THE EMERGENCE OF SENIOR SHARES

MARC PARROTT, OF HARNEYS, REFLECTS ON RECENT DEVELOPMENTS WITHIN HONG KONG'S HEDGE FUND SPACE, AND THE INCREASING PREVALENCE OF SENIOR/JUNIOR SHARE CLASS STRUCTURES

Marc Parrott is a counsel in Harneys' Hong Kong office and specialises in all types of Cayman Islands and BVI investment funds, with particular emphasis on private equity funds and hedge funds. He is a funds industry veteran, having practised for several years in the Cayman Islands where he gained extensive offshore funds experience in advising leading asset management companies and private investment firms.

HFMWeek (HFM): **Have you recently seen any interesting developments in Hong Kong's hedge fund industry?**

Marc Parrott (MP): Yes, we have. While high-profile fund launches have been limited this year, due to fewer leading portfolio managers looking to spin-off from larger existing fund management houses, there has been a reasonable number of lower profile hedge fund launches. Many of these launches have been for Chinese onshore fund managers who have been successfully running onshore RMB funds in China, and who are now looking to grow their businesses by launching USD funds offshore to be marketed to Chinese mainland investors with existing offshore assets.

As a result of this target market for raising capital, over the last 18 months or so we have seen the emergence of share class structures that are based on a structure commonly used by Chinese onshore funds, namely the senior and subordinated share class structure.

HFM: **How does this structure work and what are the key reasons for its increasing prevalence?**

MP: In general terms, the fund typically issues a senior class of shares that are only entitled to a fixed return. If the overall returns of the fund during a particular period are insufficient to provide this fixed return to the senior class, a deduction is made from the net asset value attributable to the subordinated class, with this amount then being allocated to the net asset value attributable to the senior class to effectively guarantee the fixed return to the senior class. The quid pro quo for the subordinated shareholders is that, if the fund overall earns returns above the rate required to provide for the fixed return to the senior shares, the excess returns are allocated solely to the net asset value of the subordinated share class. This provides the equivalent of leveraged returns to the subordinated share class.

In most cases, there will be a requirement for the fund to maintain a certain ratio between the net asset value attributable to the senior and subordinated share classes. If this ratio moves beyond a specific level due to the deductions made to the net asset value attributable to the subordinated class and allocated to the net asset value attributable to the senior class, there will be limitations on the redemption of any subordinated shares, and there may be compulsory further subscription requirements for the holders of the subordinate shares to move this ratio back to an acceptable level.

The key reason for the increasing prevalence of this structure appears to me to be that there is a large segment of Chinese mainland investors who are very attracted to the concept of a fixed return, with the greater certainty of returns provided by the underwriting from the subordinated shares. This is very different to the types of investors typically investing in hedge funds in North America or Europe, who traditionally seek pure equity-like returns.

Accordingly, using share classes in this way is very novel in a hedge fund context, where different share classes have conventionally been limited to providing different fees, redemption terms or minimum subscription thresholds, for example.

HFM: **What variants of this structure have you been seeing?**

MP: We have been seeing quite a few variations. Obviously, the fixed return to the senior class shares varies from fund to fund. We have seen the "rebalancing" of the net asset values of the senior and subordinated shares being implemented over different time periods, such as monthly or quarterly. We have seen funds where, rather than merely accruing the fixed return to the net asset value of the senior class, it is actually paid out as a periodic distribution, sometimes semi-annually or annually. In addition, we have seen this structuring in different forms in both open-ended funds and closed-ended funds.

We have seen some managers exploring the possibility of taking the two-tiered structure above and expanding it to create three or more levels of "structured" returns.

We have even seen one manager explore the possibility of having two different segregated portfolios in a segregated portfolio company structure, where one of the segregated portfolios had share classes with returns that were supported by share classes in the other segregated portfolio.

HFM: **Do these structures create particular legal issues where careful consideration may be required?**

MP: There are a number of issues that need to be considered. Given such hedge fund structures are almost always domiciled in the Cayman Islands, managers should always be sure to have highly experienced Cayman Islands legal counsel working with them on these fund launches.

With any of these structures, there will be a need to carefully craft the share class rights into the memoran-

dum and articles. This will lead to more bespoke memorandum and articles than would typically be the case with more traditional hedge fund structures, where in order to preserve flexibility to create different share classes over time (including dealing with certain terms that may be agreed by side letters), the articles are often deliberately quite generic with the detailed share rights only specified in the private placement memorandum or offering document.

If the fixed return is paid out as a periodic distribution, rather than accruing to the net asset value of the senior class, then consideration needs to be given to the fact that, pursuant to principles of company law, a company may not be able to pay a distribution in certain circumstances where it does not have retained profits on its balance sheet.

In the case mentioned above of the manager who was exploring the possibility of having two different segregated portfolios in a segregated portfolio company structure, where one of the segregated portfolios had share classes with returns that were supported by share classes in the other segregated portfolio, there are additional legal considerations as a result of legislative requirements applicable to the transfer of assets between segregated portfolios of a segregated portfolio company.

HFM: Do you see any potential disadvantages in utilising this structure?

MP: When using any of these structures, there is a need to carefully craft the share class rights into the memorandum and articles as well as the private placement memorandum or offering document. Having been in this business since before the financial crisis, I know that many sets of fund documents drafted prior to that time were subjected to great scrutiny in arbitration and litigation as a result of the extreme circumstances caused by the crisis. Even those documents drafted by high-quality counsel have evolved, the prior wording having been refined following extreme scrutiny as was required in those circumstances.

Unfortunately, as these share class structures are still very new in an offshore context, we haven't yet had the benefit of putting these documents through a crisis to see what can go wrong. Of course I am not looking forward to the next crisis, but to look on the bright side, it will help in the evolution and refinement of these structures. In the interim, care needs to be taken to ensure that the documents contemplate to the fullest extent possible how the structuring is supposed to work in the event of liquidity and/or solvency issues with the fund. The intention should be to minimise the likelihood of circumstances arising in the future that have simply not be been considered at the time of drafting and which are not expressly dealt with in the documents.

Given the increasing demand from Chinese mainland investors, I am confident that investment into these structures will continue, as will their evolution and refinement.

> "THERE IS A LARGE SEGMENT OF CHINESE MAINLAND INVESTORS WHO ARE VERY ATTRACTED TO THE CONCEPT OF A FIXED RETURN"