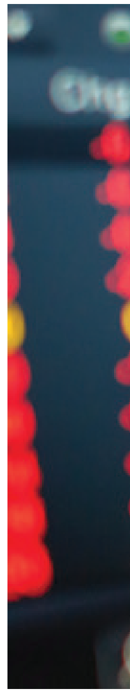
This article sponsored by Walkers originally appeared in The Legal Special 2018 published by PEI in April 2018

THE FINANCIAL CRISIS

The bear, the bull and return on investment: PE's climb to the top



A decade on from the financial crisis, private equity is thriving. Its renaissance owes much to the resilience of global markets and the ability of fund domiciles such as the Cayman Islands to adapt to new regulatory models, write Caroline Williams and Jason Allison from Walkers

What a difference a decade makes. It's 10 years since the global financial crisis developed into a fully-fledged crash in 2008 with the collapse of Bear Stearns, Lehman Brothers, Fannie Mae and Freddie Mac, liquidity freezes and bail-outs on a seismic scale, notably for AIG, Bank of America and Citigroup.

Ten years on and the global economy seems back on track with positive noises emanating from Wall Street, the City of London and other major financial hubs. While it is true that market volatility is slowly creeping back and that geo-political uncertainties have become the new zeitgeist, so far the markets have retained confidence in business. None more so than private equity.

Which raises two intriguing questions. How has private equity climbed back from the doldrums of 2008 to the high valuations and oversubscribed funds of 2018? And how has the industry managed to do this amid the introduction of a punishing post-crisis regulatory regime?

Many of the answers can be found in a small island in the Caribbean. The way the Cayman Islands has evolved in the post-crisis environment typifies how innovation and adaptability have become the bedrocks of private equity's revival since the crash.

GLOBAL TURMOIL

It's worth remembering just how far the reputation of private equity had fallen. It could not have been at a lower ebb at the start of 2008. The financial crisis had created a lot of PE-related negative press on both sides of the Atlantic inspired out of both fear and jealously. "Regulation" was the cry from both governments and citizens, and the curtailing of liberal lending conditions began to squeeze the activities of the world's major private equity funds. Deal volumes shrank, stock markets declined, some investors defaulted on their capital commitments and some funds had to be restructured to enable their investor base to reduce their capital commitments to a more manageable level to avoid defaults.

It wasn't all gloom and doom. Some saw hopeful signs. Preqin's *2008 Global Private Equity Review* was confident about the future after private equity had passed a landmark $2 trillion in assets under management in mid-2007: "The potential to grow further is enormous: we're predicting a $5 trillion industry over the next five to seven years."

MARKETS THRIVE

Jumping ahead to Preqin's *2018 Global Private Equity and Venture Capital Report*, 2017 is highlighted as a record-breaking year for the private equity industry, with aggregate capital of $453 billion raised by 921 funds and assets under management hitting an all-time high of $2.83 trillion as of June 2017. Furthermore, 95 percent of investors felt that their PE investments met or exceeded their expectations. Not quite the $5 trillion industry predicted but it appears that the PE market is excelling.

Without searching too hard, it is possible to see the ubiquity of private equity in all aspects of our lives. Your local water supplier is quite possibly PE-owned, almost all your clothes are probably made by companies owned by private equity, much of the infrastructure we take for granted (roads, rail, airports) are owned by PE firms, even

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Back from the red: *the ability of fund domiciles such as the Cayman Islands to adapt to a punishing post-crisis regulatory regime has helped PE to grow, say Williams and Allison*

your apartment block, student housing or office block could well be private equity investments. The list is endless. In every walk of life, the sheer scale of funds raising capital has enabled private equity to touch almost every corner of the globe in almost every market.

By deploying capital and management expertise in the many businesses that are part of the fabric of our daily lives, promoting growth, making those businesses more streamlined and efficient, and in some instances providing a lifeline, private equity has become intricately entwined in our daily lives. There are many components to the growth of the private equity industry over the last decade, but there's little doubt that the ability of fund domiciles such as the Cayman Islands to adapt to change has played a key role in the emergence of PE as an established asset class.

FLEXIBLE APPROACH

Two reasons stand out for why the Cayman Islands has assumed a dominant role in the private equity merry-go-round over the last decade: the responsiveness of the jurisdiction to change, and a keen awareness of the importance of maintaining a flexible and innovative approach to the introduction of new legislation covering the private equity industry.

In 2009, the Companies Law of the Cayman Islands was amended to introduce a merger regime similar to that in the US State of Delaware. In recent years we have seen the merger legislation used to facilitate complex and high profile take-private transactions which might previously have been effected under Delaware law.

In 2014, the Exempted Limited Partnership Law of the Cayman Islands (the "ELP Law") was substantially overhauled to bring it in line with the demands of the modern private equity industry. The response of the Cayman Islands legislature to meeting the needs of fund sponsors and counsel demonstrated this willingness to adapt.

Most recently, in 2016, the Cayman Islands introduced a cutting-edge Limited Liability Company statute, modelled on the equivalent legislation in Delaware. This was not done out of lack of imagination or application – but to be responsive to the demands and wishes of the private equity industry. As was the case for the ELP Law, during the drafting process, US lawyers and other experts were consulted to optimise the business-friendly nature of the Cayman Islands LLC. As such, there are some useful differences in employing the vehicle in private equity fund structuring or M&A transactions, other than the advantages of it being domiciled in a tax neutral jurisdiction.

The introduction of this new legislation in the Cayman Islands occurred, in part, in direct response to requests from leading participants in the private equity industry, but also as a result of a need identified by practitioners in the Cayman Islands. The resulting products demonstrate, and have ensured, that the Cayman Islands continue to keep abreast of, and work in tandem with, onshore legislation.

By being responsive to industry requests, and partnering with private equity thought leaders and practitioners to instigate and facilitate legislative changes beneficial to the private equity industry, the Cayman Islands has strengthened the foundations that have supported the growth of its private equity industry over the last decade, as well as creating a solid platform for further expansion and development.

IMPRESSIVE GROWTH

The Cayman Islands has been a fully committed player during the impressive »

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» growth that private equity has experienced over the last decade. In the 10 years following the crisis, fund sizes grew considerably larger. In 2017, we saw Apollo raise the largest buyout fund ever at $24.7 billion.

Demonstrating the importance that technology is going to continue to play in the PE world, SoftBank created great excitement by raising its $98 billion technology focused Vision Fund. With such an inordinate amount of dry powder, the spending of capital raised by Vision Fund will almost inevitably involve Cayman Islands structures. Larger fund sizes have led to more dry powder being available for deployment. When it comes to spending the dry powder, these monstrous fund sizes have also led to larger and more complex deals.

The start of the financial crisis saw the world of banking and finance indiscriminately affect the funds industry – both private equity and hedge funds. Of course, not all facets of the private equity industry would say that the crisis was a bad thing. Those sponsors with their eyes on the distressed-strategies ball came into their own and their prowess saw the raising of several successful and, in many cases, oversubscribed funds.

In tandem with being at the offshore cutting edge in introducing new legislation, the Cayman Islands has also been responsive and collaborative in assisting with navigating and complying with the impact of onshore regulation. Following the introduction of Dodd-Frank and the Volcker Rule, Cayman Islands lawyers helped private equity fund sponsors with structuring to ensure that their Cayman entities fell within the requirements of the Volcker Rule.

From a transactional perspective, the Cayman Islands also played a pivotal role in spin-out transactions to enable banks to divest their private equity platforms whilst helping new managers establish their platforms and create new opportunities from the shedding of such assets. Ten years on, such new managers have developed into established members of the industry.

REGULATION: THE NEW NORM

No commentary on PE would be complete without a description of the increased regulatory scrutiny to which the industry became subject as a result of the financial crisis and how this has been received.

In the US, regulatory change was primarily effected through legislation known as Dodd-Frank. For the first time, PE managers were required to register with the US Securities and Exchange Commission and become subject to its regulation. This compelled managers to make large investments in additional compliance personnel and IT systems.

It also led to a change in overall compliance culture. Clearly it also increased the cost of doing business, but is now accepted as the norm and some managers even regard it as a positive development as it helped to level the playing field. From an investors' perspective, even though they end up bearing some of the costs, they can take comfort that there is a minimum standard of regulatory oversight to complement their due diligence processes.

Somewhat ironically, the largest managers (ie, the ones who presumably presented the greatest systemic risk and were therefore those who attracted the attention of the regulators in the first place) have become even more competitive as they are able to use economies of scale to spread the cost of compliance across a range of funds thereby reducing the percentage passed on to investors. One other benefit of SEC registration has been that Cayman Islands service providers can apply streamlined AML due diligence procedures, thereby speeding up the process.

FATCA and CRS were also introduced in the wake of the crisis (and implemented

Whilst immediately post the global financial crisis, CDOs and CLOs were, for many, the personification of profanity, fast forward 10 years and we have seen a healthy revival of CLO issuances and an interesting convergence of debt and equity with the continued increasing popularity of credit funds.

A number of the leading institutional private equity sponsors have been active in the credit space in recent years, raising substantial funds and sponsoring CLO issuance in addition to raising funds to invest in such CLOs. This made 2017 the year for debut managers in the CLO space.

Despite the initial fears surrounding the impact of risk retention, we have not only seen previously inactive managers re-emerge but new players entering the market. These new entrants include PE managers who continue to bring fresh strategies and impetus to the product. ■

into Cayman Islands law). Shrinking global economies meant a corresponding reduction of tax revenues worldwide. One reaction was to seek to clamp down on those thought to be not paying the taxes that were due from them, in particular where assets were held in foreign jurisdictions. The mechanism introduced was to require foreign entities to register and report certain information on their ultimate beneficial owners and, in the case of FATCA, to apply a 30 percent withholding tax on US source income in the event of non-compliance. The Organisation for Economic Co-operation and Development subsequently adopted a similar regime (but without the withholding tax aspect) for a host of other countries.

There is no doubt that FATCA and CRS have increased the costs of doing business, ranging from significantly longer subscription documents to outsourcing of classification and reporting functions to third parties (or hiring people and buying systems to do it in-house).

Finally in relation to regulation, and in response to discussions with the OECD, the Cayman Islands in 2017 introduced a beneficial ownership regime to further facilitate information sharing between regulators. The essence of the regime is that service providers must maintain registers of those who own at least 25 percent of certain designated "in scope" companies and LLCs and such information is then transported via flash drive to a central "air-gapped" (ie, not connected to the internet) government computer. If a relevant enquiry is made from an overseas regulator or other authority, the data can be accessed and relevant information provided.

Highlighting the implementation of the Cayman Islands beneficial ownership regime is more of a footnote in its level of importance in the context of private equity as PE funds and most entities in PE structures are not considered "in scope" of the regime (mainly on the basis that PE fund managers are already adequately regulated). Nevertheless, a classification exercise needs to be carried out and a form filed for each company and LLC whether or not they lie within the scope of the regime.

The Cayman Islands has consistently been an early adopter of international regulatory initiatives and as such is fully compliant while remaining true to its raison d'etre: an easy place to do cross border business.

THE NEXT DECADE

In Preqin's *2018 Global Private Equity and Venture Capital Report*, Christopher Elvin stated: "While many in the industry anticipated 2017 would be another strong year for private equity fundraising, I suspect few would have predicted that 2017 would witness the largest amount of [aggregate] capital ($453 billion) raised in any year...2017 marked the fifth consecutive year in which private equity fundraising has surpassed $300 billion; even in the build-up to the GFC, only three consecutive years (2006-2008) saw fundraising surpass $300 billion."

Whilst it is true that the major private equity houses are able to raise larger funds more quickly, the excess of dry powder in the market can only keep valuations high. However, there is still value in the market which is why we continue to see large volumes of deal making. With value and deal-making opportunities in abundance, it is easy to notice an increase in new, smaller, nimbler funds. Our internal data showed, in 2017, an increase in mid-market fundraising activities. Whilst the behemoths of the industry will continue to attract headlines and execute prestigious deals, smaller funds will be able to focus on niche areas and provide excellent returns to their investors, benefiting the market by adding competition.

Over the past decade we have seen bears and bulls, and the next decade will undoubtedly be the same. We look forward to the next 10 years from a much sunnier platform than in 2008. ■

OFFSHORE VS ONSHORE: BLURRED BOUNDARIES

From a structuring perspective, the distinction between onshore and offshore has become more blurred as onshore considerations have led to the structuring of complex M&A transactions using multiple layers of Cayman Islands entities for acquisition financing and the facilitating of complex transactions.

The efficient and collaborative response of the Cayman Islands in introducing new legislation that dovetails with the requirements of an ever-evolving and fast-paced industry has positioned the Cayman Islands as a springboard for nimble and versatile structuring and the efficient execution of high value and market-leading transactions. ■

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