CADWALADER

FUND FINANCE FRIDAY

Fund Finance: Sanctions

June 17, 2022 | Issue No. 180

By Alexandra Woodcock
Partner | Mourant Ozannes (Cayman) LLP

By Sara Galletly
Partner | Mourant Ozannes (Cayman) LLP

By Alex Last
Partner | Mourant Ozannes (Cayman) LLP

By Finn Howie
Counsel | Mourant Ozannes (Cayman) LLP

Following on from the *Fund Finance Friday* articles of March 11 and May 13, which looked at the sudden escalation of sanctions measures following Russia's invasion of Ukraine and the associated issues being considered by lenders in the fund finance space, this article focuses on the current state of play in the Cayman Islands and some of the questions which Cayman Islands funds are facing in practice.

The Cayman Islands sanctions framework

Whilst sanctions can be imposed domestically in the Cayman Islands, in practice, the financial sanctions in force in the Cayman Islands are essentially those in force in the United Kingdom. It is the UK's policy to ensure that British Overseas Territories like the Cayman Islands are legally and practically enabled to implement United Nations and UK sanctions in order to ensure compliance with international obligations. This is principally achieved via the extension of the UK sanctions measures to the Cayman Islands, with certain modifications.

Whilst other non-UK sanctions regimes, such as those of the United States and the European Union, do not apply in the Cayman Islands as a matter of law, those regimes can have far-reaching, extra-territorial impact and may still be applicable. Therefore, many Cayman Islands funds choose to monitor and comply with non-UK sanctions in practice, particularly the U.S. regime administered by the Office of Foreign Assets Control ("OFAC"). This may be required in situations where there is jurisdictional overlap between the various regimes due to a fund's structuring and underlying operations. These can be difficult waters to navigate and, in particular, there are some areas where the UK/Cayman Islands regime differs from the U.S./EU sanctions regimes.

Aggregation of the holdings of separate sanctioned investors

One such area is with aggregation − that is, where a fund has more than one sanctioned investor/limited partner, neither of whom individually "own or control" the fund for the purposes of the relevant legislation.[1] The Cayman Islands follow the UK position here, with the Office of Financial Sanctions Implementation ("OFSI") having recently updated its guidance to clarify that, when making an assessment on ownership and control, OFSI would not automatically aggregate sanctioned persons' holdings in a fund; there must be evidence of a joint arrangement between those parties, or evidence that a sanctioned person controls the fund for the purposes of the relevant sanctions legislation.[2] Notably, this is different from the U.S. and EU sanctions regimes, both of which do aggregate the ownership interests of multiple sanctioned persons in a fund to determine whether the ownership threshold has been met.

Actions required

The Cayman Islands anti-money laundering and countering financing of terrorism regime requires that applicable sanctions lists must be checked frequently to identify whether a fund maintains any accounts or holds any funds or economic resources for designated persons or entities, whether directly or indirectly. The fund must look through to the ultimate beneficial owners of their direct clients/investors. In practice, this "scrubbing" of sanctions lists is often conducted via a third-party service provider or as part of the compliance function within larger or more sophisticated fund managers.

Where a sanctions hit occurs, the fund is required to:

- **Freeze:** freeze any accounts, other funds or economic resources (which terms are defined extremely broadly) that are owned or controlled by designated persons or entities;
- **No dealing:** refrain from dealing (also defined extremely broadly) with the funds or assets, or from making those funds or assets available (directly or indirectly) to, or for the benefit of, the designated person or entities, unless an appropriate license is held;
- **Report:** report any findings to the Cayman Islands Financial Reporting Authority (the "FRA") as soon as practicable by completing and submitting a compliance reporting form in the prescribed form;[3] and
- **SAR:** consider whether a suspicious activity report ("SAR") also needs to be made to the FRA.[4]

What is an asset freeze?

In the context of a fund, an asset freeze means that the fund may not process any redemption, withdrawal or transfer of, or make any distributions in respect of, the frozen interest; nor may the fund accept any additional subscriptions from or make capital calls on the relevant investor. In addition, the fund must not otherwise alter, move or allow the designated person to access or receive the benefit of the investment. Additional complexities may arise in practice, dependent upon the precise terms of an investment fund, in determining how far an "asset freeze" may extend and what actions, such as payment of fees, may be permitted at the fund level. However, where a designated person holds a minority interest in a fund, the impact on day-to-day activities can be expected to be minimal.

Impact on subscription credit facilities

Most credit agreements will also include express representations and restrictive covenants which require the borrower to actively monitor for sanctions risk at the investor level, where the possibility arises of controlling persons or individual officers or employees becoming sanctioned. While the sanctions language is often subject to negotiation with the input of specialist counsel, the term "sanctions" is typically broadly defined to include all economic or financial sanctions imposed, administered or enforced by any governmental authority with jurisdiction over the borrower or its affiliates, including OFAC in the case of U.S. sanctions, and OFSI in the case of UK and Cayman Islands sanctions.

The exact wording of any such sanctions provisions must be considered on a case-by-case basis. The sanctions provisions may not necessarily be breached solely by reason of an individual non-controlling/minority investor in a fund becoming subject to sanctions. However, where an investor in the fund is sanctioned, the borrower will need to take active steps to ensure it remains compliant with these contractual provisions, which may lead to challenges in practice. Most notably, a typical sanctions covenant will strictly prohibit any proceeds of a sanctioned transaction being used to repay advances under the facility, and will prohibit any proceeds of the facility being made available (directly or indirectly) to any sanctioned person.

In any event, both lender and borrower need to remain mindful that, under a typical credit agreement, an investor (including those holding a minority interest) becoming sanctioned is likely to, at minimum, result in that investor being excluded from the borrowing base (by becoming an "excluded investor" or pursuant to an analogous definition). In turn, that may trigger a prepayment requirement if the borrowing base is exceeded.

General license to alleviate the position

That being said, there are reasons why a Cayman Islands fund would want to cause a designated person to exit the structure, including whether due to the nature of the other investors in the vehicle and reputational or perception issues, or because of the impact under existing facility terms. Currently, a mandatory transfer cannot be achieved without a license specific to that vehicle and the licensing process is, at this stage, uncertain and time-consuming.

However, talks are underway between the FRA and the UK authorities regarding the grant of a general license which would allow Cayman Islands funds to effect mandatory redemptions or withdrawals of frozen investors and place the proceeds into a blocked account. If issued, such a license will provide operators and managers of funds with frozen investors (including funds

with majority frozen investors, which are themselves then subject to sanctions) with a way forward to improve the position of the fund (and its remaining investors) and remediate any technical breaches of credit facility terms.

It is expected that any such license would be closed-ended, requiring impacted funds to take action within a certain window of time. Therefore, it is essential for fund sponsors and their counsel to stay abreast of this development.

[1] Under The Russia (Sanctions) (EU Exit) Regulations 2019, an entity is "owned or controlled, directly or indirectly" by another person if:

- the person holds (directly or indirectly) more than 50% of the shares or voting rights in an entity;
- the person has the right (directly or indirectly) to appoint or remove a majority of the board of directors of the entity; or
- it is reasonable to expect that the person would (if they chose to) be able, in significant respects, by whatever means and whether directly or indirectly, to achieve the result that the affairs of the entity are conducted in accordance with their wishes.

[2] Paragraph 4.1.4, **OFSI General Guidance - UK Financial Sanctions**.

[3] Available at the FRA's website **here**.

[4] It should be noted that suspicious activity is reported to the FRA in a different format from sanctions-related reporting; the FRA's prescribed SAR form is available at the FRA's website **here**.