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Loeb Smith Attorneys

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Using a segregated portfolio company for private equity funds

Q&A with Gary Smith

Could you briefly explain the concept of the Segregated Portfolio Company?

Once registered under the Cayman Islands Companies Law, a segregated portfolio company ("SPC") can operate segregated portfolios ("SPs") with the benefit of statutory segregation of assets and liabilities between portfolios.

Under Cayman Companies Law, an SPC is an exempted company which has been registered as a segregated portfolio company. It has full capacity to undertake any object or purpose subject to any restrictions imposed on the SPC in its Memorandum of Association ("Memorandum"). The SPC is able to create one or more SPs in order to segregate the assets and liabilities of the SPC held within one SP from the assets and liabilities of the SPC held within another SP of the SPC.

The general assets and general liabilities of the SPC (i.e. assets and liabilities which cannot be properly attributed to a particular SP) are held within a separate general account rather than in any of the SP accounts.

This statutory requirement for an SPC to make a distinction between "segregated portfolio assets" (i.e. assets of the SPC designated or allocated for the account of a particular SP of the SPC) and general assets (i.e. assets of the SPC not designated or allocated for the account of any particular SP of the SPC) and similarly the distinction between "segregated portfolio liabilities" (i.e. liabilities of the SPC designated or allocated for the account of a particular SP) and general liabilities means that



Gary Smith, Partner in the Corporate and Investment Funds Group at Loeb Smith Attorneys

each SP should have, as appropriate, its own bank account, brokerage account, and other accounts to hold its assets to avoid co-mingling with the assets of other SPs and out of which liabilities can be satisfied.

It is the duty of the Directors of the SPC to establish and maintain (or cause to be established and maintained) procedures:

- to segregate, and keep segregated, portfolio assets separate and separately identifiable from general assets;
- to segregate, and keep segregated, portfolio assets of each SP separate and separately identifiable from segregated portfolio assets of any other SP; and
- to ensure that assets and liabilities are not transferred between SPs or between an SP and the general assets otherwise than at full value.

Who, historically, has tended to use SPC structures and what would you say one or two of the key benefits are to doing so?

In the investment funds context, SPCs have traditionally been used as a basis for investment platforms on which a Fund Manager can employ varying strategies and use different SPs to hold and segregate assets relating to such strategies (e.g. trading public securities, bonds and other debt instruments, and certain crypto currencies) on the same SPC platform.

The SPC structure is also frequently used for multi-class hedge funds, umbrella funds and master-feeder structures owing to the various benefits of the SPC structure.

What level of activity have you seen among fund managers using SPCs over the last couple of years and have you noticed growing interest among PE/RE managers?

One of the benefits of our firm having a strong investment funds' practice for clients in the United States and in Asia is that we get to see and to advise on developing trends for offshore funds and the Cayman corporate structures which are preferred for strategies in both geographical markets for funds.

While the SPC structure has been traditionally used in the manner described above, we have seen SPCs being used increasingly in Asia as the preferred structure for private equity funds, real estate funds, and certain other closed-ended funds that allow investors to participate entirely on a deal-by-deal basis.

The more typical approach for structuring a private equity (PE) or real estate (RE) fund in certain other geographical markets (e.g. the US, the UK) is the LP/GP structure where investors invest by acquiring interests in a limited partnership (LP) managed by a general partner (GP) and investors invest on a blind pool basis.

With this approach, the Fund Manager can attract institutional investors who are either not equipped or do not wish to review investments on a deal-by-deal basis and prefer to rely on the expertise of the Fund Manager or GP. Investors are effectively investing in a blind pool fund and do not have any clear indication at the time they make their investment of any of the underlying assets that the Fund will ultimately acquire. Trust is placed by investors on the reputation and ability of the GP or Fund Manager to source and execute unknown deals on terms that will lead to attractive returns over time.

The increasing use in Asia of the SPC structure for PE and RE funds allows the Fund Manager to create one or more SPs in order to segregate the assets and liabilities of each SP from the assets and liabilities of any other SP. The creation of the SP is straightforward and negates a large number of the requirements for setting up an entirely new exempted company for each new transaction to acquire a portfolio

asset. These SPC funds appear more likely to attract non-institutional high net worth investors who prefer overseeing each investment decision. The increasing use of the SPC in this way is, among other things, a result of there being less appetite from many non-institutional high net worth investors to invest on a blind pool basis.

What additional considerations or difficulties, if any, do private equity managers face when utilising the SPC structure to cater to investors' preference for a deal-by-deal approach?

First, with a typical GP/LP structure, GPs and Fund Managers will have some certainty as to how much investor capital is available for any given transaction. With such an SPC structure, which allows investors to invest on a deal-by-deal, the Fund Manager will not have existing contractual commitments from investors, or that can be drawn down at very short notice, and this can affect the ability of the Fund Manager to commit to underlying transactions in a timely manner.

Secondly, the uncertainty of how much investor capital is available, delays caused by investors' review and decision period and the need for possible joint venture participation can make it difficult for Fund Managers to bid for portfolio acquisition opportunities on time-sensitive transactions.

Thirdly, as all of the capital raised by each SP will often be used to fund the acquisition of the single underlying asset for which the SP was created, the management fees charged on the portfolio asset are often charged up-front at the launch of the SP as a percentage of the aggregate subscription proceeds and often several years' management fees are charged in advance. This deals with the issue of the SP not having access to cash to make monthly or quarterly management fee payments after acquisition of the portfolio asset.

Fourthly, some of our Fund Manager clients in Asia have used the deal-by-deal SPC fund as a springboard to subsequently launching a larger blind pool fund structured as LP/GP, thereby allowing themselves time to build a track record, build reputation, and importantly meet demands of investors by utilising Cayman fund structures. ■