Cayman Islands and Luxembourg Parallel Funds:

How to navigate structuring your next fund targeting European investors in this challenging fundraising environment?

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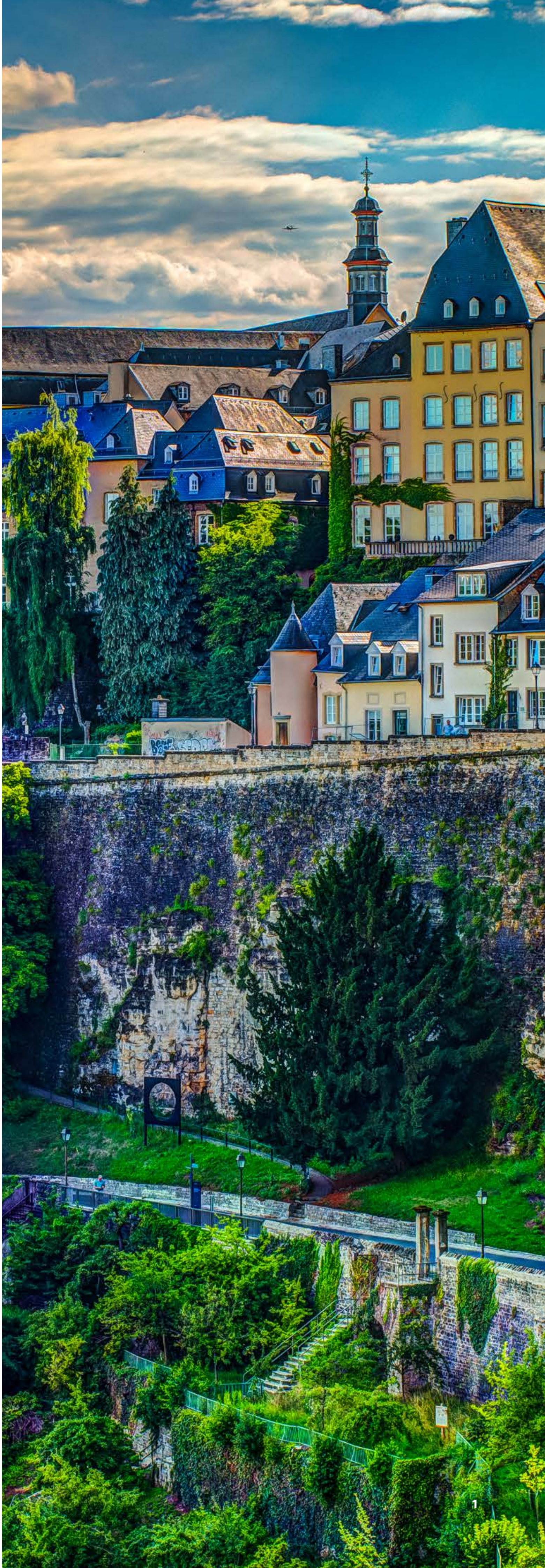
Introduction

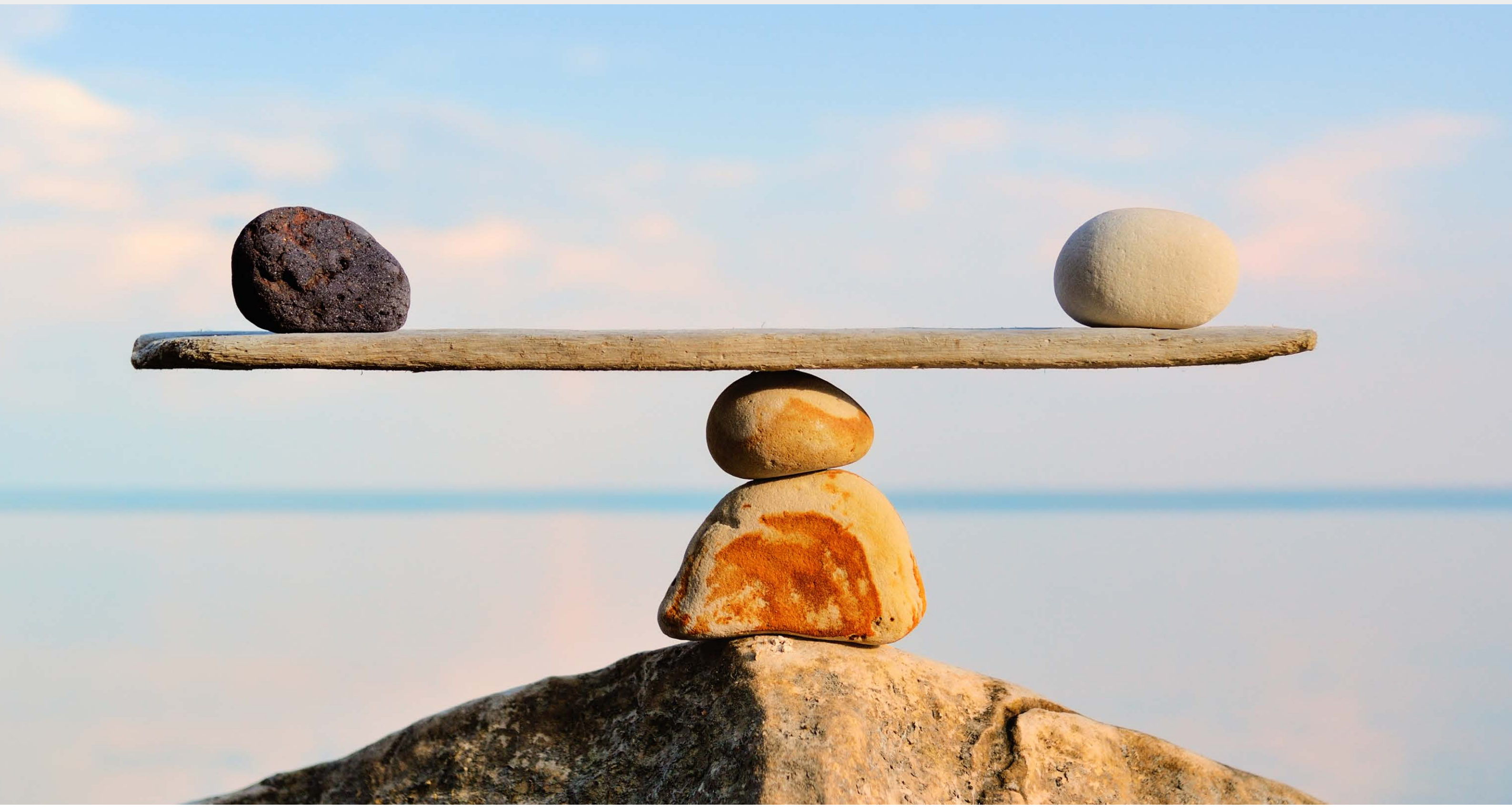
In recent years we have seen an increased interest in combined Cayman Islands and Luxembourg vehicles from Asian managers targeting both EU and Asian (and potentially US) investors for a particular investment strategy.

While Cayman remains the predominant "go-to" domicile for Asian managers raising funds through private placement, Luxembourg is an attractive choice when a more global offer, specifically including European investors, is considered. Of course, there is now an increasing array of leading domiciles on the scene for Asian managers to choose from, including Hong Kong, Singapore, Delaware and others depending on where their investors are located. However, when it comes to marketing in Europe, managers will often be looking for a jurisdiction that can take advantage of a marketing "passport" under Directive 2011/61/EU, better known as the Alternative Investment Fund Managers Directive (AIFMD).

In order to overcome regulatory, tax and other differences of jurisdictions where investors are themselves located, use of parallel fund structures may be the appropriate choice rather than a structure domiciled in one jurisdiction only. However, the benefits of opting for such a structure have to be weighed up against the additional costs and operational complexities of managing two funds based in different jurisdictions. The considerations for opting for such a structure are further explored below.



What is a parallel fund structure?



A parallel fund is a structure where two side-by-side funds invest and divest at the same time in a common portfolio of assets. The terms on which the parallel fund operates are similar to the terms of the main fund, which means that the parallel fund has a common investment policy and common asset targets to the main fund. Any differences between them tend to relate to regulatory or operational considerations.

According to Clare Chang, Managing Director of IQ-EQ Greater China, "US investors have historically been the major investor group for fund managers in Asia. Yet, as the global fundraising environment has become more difficult, we're seeing a trend of Asian managers reaching out to investors in other regions, such as Europe and the Middle East. Accordingly, we are helping more and more managers set up and administer parallel funds as EU structures are strongly preferred by investors in Europe."

Colin Sau, Managing Partner at TR Capital, mentioned that

"as a pioneering secondary fund manager in Asia, TR Capital already has significant experience managing parallel funds. Running such structures has many benefits, and one of the greater ones is giving their investors a preference on the jurisdiction they wish to invest in, which attracts a larger pool of potential investors".

Why opt for a Cayman-Luxembourg parallel fund structure?

Kate Hodson, partner in Ogier Hong Kong, explains: "It is all about creating a global offering. Sponsors striving to attract investors from multiple domiciles have to account for and manage the various concerns of different types of investors such as those mostly commonly associated with investors in the APAC region versus those in the EU, where the regulatory environments can be quite different. Using one or more parallel funds allows for each to be co-managed whilst targeting the same portfolio and meeting the different requirements of investors in these jurisdictions."

Anne-Gaëlle Delabye, partner in Ogier Luxembourg, adds: "Luxembourg and the Cayman Islands are well established funds jurisdictions, each dedicated to maintaining the highest global governance standards and, as such, are of interest to the institutional investors of APAC and EU. Luxembourg fund structures imply an additional regulatory overlay compared to their Cayman counterparts. This being said, the appointment of an authorised alternative investment fund manager (AIFM*) allows the use of the pan-European marketing passport to professional investors in Europe."

With a parallel fund structure using Cayman and Luxembourg fund structures, Asian investors can continue to invest in a Cayman Islands fund (carrying proportionately lower costs) given that they typically don't have the same restrictions as some EU investors may have from investing in a Cayman Islands vehicle.

*Article 4(1)(b) of Alternative Investment Fund Managers Directive 2011/61/EU

Typical Cayman and Luxembourg vehicles for closed ended funds

Cayman Exempted Limited Partnerships (ELPs) and Lux Special Limited Partnerships (SCSp) are flagship vehicles most commonly used for closed ended parallel fund structures as they not only offer the widest structuring flexibility, but also have similar functioning mechanics. The Luxembourg SCSp has comprehensive functionality and is appealing to investors who are accustomed to Anglo Saxon partnerships, such as Cayman partnerships. Both vehicles provide Asian managers with a tool that they are accustomed to from an operational standpoint (primarily through the flexibility offered by the limited partnership agreement).

According to Fèmy Mouftaou, Managing Director of IQ-EQ's AIFM offering in Luxembourg and France managers sometimes consider country-specific structures if their investors are more concentrated. For example, managers may prefer to set up funds domiciled in France if all investors are French. In general, for most managers, the SCSp is one of the most popular structures when it comes to parallel funds.

In terms of the range of structuring options available in Luxembourg it is also worth mentioning the Luxembourg Reserved Alternative Investment Fund (RAIF), a regime complementary to the SCSp, which enables setting up umbrella structure with segregated compartments, should the sponsor foresee to accommodate several investment strategies targeting different investor groups.

What makes Luxembourg attractive?

Stable, respected and well connected, Luxembourg stands tall as the preferred jurisdiction for fund sponsors seeking to access European capital.

- A leading global jurisdiction for the establishment of investment vehicles – Europe's premier investment fund centre and the second largest in the world
- Demonstrates one of the most solid track records of stability, with robust governance and regulation, an AAA credit rating, low levels of sovereign debt and one of the highest per capita GDPs globally
- Offers a flexible and varied corporate toolbox, providing a plethora of corporate/product options to sponsors – including sponsor-friendly partnership rules
- Provides sponsors access to the European passport for marketing purposes where the fund appoints an authorised AIFM
- Offers seamless, cost-efficient access to multiple investor bases (in Europe and globally) as well as tax transparency
- Significant flexibility around fund structure. No matter where investors or managers are based, they will find fund structures in Luxembourg that are familiar to them

What makes Cayman attractive?

Cayman is the natural choice for many Asian fund sponsors because of their familiarity with the jurisdiction and Cayman's favorable legal system.

- Familiarity with Asian investors and sponsors; no reinvention of the wheel
- A sophisticated and deeply entrenched fund ecosystem that makes this solution efficient from a time-to-market perspective
- Tax neutrality
- Flexibility of structuring options and a government that is reactive to industry requirements and embraces evolution within the industry
- Global governance standards – Cayman is dedicated to maintaining the highest global governance standards

Bram Eijsbouts, Chief Commercial Officer at IQ-EQ Luxembourg, explained that majority of clients who choose Cayman and Luxembourg as their fund jurisdictions do so mainly because of familiarity of regulations and their general recognition as preferred jurisdictions for investors. On top of that, a mature legal framework and sophisticated funds industry ecosystem make Luxembourg one of the most popular jurisdictions in Europe.

Legal and operational considerations for parallel structures

In terms of fund size, usually the whole structure is considered by aggregating the AUM of all funds to determine the overall size of the structure. The size of a main fund and its parallel funds may not be the same. For instance, the parallel fund may be larger than the main fund. Investors in the main and parallel funds may also (where appropriate) be aggregated to determine the voting rights of investors in the structure. The main fund and parallel fund remain separate legal entities, operated in different jurisdictions and yet are part of the same global asset pool.

In the context of parallel structures, we would flag the following points of attention when it comes to drafting the framework for parallel funds (as documented in the partnership agreements) and ongoing operational considerations:

1. Organizational costs
2. Timing of investments and dispositions
3. Allocation of co-investment opportunities
4. Differences in exit terms
5. Key persons
6. Organisation of governance structure to ensure effectiveness and efficiency
7. Capital call procedures and defaults
8. Aggregation of voting rights

To summarise: What are the benefits of a parallel fund structure?

Greater investor reach / customised solutions

- Offering a choice between onshore and offshore jurisdictions is likely to meet the needs of a greater range of investors and to provide them with a more customised solution

Scale

- A larger investment pool means that funds can more easily reach their target size and meet their investment objectives faster

Structure optimisation

- The parallel fund approach makes it possible to create ad-hoc structures in each jurisdiction to meet the needs of the specific investors targeted, rather than trying to find a 'one size fits all' structure

Internal tax/regulatory motives

- Certain investors may have internal guidelines or may be subject to a tax and/or regulatory regime that restricts their ability to invest in an offshore vehicle – marketing restrictions and permissions need to be considered
- In contrast to marketing a Cayman fund in the European Union, a parallel fund can be established in order to gain access to the EU-wide marketing passport thus circumventing the need to file and receive regulatory approval on a country-specific basis prior to commencing marketing. This puts the fund sponsor in control over the reach and timing of marketing

Flexible solution/similar strategy

- Parallel funds give investors the ability to choose the fund vehicle that will best suit their particular risk profile, regulatory requirements and tax appetite while ultimately remaining invested in the same target investments
- Parallel funds allow for segregation of jurisdiction-specific expenses. It is also possible to segregate certain regulatory costs. For instance, costs associated with the AIFMD can be restricted to the Luxembourg parallel fund with no correlative financial impact on the non-EU fund

Parallel fund structures represent a real structuring option in the funds industry, because of the customised solutions they offer potential investors and the possibility for fund sponsors establishing sizeable funds to reach a much larger investor base for any given investment strategy.

Derrick Chiu, Financial Controller at TR Capital, shared that

"greater investor reach and customized solutions are really the key benefits that we considered. However, Cayman and Luxembourg have very different sets of rules and regulations, which make the operational side a little more complex in terms of corporate governance, AML/KYC, taxation, etc. As a result, being able to partner with a service provider that can support both jurisdictions, like we have with IQ-EQ, is one of the key success factors in running our business."

IQ-EQ's Clare Chang notes: "Using a parallel fund can significantly benefit fundraising while maintaining a good balance on costs, but managers in Asia are often worried about having substance and applying for a fund management licence in Europe. By harnessing the capabilities of a service provider with strong teams in Asia and globally that can take full care of the operational running of parallel funds, managers can leverage their benefits while focusing on what they do best: creating value for investors."

Ogier's Anne-Gaëlle Delabye adds: "As they make it possible to meet the needs of specific investors on a targeted basis, parallel funds have a proven track record in terms of providing opportunities for agile fund sponsors to position themselves in a way to reconcile regulatory constraints, ultimately enabling them to expand their investor reach."

IQEQ

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