

FUND FINANCE FRIDAY

The Risk of De-Reg to the Pledge: Considerations for Lenders When Negotiating Private Funds Act Grace Periods

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Much has been written about the introduction of the Cayman Islands Private Funds Act (as revised) (the “PF Act”) and the impact of the PF Act on subscription facilities generally. Here we take a look at the genuine risk of de-registration by the Cayman Islands Monetary Authority (“CIMA”) of an in-scope private equity fund (“Fund”) and practical considerations for a lender when considering any grace period for re-registration. (Please see the end of the article for a quick recap of the PF Act in the context of subscription facilities.)

We are often asked by lenders to provide some insight as to the risk of PF Act de-registration and how long re-registration could take, usually in the context of the discussions around the event of default (“EoD”) grace period for a breach of the covenant requiring a Fund to maintain its PF Act registration (“PF Act Covenant”). Should de-registration trigger an immediate EoD? Should there be a grace period of 5, 15 or 30 days for the Fund to re-register? Lenders generally appreciate that the consequences of de-registration can be significant for the security package, but in negotiations they will want to consider: how likely is de-registration in practice, and how soon can it be rectified?

Why would a Fund be de-registered? Is it a genuine risk?

A Fund can be de-registered by CIMA pursuant to the PF Act if it fails to comply with the requirements set out therein. As the PF Act includes a suite of requirements to be met by Funds, the scope and severity of what constitutes a breach can be broad, ranging from late payments of fees through to failure to comply with reporting obligations or significant AML breaches. This also means that a de-registration would likely be fairly fact-specific.

Rather than proceeding straight to de-registering a Fund, in practice CIMA would likely (i) notify the Fund of any breach and offer a chance to rectify it, and (ii) utilize various other enforcement options available to it – for example, imposing monetary fines (which can be significant). On this basis, we would expect, save in the case of significant and ongoing non-compliance, the risk of de-registration to be fairly remote, particularly in relation to otherwise well-managed and reputable Funds.

So we have a de-registered fund. How long does it take to be re-registered? Is it possible within the grace periods generally offered?

The timing and process for re-registration will be largely dependent on the reason and circumstances that led to the de-registration. For example, a late payment of fees could potentially be dealt with quickly, whereas a serious AML breach would be a much bigger issue and involve a greater time lag. There will also be various unknowns in the process, such as the current workload of CIMA and if certain compliance aspects are being scrutinized in additional detail at the time. Also relevant will be whether the Fund has a history of breach or non-compliance with CIMA requirements.

When it comes to grace periods, a lender's preference would obviously be that a breach of the PF Act Covenant should trigger an immediate EoD, but often some cure period is given (ranging from 5 through to, in some cases, 30 days). Such a cure period would give the Fund the chance to re-register in that window, if possible, meaning in practice a Fund could potentially be re-registered and avoid the EoD once a minor PF Act breach has been rectified, but a more serious PF Act breach would ultimately trigger the EoD on expiry of the grace period.

In summary, what should a lender be considering?

As a high-level PF Act risk analysis:

- Likelihood of de-registration: fairly unlikely (assuming a reputable and well-managed fund).
- Consequences of de-registration for the security package: very serious.
- Likelihood that Fund can be re-registered quickly: depends on the reason for de-registration, but still fairly unlikely even for a minor breach (given CIMA would have likely taken other enforcement steps prior to de-registration). For a major breach – very unlikely.

A lender might decide that they can live with the risk of a breach of the sort that would likely result in the Fund being re-registered within a satisfactory grace period. Conversely, they might want the flexibility to declare an immediate EoD for any de-registration, regardless of how quickly it might be rectified.

Moving away from the straight PF Act analysis and looking at Fund management more generally, it is also worth considering that if a Fund is being managed in such a way that it has been de-registered by CIMA under the PF Act, then the de-registration is potentially not the only issue and that other (unrelated) defaults may also have occurred under the facility.

Conclusion

When considering cure periods offered for a breach of the PF Act Covenant, lenders will need to consider the likelihood, as well as the seriousness of the consequences of, de-registration. Given that de-registration is in itself a fairly fundamental administrative failing by a Fund, lenders may wish to retain the flexibility of an immediate EoD, but we all appreciate that facilities are negotiated through the lens of the relationship of the parties and the wider commercial context. For now, de-registration by CIMA remains a relatively remote risk, but we will continue to closely monitor CIMA's approach as the regime becomes more established.

PF Act recap

Here is a very quick PF Act recap in the context of a subscription facility.

PF Act summary: Certain private equity funds must be registered with CIMA pursuant to the PF Act within 21 days of accepting capital commitments before such funds can receive capital contributions from investors.

Concern for subscription facilities: If an in-scope private equity fund is not registered pursuant to the PF Act, there is a risk that it might not be able to accept capital contributions to repay a facility (on enforcement or otherwise).

Market approach for subscription facilities: To address this risk, current market position is generally (i) a condition precedent requiring PF Act registration of applicable Funds, (ii) a covenant requiring the Fund to (among other things) maintain its PF Act registration; and (iii) an accompanying EoD, either immediate or with a grace period.