Q&A - Luxembourg parallel structures: advantages, challenges and considerations

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Anne-Gaelle Delabye, a partner in Ogier's Luxembourg investment funds team, discusses the advantages, challenges and considerations to be made when setting up a Luxembourg parallel fund structure.

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Q: What is a parallel fund structure?

A: Parallel funds are those which co-invest and divest alongside the main fund. They co-invest and divest at the same time and on similar terms. This is on a pro-rata basis per their commitments, so a manager has two funds side by side which 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. This means that the parallel fund has a common investment policy, and common asset targets because they are investing in the same portfolio. The differences between them are mainly due to regulatory or operational reasons.

The size of a main fund and some of its parallel funds may not be the same. For instance, the parallel fund may be larger than the main fund and, in most cases, the AUM of all funds will be aggregated to determine the size of the overall structure. Investors in the main and parallel funds will also be aggregated to determine the voting rights of investors in the structure. This being said, what is quite complicated in a parallel fund is that the main and parallel fund are separate legal entities, and there will need to be a fine balance between the fact that different legal entities are being operated in different jurisdictions and yet these entities are part of the same global asset pool.

Q: Why are the Cayman/Luxembourg parallel funds structures generating such strong interest from US and Asian fund sponsors at this time?

A: When you're an initiator, you have to reconcile the concerns of different types of investors in different jurisdictions. You may need to structure a fund programme with one or more parallel funds which are co-managed by the initiator and that are targeting the same portfolio. Cayman is the natural choice for many US and Asian fund sponsors because they are used to this product and it's efficient from a time to market perspective.

When Asian or US sponsors want to reach European investors, Luxembourg (and in particular its limited partnerships) is considered as the EU equivalent in terms of comprehensible environment enabling the setup of flexible structures, and this is why parallel structures in these jurisdictions pair well together.

Another important point is that when you create a parallel structure, you enable investors to choose between an offshore and onshore jurisdiction, while maintaining the same investment policy.

Q: Why might this matter?

A: It might matter for several reasons: certain investors may have internal guidelines which restrict their ability to invest in an offshore vehicle, or there may be regulatory or tax implications arising from an investment in (either) vehicle. Having the choice between on- and offshore jurisdictions is likely to meet the needs of a greater range of investors.

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One of the products which is important is the Luxembourg limited partnership (LP). This product has comprehensive functionality and is appealing to investors who are accustomed to Anglo Saxon partnerships. It really offers the same flexibility in terms of structuring that is available in a Cayman or UK limited partnership.

The Luxembourg parallel also provides access to the European passport for marketing purposes if the fund appoints an authorised AIFM. Further, in the context of Brexit, some Asian and US managers based in the UK are now choosing Luxembourg as their European base, and we have seen a lot of movement since the Brexit vote result.

Q: What makes parallel structures appealing?

A: They are very flexible. A parallel structure gives a lot of options to investors (and ipso facto to the initiator). Investors have the ability to choose the fund vehicle that will best suit their particular risk profile, regulatory requirements, tax appetite and more -- all very helpful choices in practice.

To a certain extent, the parallel structure also helps overcome certain regulatory barriers. For example, the regulatory costs linked to AIFMD can be restricted in relation to the Luxembourg parallel fund with no financial impact on the non EU main fund ie it is possible to segregate certain regulatory costs.

In terms of efficiency of structure, a larger investment pool means that funds can be managed more efficiently, and has the potential to escalate the speed at which managers are able to meet their investment objectives. The use of multiple domiciles can result in optimisation of the structure. When you use several jurisdictions, you will meet the concerns of more investors, and when you have this form of global asset pooling structure, you will pool assets together and can also increase efficiency in terms of profitability.

Finally, the other notable Luxembourg structure is the RAIF – the reserved alternative investment fund. This is an unregulated product, and we say that it is a 'hybrid' product - it is indirectly regulated at the level of its manager. A RAIF is required to appoint an authorised AIFM, subject to supervision by the European supervisory authority of the AIFM. If the initiator wants to have a product in which they can have an umbrella structure, a RAIF is able to have segregated compartments, making it a good choice of vehicle if an initiator envisages several investment policies targeting different pools of investors.

Q: What are the main challenges of the set-up of Cayman/lux parallel structures in practice?

A: The operational component is a key challenge because when you operate multiple co-investing parallel funds with cross-jurisdictional vehicles, investors will still require equal treatment. In practice, this means that there will be an additional administrative burden and a lot of complexity to deal with. For instance, there may be different base currencies and different reporting obligations of the different vehicles to navigate.

In terms of expenses, it's also important to note that an adequate allocation of costs between the different funds in the structure will be required. You will also have to achieve a fair balance between the voting rights of different investors. Sometimes you may have to rebalance costs from one pool of assets to another, too.

Overall it's vital that the cost and expense allocation mechanism -- the voting rights, distribution waterfall, for instance - are modelled at the structuring stage of the fund to ensure that they will work effectively in practice.

The next challenge may relate to the delegation model. In the offshore world, the sponsor will usually be remediated through an advisory or management fee. This will be the same in a Luxembourg fund but if you, for example, have a Luxembourg fund that needs to appoint an external authorised AIFM to access the European passport, it will have a third-party service provider that will be included in the fee and delegation structure. This may make things difficult because you will need to carefully monitor the flow of fees within both structures, and the delegation structure in each fund may not be the same.

The final key challenge is sustainability. Due to the costs that the structure will generate, it may be a sustainability challenge for smaller funds. This also needs to be carefully studied at the structuring stage of the parallel structure.

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