Alert

"The New Cayman Regulatory Landscape - What Questions Should a Lender Ask?"

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The Cayman Islands continue to be at the forefront of the implementation of global standards for transparency and regulatory oversight in respect of the financial services industry.

While the primary responsibility for implementing regulatory requirements concerning Cayman Islands investment fund structures falls to the relevant fund manager, a knock on effect is that prospective lenders to such funds must now also verse themselves on the relative importance of certain Cayman Islands regulatory measures to their due diligence and lending processes.

This article addresses what Cayman Islands regulatory requirements lenders in the fund finance arena should be aware of and breaks down our views as to what questions can reasonably be asked of borrowers as part of the due diligence process. The below is based on the most frequent scenario encountered – which is the 'fund' vehicle being a Cayman Islands exempted limited partnership and the ultimate general partner of such vehicle being either a Cayman Islands or Delaware incorporated exempted company or limited liability company.

Anti-Money Laundering Requirements

In order to comply with the Cayman AML Regime[1] a Cayman fund is, amongst other things, required to: (i) appoint certain money laundering compliance officers, namely an Anti-Money Laundering Compliance Officer, a Money Laundering Reporting Officer and a Deputy Money Laundering Reporting Officer (together the "AML Appointees"); and (ii) adopt (or rely upon) written policies and procedures to meet the requirements of the Cayman AML Regime.

From a lender's perspective, the relevance of the Cayman AML Regime is that the backbone of a lender's security is the ability to call undrawn capital commitments from limited partners. If a fund is not in compliance with the Cayman AML Regime at the time of a default then the lender is potentially in a position where, in enforcing its rights, it may unintentionally be calling capital from investors who have not been correctly verified under the Cayman AML Regime. While most lenders will have a good understanding of the potential AML risks attaching to the respective limited partners of their borrowers, in an extreme (albeit unlikely) scenario, the failure of the borrower to comply with the Cayman AML Regime could lead to capital being called and received into the lender's designated account from bad actors or unverified investors.

From a risk perspective, we view compliance by borrowers with the above obligations as important for our lender clients both: (i) from the perspective of the security package; and (ii) from a reputational perspective – so as lenders are not drawn into the net of negative publicity should they provide a facility to a borrower who has not complied with the Cayman AML Regime.

As part of our due diligence process when acting for lenders we suggest that a prudent approach is to request that the borrower provides at least some information in respect of its compliance with the Cayman AML Regime. Our view is that, notwithstanding any pushback from borrowers[2] in respect of such a request, if the fund is in fact in compliance it should not be an issue to demonstrate this.

[1] *Proceeds of Crime Law* (*as revised*) ("POCL") as supplemented by the *Anti-Money Laundering Regulations* (*as revised*) ("AML Regulations") and *Guidance Notes on the Prevention and Detection of Money Laundering and Terrorist Financing in the Cayman Islands* (*as revised*) (the "AML Guidance Notes" and together with the POCL and AML Regulations the "Cayman AML Regime")

[2] The regular response from borrower counsel is that that such information is not included in the term sheet/closing checklist or that it is covered by the AML representation in the credit agreement.

We are of the view that a number of approaches can be utilised by lenders depending on their comfort level with the borrower's compliance programme:

A conservative approach: An approach that will gain full confirmation of the position is to request from the borrower full details (including any service agreements appointing AML Appointees) of the relevant AML Appointees and disclosure of how the fund meets its requirements to maintain and implement policies and procedures under the Cayman AML Regime[3].

A midway approach: A second approach is to request confirmation by email (from legal counsel or a borrower representative) of the names of the AML Appointees and that the relevant fund maintains and implements policies and procedures under the Cayman AML Regime.

Alternative approach: An alternative approach is to rely on representations in the credit agreement that the fund is in compliance with the Cayman AML Regime. This approach is generally used if the lender is comfortable with a particular borrower's business (for example from previous transactions or an ongoing relationship with a borrower client).

Economic Substance Requirements

The Economic Substance Law[4] was introduced in the Cayman Islands in December 2018 and comes into effect for entities in existence prior to 1 January 2019 from 1 July 2019.

For the most-part, the Economic Substance Law will be of limited relevance in the fund finance space (as limited partnerships are not 'relevant entities') but it will be of relevance in due diligence of Cayman Islands funds to the extent that:

1. The general partner is a: (i) Cayman Islands exempted company or limited liability company; or (ii) a Delaware limited liability company registered in Cayman as a foreign company, and in each case the fund structuring and activities are such that the general partner is considered to be a 'relevant entity' conducting 'relevant activities' under the Economic Substance Law; and/or
2. The borrower fund or a portfolio company is a Cayman Islands exempted company or Limited Liability Company.

Similar to compliance by funds with the Cayman AML Regime we suggest that a prudent approach in respect of the Economic Substance Law will be to ask the borrower for at least some information in respect of its compliance with the Economic Substance Law - or reasoning for such law being inapplicable to the given general partner/fund.

In certain circumstances we would anticipate pushback from borrower counsel on these requests but, as with the Cayman AML Regime, if the general partner/fund is in fact in compliance or outside of the scope of the Economic Substance Law it should not be an issue to demonstrate this.

One additional repercussion of the Economic Substance Law is that Cayman Islands law firms will likely already be in the process of updating their standard legal opinions to include assumptions/qualifications in respect of the Economic Substance Law. We don't expect however that such additional assumptions/qualifications will generate material debate between the respective borrower/lender counsel on a fund finance transaction.

What's Next?

As international initiatives are introduced or amended, the Cayman Islands will continue to develop its regulatory framework to satisfy such requirements. Accordingly, lenders will continue to need to remain informed in respect of these developments. We expect that over time due diligence requests in respect of such regulatory initiatives will become standardized and will be included in closing deliverable checklists in fund finance transactions.

As ever, the point will always remain that the lender is entitled to ask for such information as it reasonably requires - and information on regulatory compliance by funds is in our view always a reasonable request.

[3] Our experience is that this approach is currently met with considerable resistance by borrower counsel but that ultimately if the lender seeks the information, and the relevant borrower is in compliance with the Cayman AML Regime, there is limited reasoning as to why full details should not be provided.

[4] *The International Tax Co-operation* (*Economic Substance*) *Law, 2018* ("Economic Substance Law")

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