genuine, there are a number of steps that managers of Cayman funds can consider taking in the interim to help mitigate potential liabilities:

- Review existing fund terms and obligations to LPs: fund managers should consider reviewing existing disclosure to investors and/or commercial arrangements to determine whether there are any areas of weakness, or potential obligations which may be difficult for them (or their LPs) to comply with during this period–. For example, relevant considerations may include triggers for LP default under the partnership agreement, capital call restrictions and/or timing of reporting requirements.

- **Review existing legal responsibilities to portfolio companies and third parties (e.g. lenders under financing arrangements)**: similarly, it would be worthwhile to review existing arrangements with portfolio companies and any relevant lenders to determine whether there may be difficulties meeting their obligations, as well as consider how they might mitigate any potential future friction.
- **Assess corporate governance and business continuity plans for the Cayman GP/Manager/Portfolio Companies**: sponsors should review existing corporate governance arrangements and consider whether relevant contingencies exist – for example: (i) reviewing the steps required to appoint a replacement director in the event members of the board become ill, (ii) considering whether their current arrangements allow for board meetings to be held electronically/via phone given travel disruptions and (iii) assessing whether the board will have access to all relevant information required to exercise proper oversight and decision making power, and if not, consider what additional information will be required to discharge this obligation properly.
- **Review regulatory requirements**: take the time to step through all of the relevant regulatory requirements and ask whether the current situation may complicate the ability for compliance – for example: (i) if the fund manager is holding board meetings in the Cayman Islands in order to comply with any applicable economic substance rules, consider how travel restrictions might impact this, or (ii) consider all regulatory filings which need to made and assess how remote working and/or physical location of signatories may complicate meeting any deadlines – this may be particularly relevant for fund managers given the new registration requirements under the Cayman Islands Private Funds Law 2020, as well as any applicable economic substance obligations.
- **Be pre-emptive and reach out**: as vigilant as fund managers are, there will always be certain legal or regulatory matters which are simply not at front of mind in the current environment. Fund managers should take the time to be pre-emptive and reach out to their legal counsel regarding any other steps to be undertaken given their specific circumstances – this is the best way to ensure that all bases are being covered.

Cayman Regulatory Update

The Cayman Islands Monetary Authority (**CIMA**) and the Cayman Islands Registrars of Companies and Exempted Limited Partnerships (the **Registrars**) have been responsive and understanding to the COVID-19 situation. In addition to publishing updates regarding their own operations, they have been diligent in clarifying their expectations regarding compliance with certain regulatory and corporate filing requirements in light of the pandemic, as well as showing flexibility with respect to many existing deadlines.

As of 6 April 2020 such steps include:

Economic Substance: CIMA Clarification Regarding Physical Board Meetings held in Cayman

- While holding physical board meetings in Cayman is only one element of the economic substance test for Cayman Islands incorporated fund managers (the economic substance rules **do not** apply to investment funds), CIMA has clarified that the Department for International Tax Cooperation (**DITC**) is aware that COVID-19 related travel restrictions may affect the ability of some entities to hold board meetings in Cayman during the year. As a result, where meetings are required to be held virtually during this period of uncertainty, the DITC will take that into consideration on a case-by-case basis when assessing the economic substance test in its reporting, which is due in 2021.

Filing Extensions

- **Annual Returns for Companies and Exempted Limited Partnerships**: The Registrars have extended the filing deadline for Annual Returns until 30 June 2020, which will apply to all companies and exempted limited partnerships. Annual fee payment obligations have also been deferred until 30 June 2020.
- **Economic Substance Notification Forms**: The filing deadline is extended to 30 June 2020.
- **Audited Financials FY Dec 2019 for Registered Persons**: Entities registered as 'registered persons' under the Securities Investment Business Law should try to meet the original deadline, but may notify CIMA where an extension is required and may be granted a 30 day extension on a case-by-case basis.
- **Beneficial Ownership Regime**: A one month extension (to 20 April 2020) for beneficial ownership submissions given difficulties by corporate service providers to retrieve information from overseas clients. CIMA has also indicated that the digital platform to make electronic filings should be available within the coming weeks.

- **Entity Changes**: Changes to directors and officers, registered offices and amendments to M&As have all been granted a 30 day filing extension for any change which has occurred on or after 1 March 2020.

Other Relevant Considerations

- **Flexibility on Signing Formalities**: the Registrar of Companies will accept affidavits or other documents that have been notarized/certified online or utilizing audio-video technology during this time.
- **Written Confirmation for New Fund Submissions**: in lieu of a notarized affidavit, CIMA will also accept written confirmation from an operator of a fund, applying to be registered/licensed pursuant to the Mutual Funds Law or Private Funds Law, authorizing the registered office or other service provider to file the fund's registration/application on behalf of the operator.
- **Uncertified Resolutions for Fund De-Registration/Cancellation**: CIMA will accept uncertified resolutions that confirm the de-registration/cancellation date of a fund.

Conclusion

This is an incredibly challenging time for the global economy but it will pass and it will inevitably create opportunity. Although, the crisis may lead to a decrease in investor appetite in the short term, many of the most successful vintages of private funds were raised during the last financial crisis. This fact is not lost on sponsors and on institutional investors (who will not want to miss out on opportunities this time around). Arguably the biggest issue facing the industry last year was high asset prices. The new found availability of distressed assets and debt will undoubtedly create new investment opportunities for managers and investors.

The Cayman Islands is the leading domicile for private funds outside of the USA. The strength of its legal regime and the quality of its service providers coupled with the flexibility being shown at the moment by the Cayman Government and the regulator mean that it will continue to be at the vanguard of the development of new products emerging from this crisis. Managers and investors will want legal certainty in the structures they use in order to take advantage of the uncertainty in the markets.

There is a lot of truth in the statement that 'the best offense is a good defense'. While we may not fully understand the wider implications of this crisis yet, managers need to be on the front foot and communicating constantly with their investors. How managers respond, both in terms of investment decision but also on a human level (e.g. in relation to the treatment of portfolio companies and their employees), will undoubtedly form a key part of LP discussions in the future.

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