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# Private Equity 2023

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## **Cayman Islands: Trends & Developments**

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# CAYMAN ISLANDS



## Trends and Developments

### Contributed by:

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**Maples Group** advises global financial, institutional, business and private clients on the laws of the British Virgin Islands, the Cayman Islands, Ireland, Jersey and Luxembourg through its leading international law firm, Maples and Calder. With offices in key jurisdictions around the world, the Maples Group has specific strengths

in the areas of corporate commercial, finance, investment funds, litigation and trusts. Maintaining relationships with leading legal counsel, the Group leverages this local expertise to deliver an integrated service offering for global business initiatives.

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# CAYMAN ISLANDS TRENDS AND DEVELOPMENTS

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## Private Equity Trends and Developments in the Cayman Islands

We continued to see robust levels of activity throughout 2022 notwithstanding market uncertainty, rising interest rates, a higher than usual inflationary environment, and tightening credit markets. This backdrop had an impact on transaction activity in late 2022 and early 2023 compared to 2021 levels. Nonetheless, there continues to be strong interest in the use of Cayman Islands structures, with sustained levels of entity formations in connection with fund formation and transactional activity.

Sponsors continue to look to the Cayman Islands when structuring and offering private equity products that provide strategies tailored to the current market environment, including infrastructure, credit opportunities, market dislocation and special situations opportunities funds and products with regional or focused investment mandates, including environmental, social and governance (ESG) strategies.

The Cayman Islands continues to be well-positioned to respond to a volatile and challenging global environment and retain its pre-eminent offshore position due to its legislative and regulatory framework, tax-neutral status, flexible structuring options, respected legal system developed from English common law and experienced and responsive service providers coupled with broad market familiarity with Cayman Islands structures.

### *Regulatory developments*

The most notable regulatory development in the Cayman Islands in recent years has been the introduction and implementation of the Private Funds Act, which provided for registration of closed-end collective investment vehicles with the Cayman Islands Monetary Authority (CIMA).

More than 16,000 investment funds are now registered under the Private Funds Act. Cayman Islands regulation is, generally, fund-level focused and there is no requirement for a non-Cayman Islands manager of a private fund domiciled in the Cayman Islands to be regulated in the Cayman Islands. Most managers of private funds are not domiciled in the Cayman Islands and are regulated by various onshore regulators such as the US Securities and Exchange Commission, the UK's Financial Conduct Authority, the Hong Kong Securities and Futures Commission, the Monetary Authority of Singapore, or the Japanese Financial Services Agency. A Cayman Islands-registered manager would be subject to oversight by CIMA and be required to have sufficient substance in the Cayman Islands with reference to its business activities.

Within this regulatory framework, sponsors, allocators and investors are able to legislate their own contractual arrangements, which is particularly helpful as strategic investors seek alternatives to traditional co-mingled fund structures and vehicle types.

### *Alternative structures and the Cayman Islands*

The Cayman Islands' offering is well-positioned for alternative structures; ranging from separate accounts and funds of one through to "permanent capital" structures and other strategic transaction structures, such as end-of-life liquidity options, continuation vehicles and GP minority equity stake deals.

While the Cayman Islands is most commonly associated with private equity fund establishment, whether main, feeder/blocker, parallel, alternative investment or co-investment vehicles, there continues to be a strong demand for Cayman Islands structures in transactional con-

texts, particularly buy-out and secondary transactions, including as management holding vehicles. Cayman Islands vehicles have also been widely adopted to comply with new regulatory and tax developments, such as being a preferred structure to act as a carry and co-invest vehicle for a management company's Indian tax resident principals.

The nature, scope and volume of work being undertaken in the Cayman Islands gives rise to a number of trends and developments which reflect emerging technologies and work practices, a mature funds industry and the multi-jurisdictional dimension of offshore practice.

### *Fund structuring*

A key reason for the jurisdiction's success is the range of Cayman Islands vehicles that are available to sponsors/managers, enabling them to structure closed-end fund products in a manner that meets the diverse profile of investors domiciled in geographically disparate regions.

The most popular Cayman Islands-domiciled vehicles for structuring investment vehicles are:

- exempted limited partnerships (ELPs);
- exempted companies; and
- limited liability companies (LLCs).

The use of Cayman Islands LLCs, similar to the Delaware variant, introduced in mid-2016, has continued to be popular as a flexible structuring vehicle, with now in excess of 4,900 Cayman Islands LLCs registered.

The Cayman Islands Limited Liability Partnership (LLP), available for registration since November 2020, combines the flexible features of a general partnership but has the benefit of separate legal personality and affords limited liability status to

all its partners. This vehicle provides an additional structuring option and may be suitable for general partner, fund of funds or holding partnerships.

The popularity of exempted companies and ELPs generally continues to be unaffected by the introduction of LLCs and LLPs. By way of illustration, there has been consistent year-on-year growth in the number of ELPs in existence.

There are, however, nuanced regional differences in the types of vehicles being used for private equity mandates. By way of example, the preferred investment vehicle for many Japanese investors continues to be the Cayman Islands unit trust.

### *North American and European markets*

In the North American and European markets, most primary, feeder, parallel, alternative investment and co-investment vehicles are typically formed as an exempted limited partnership unless a tax blocker is required.

In onshore-offshore fund structures, the ability to provide symmetry between the offshore fund vehicles and their equivalent onshore counterparts (notably Delaware and Luxembourg limited partnerships) can lead to greater ease and cost efficiency of fund administration, pass-through tax treatment and has helped to better align the rights of investors between the different vehicles in a fund structure.

The exempted company is less regularly employed as a fund vehicle other than with respect to certain types of target investors and with reference to certain assets. Its key feature (being a corporate vehicle with separate legal personality) lends these vehicles to being most commonly used as general partner, manager,

blocker or holding vehicles (although one of the exempted company variants, the segregated portfolio company, can be an attractive option for managers targeting certain Middle Eastern-based or family office investors).

The LLC has been an appealing alternative for general partner, upper tier, manager and co-investment vehicles. The absence of share capital (and the absence of the need to maintain a share register), combined with the ability to intuitively track and record the capitalisation of an LLC and its distributions, has also led to LLCs being attractive for blocker, aggregator and holding vehicle applications. Because a member is not required to make a contribution but may benefit from profit allocations, the LLC has been adopted for certain employee award and grant schemes.

## *Japan*

In a Japanese context, a unit trust structure can often offer tax and other benefits to many Japanese investors when compared to a limited partnership vehicle. It is possible to structure the unit trust to incorporate characteristics of a traditional private equity fund, including commitment and capital call features, claw-backs and defaulting investor provisions.

Private equity has proved popular with Japanese banks, pension funds, life insurers and other institutional investors seeking to rebalance their portfolios into private equity in the search of higher yields over a number of years, including foreign private equity, despite a historic weakening of the Yen against the US Dollar in recent years which has put pressure on Japanese investors to fund US Dollar denominated commitments and in some cases led to reduced commitment sizes or increased selectivity on targeted funds.

## *Global structures*

A number of managers will utilise a mix of parallel fund vehicles to maximise the global distribution of their funds and manage downstream assets. By way of example, managers targeting investors in multiple regions, including Europe, may look to offer parallel Cayman Islands, Delaware and Luxembourg fund options or a variation on that arrangement, such as a master-feeder fund structure with a Cayman Islands closed-end fund vehicle operating as a feeder fund into a European (such as an Irish or Luxembourg) master fund. Similarly, a Cayman Islands closed-end fund vehicle may set up holding or trading vehicles in various European jurisdictions (such as Ireland or Luxembourg) to facilitate its investment objectives.

## *Regulatory*

A sophisticated legislative and regulatory framework has enabled the Cayman Islands to respond to the challenges and opportunities arising out of evolving, and often conflicting, regulatory developments. Several key regulatory developments in recent years are outlined below.

### *The implementation of the Private Funds Act in 2020*

This regime requires closed-end funds (Private Funds) to register with CIMA, introduced a proportionate regulatory overlay for closed-end funds with several benefits, was responsive to recommendations by international partners and reflects the Cayman Islands' commitment as a co-operative jurisdiction as affirmed by various international organisations. It covers similar ground to existing or proposed legislation in a number of other jurisdictions. Furthermore, in April 2023, CIMA released a series of updated and new regulatory measures for regulated entities (including Private Funds), which included the Statement of Guidance on Corporate Govern-

ance for Mutual Funds and Private Funds, the purpose of which is to provide guidance on the minimum expectations for the sound and prudent governance of the regulated funds and sets out the key corporate governance principles pertaining to the operators of regulated funds as a guide to CIMA's expectations with regard to governance. CIMA also released:

- the Rule and Statement of Guidance – Internal Controls for Regulated Entities, requiring regulated entities (including Private Funds) to establish, document and maintain an adequate and effective system of internal control; and
- the Rule – Corporate Governance for Regulated Entities, requiring regulated entities (including Private Funds) to establish, implement and maintain a corporate governance framework commensurate with its size, complexity, nature of business, structure, risk profile and its operations, with the new regulatory obligation associated with these new rules coming into effect in October 2023.

### *Automatic exchange of information (AEOI) regimes*

The Cayman Islands has implemented the comprehensive automatic exchange of information (AEOI) regimes of both the Organisation for Economic Co-operation and Development's (OECD) Common Reporting Standard (CRS) and the US Foreign Account Tax Compliance Act (FATCA). Reporting financial institutions have customer due diligence and annual reporting obligations in the Cayman Islands and the recent new annual requirement to file a CRS Compliance Form. Reports, as well as the annual CRS Compliance Form, are made to the Cayman Islands Tax Information Authority (TIA) administered by the government's Department for International Tax Cooperation. The TIA, in turn, provides account

information automatically to the tax authorities of over 100 jurisdictions.

### *The maintenance of beneficial ownership information and a requirement for a beneficial ownership register*

Subject to any available exemptions, exempted companies and LLCs are required to complete and maintain a beneficial ownership register at their Cayman Islands registered office with a licensed corporate service provider with information made available by the Cayman Islands government to certain law enforcement agencies upon legitimate request.

### *Tax Information Authority (International Tax Compliance) (Country-by-Country Reporting) Regulations in 2017*

The Cayman Islands introduced the Tax Information Authority (International Tax Compliance) (Country-by-Country Reporting) Regulations in 2017. In summary, these regulations implement in the jurisdiction the model legislation published under the OECD's Base Erosion and Profit Shifting Action 13 Report (Transfer Pricing Documentation and Country-By-Country Reporting).

### *Anti-Money Laundering (AML) Regulations*

The Cayman Islands continue to review and revise its AML Regulations and related guidance to ensure they remain in line with current Financial Action Task Force (FATF) recommendations and global practice from time to time. The requirements of the AML Regulations include the appointment of natural persons as AML officers to entities carrying on "relevant financial business" (which includes Cayman Islands investment funds vehicles) to oversee the effective implementation of AML programmes carried out by or on behalf of such entities. As a result of the Cayman Islands' continued enhancement of its AML/CFT regime, including by way of introduc-

ing administrative penalties and sanctions that are intended to be effective, proportionate and dissuasive, the FATF has determined that the Cayman Islands has the highest compliance rating with respect to all 40 FATF recommendations relating to anti-money laundering and countering the financing of terrorism and has satisfied all of the FATF's recommended actions for the jurisdiction, recognising that the Cayman Islands has a robust and effective anti-money laundering and counter-terrorist financing regime.

### *The International Tax Co-Operation (Economic Substance) Act*

In further response to and compliance with OECD Base Erosion and Profit shifting standards, in December 2018, the Cayman Islands brought into force the International Tax Co-Operation (Economic Substance) Act (As Revised) and associated regulations and guidance. This law introduced reporting and economic substance requirements for certain Cayman Islands-domiciled entities and partnerships undertaking certain activities, with reporting made to the TIA. The economic substance regime incorporates certain exemptions, specifically for vehicles that fall within the statutory definition of an investment fund.

### *The Data Protection Act*

The Data Protection Act (As Revised) (DPA) came into force in late 2019. This law imposes certain obligations on Cayman Islands vehicles that handle personal information relating to an individual with respect to that information. The DPA data protection principles are equivalent to those in force under other comparative legislation, such as GDPR in Europe.

### *Continuing dialogue*

The Cayman Islands continues its dialogue with a number of international partners and govern-

ing regulatory bodies, including the OECD and the FATF, to ensure the jurisdiction maintains a robust and proportionate regulatory framework that is implemented in an effective manner to meet internationally accepted best practice standards.

### *Offering and subscription documents*

At the establishment stage, these regulatory matters are being reflected in more detailed disclosures in offering and subscription documents. By way of example, investors are being required to make disclosures that pertain to AML and tax transparency considerations and sponsors are addressing data protection and sanctions obligations together with economic considerations, such as pertaining to the costs that will be allocated to the fund as fund expenses as opposed to incurred by the manager.

These are dynamic and ongoing obligations, the nature of which is reflected in fund documents and Cayman Islands notification and reporting obligations of the nature described above.

### *Fair disclosure and compliance*

There is also an emphasis on fair disclosure. During a fund's life cycle, as in key onshore jurisdictions, sponsors engage in ongoing dialogue with investors and advisory boards to ensure key matters, notably conflicts, are fairly disclosed, including in the context of fees (which has been an area subject to well-publicised onshore regulatory enforcement actions).

The scope for conflicts can be particularly acute at the end of a fund's life, for example where liquidity is sought, or value optimised, by way of a continuation fund, general partner-led secondary transaction or a term extension. In those instances, a sponsor may receive new material information in the midst of an all-partner consent

process, or prior to a deal being consummated, which the sponsor (and/or general partner) must disclose so that investors are able to make an informed decision with reference to those revised particulars.

Given that the regulatory framework is evolving quickly and becoming more complex and multi-layered, an increasing number of sponsors look to outsource compliance functions, such as AML/KYC verification and tax transparency reporting obligations, to third-party specialists. This allows management companies to dedicate more resources to their core investment-focused activities and more clearly delineate between fund and house expenses.

## Geographic Factors Impacting Cayman Islands Private Equity Trends

The Cayman Islands product has broad global appeal although several trends are dictated by geographic factors.

### *Fundraising*

The softening of the North American fundraising market in 2022 has continued into the beginning of 2023 as a result of the difficult economic and political environment. Nonetheless, there continues to be consistent demand for the establishment of Cayman Islands structures, with a range of vehicles, from small bespoke sidecar funds to mega-funds, as well as downstream structuring vehicles, being established in the Cayman Islands. The broad flexibility of the Cayman Islands' offering ensures there is wide appeal among mid-market and start-up managers as well as allocators and investors to establish Cayman Islands vehicles intended to fulfil a wide range of purposes.

The European private equity market has continued to be dominated by global market uncer-

tainty, inflation and the war in Ukraine, resulting in fewer deals being completed than in previous years. With the exception of certain large buyout funds, the European private equity markets have also seen a tougher environment for fundraising and, as a consequence, some fund managers have considered extending existing fund terms or pursuing a continuation strategy pending a realisation opportunity arising.

The Cayman Islands continues to be a popular jurisdiction for UK managers looking to establish offshore private equity funds, especially where there is a transatlantic nexus. Increased fund oversight and investor protection through the implementation of the Private Funds Act and the strengthening of CIMA's regulatory powers have, together with certain other recent legal and regulatory developments, served to more closely align Cayman Islands private funds with the regulated framework that European private equity fund managers and investors are used to operating in under AIFMD.

Owing to pandemic disruptions, geo-political uncertainties and regulatory clampdowns, fundraising in the region proved difficult throughout 2022 and into 2023. Despite the rise of "onshore" fund jurisdictions in Asia, Cayman Islands entities continue to remain the vehicle of choice, particularly for large global managers.

### *Global landscape*

A number of potential headwinds have arisen in Asia Pacific as we move into late 2023: global investors are still concerned about China's slowing economic growth and increasing investment risk given rising geopolitical tensions and tighter industry regulations. Political and economic uncertainty cast a shadow over the region's exit market and the closing of the US IPO exit route for Chinese companies has significantly reduced

the number of Chinese firms listing in the US. Additionally, global macro factors, including the war in Ukraine, high inflation, increased interest rates and a potential US recession may be negatively impacting investor sentiment.

The Cayman Islands continues to be the dominant jurisdiction of choice for sponsors and investors alike in the Asia region, being favoured for investment funds launched across different disciplines, ranging from traditional private equity to real estate and credit funds.

### *Continued growth*

As noted above, there is increasing interest from Japanese institutional investors in private equity, with many Japanese investors now expanding into the asset class or increasing allocations. Tech investments continue to be a major focus in the South East Asian region. With many valuations coming down, this may lead to increasing deal flow, although this may be tempered by a “risk off” approach being adopted by investors given global macro factors.

### **Looking Ahead**

While volatility in global markets often lead investors to allocate a significant portion of their investment capital to alternatives, the continued difficult political environment and weakening economic activity are expected to impact investment valuations and realisations and, as a result, may cause managers to consider extending fund terms or pursuing continuation strategies in the near-term.

Against this backdrop, and notwithstanding such volatile macro-economic landscape, the Cayman Islands remains well placed to maintain its position as the principal offshore jurisdiction for private equity given the flexible structuring options, investor familiarity with Cayman Islands structures and a proportionate regulatory framework that continues to adapt in a robust and responsive manner to the needs and expectations of sponsors, investors and international partners.

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