SEGREGATION OF ASSETS AND LIABILITIES UNDER THE VARIABLE CAPITAL COMPANY FRAMEWORK

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Authors and Contributors: Bill Jamieson, Goh Wan Shuen and Neeti Relan.

Introduction

On 3 December 2019, the Singapore Academy of Law ("**SAL**") published two model constitutions on the Variable Capital Company ("**VCC**") framework, one for open ended funds and another for closed ended funds ("**Model Constitutions**").

Industry stakeholders and professionals have given their comments on an earlier draft of the published documents. The Model Constitutions thus capture practical aspects affecting the investment funds industry and serve as a useful starting point in fund documentation.

However, it should be noted that neither the Monetary Authority of Singapore ("**MAS**") nor the Accounting and Corporate Regulatory Authority of Singapore were involved in the drafting of the Model Constitutions.

One of the areas where the VCC represents an innovation in Singapore (although some other jurisdictions have already provided for a similar concept in their funds/company law) is the segregation of assets and liabilities of sub-funds within an umbrella VCC, which is a key tenet of the VCC framework.

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Segregation of assets and liabilities under the VCCA and the Model Constitutions

By way of background, the importance of ensuring segregation of assets and liabilities arises from the fact that each sub-fund does not have a separate legal personality from the umbrella VCC. The lack of a separate legal personality gives rise to the possibility that the liabilities of one sub-fund could be discharged out of the assets of another sub-fund.

To mitigate this risk, the VCCA provides for the segregation of assets and liabilities of sub-funds within an umbrella VCC. Under the VCCA, the assets of a sub-fund must not be used to discharge any liability of the umbrella VCC or any other sub-fund, including in the winding up of the VCC or any other sub-fund. Any liability of a sub-fund must be discharged solely out of the assets of that sub-fund, including in the winding up of the sub-fund. The segregation thus serves as a safeguard for the shareholders as well as creditors of the sub-fund.

The VCCA also contemplates that an umbrella VCC may allocate any assets or liabilities (i) that it holds or incurs on behalf of its sub-funds or in order to enable the operation of the sub-funds, and (ii) that are not attributable to any particular sub-fund, between its sub-funds in a manner that it considers fair to its shareholders.

Further, the VCCA provides that (i) it is implied in the constitution of every VCC that the VCC's assets and liabilities must be allocated to, and used to discharge the liabilities of each of its sub-funds in accordance with the VCCA, and (ii) the constitution of every VCC that consists of two or more sub-funds must state the fact that it consists of two or more sub-funds and state the VCC's policy for forming a sub-fund and allocating any assets and liabilities between the VCC's sub-funds.

The Model Constitutions are hence drafted to reflect these provisions. For instance, Regulation 12 of the Model Constitution for closed ended funds provides for the allocation of assets and liabilities between sub-funds as follows

> *"All Sub-Fund Assets and Sub-Fund Liabilities (including investments of a Sub-Fund, and all income, earnings, profits and proceeds from such investments, and liabilities and expenses relating to such investments) of a Sub-Fund shall be kept separate from all other monies, investments, assets, liabilities and expenses of the Company and any other Sub-Fund and in particular, in respect of each Sub-Fund —*
> *(1) the Company shall keep, for each Sub-Fund, separate books and records (in each case purely as an internal accounting matter) in which all transactions relating to such Sub-Fund shall be separately recorded and the Sub-Fund Assets and the Sub-Fund Liabilities and income and expenditure in respect of or attributable to such Sub-Fund shall be applied or charged to such Sub-Fund subject to this Constitution and the Act;*
> *(2) any asset derived from any Sub-Fund Asset (whether cash or otherwise) shall be applied in the books and records of the Company to the same Sub-Fund as the asset from which it was derived and any*

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> *increase or diminution in the value of such asset shall be applied to such Sub-Fund;*
> *(3) each Sub-Fund shall be charged with the liabilities, expenses, costs and charges of the Company in respect of or attributable to that Sub-Fund; and*
> *(4) any assets, liabilities or contingent liabilities held, received or incurred by the Company for the purpose of the Sub-Funds or in order to enable the operation of the Sub-Funds (in each case as determined by the Directors in their discretion) and which are not in respect of or attributable to any particular Sub-Fund may be allocated between the Sub-Funds, and may subsequently be reallocated, in such manner as the Directors may determine in their discretion to be fair to the Members of the Company."*

"Sub-Fund Asset" means an asset of the Company in respect of or attributable to or allocated or held by the Company for the purpose of a Sub-Fund.

"Sub-Fund Liability" means a liability of the Company in respect of or attributable to or allocated or incurred by the Company for the purpose of a Sub-Fund.

One comment that perhaps can be made on this drafting is to note that it uses defined terms that themselves already incorporate the notion that assets and liabilities may be allocated between more than one sub-fund. When the constitution provides "*All Sub-Fund Assets and Sub-Fund Liabilities (including investments of a Sub-Fund, and all income, earnings, profits and proceeds from such investments, and liabilities and expenses relating to such investments) of a Sub-Fund shall be kept separate from all other monies, investments, assets, liabilities and expenses of the Company and any other Sub-Fund"* there is buried within this statement the meaning that liabilities incurred on behalf of more than one sub-fund attributed to, say, Sub-Fund A must be kept separate from the share of the same liabilities attributed to, say, Sub-Fund B. One might ask in what sense are they separate? The answer is they are **legally** separate allocations of shared liabilities between the sub-funds.

Segregation of assets and liabilities in practice

Although the VCCA uses as the heading to section 29 *"Segregated assets and liabilities of sub-funds"* nowhere does the VCCA require assets or liabilities of sub-funds actually to be kept separate from each other. Of course one has to recognise that the intention behind the whole concept of segregation of assets and liabilities of a sub-fund is to facilitate the stated aim of the VCCA that the property of a sub-fund is subject to orders of a court as it would have been if the sub-fund were a separate legal person (and not the orders of a court in relation to any other sub-fund), which is why the VCCA requires the VCC to keep separate accounts of each sub-fund. In practice commingling of assets of more than one sub-fund might interfere with the ability to achieve that legal separation and separation of accounts.

As mentioned above, the VCCA provides that an umbrella VCC may attribute assets that it holds on behalf

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of its sub-funds or in order to enable the operation of the sub-funds, and that are not attributable to any particular sub-fund, between its sub-funds. This approach suggests that it is contemplated that the umbrella VCC will hold assets on behalf of its sub-funds and that it is intended that the umbrella VCC will be able to attribute these assets between its sub-funds.

Given the practical issues described above, it remains to be seen what these assets that the umbrella VCC will hold on behalf of its sub-funds may be. While the various consultation papers issued by the MAS on the VCC framework as well as the speech made at the Second Reading of the Variable Capital Companies Bill cite examples of liabilities of an umbrella VCC that are not attributable to a particular sub-fund, there are no corresponding examples of such assets.

Examples of the abovementioned liabilities include the cost of engaging service providers for the VCC (such as a fund manager, custodian, auditor and administrative agent), the cost of administrative functions such as the holding of general meetings and preparation of prospectuses, as well as rental expenses for the office building.

A related issue is whether the umbrella VCC will be able to attribute assets to itself, as opposed to attributing the assets between its sub-funds.

A respondent to the Consultation Paper on the Proposed Framework for Singapore Variable Capital Companies issued by the MAS on 23 March 2017 asked whether an umbrella VCC could attribute shares and assets to itself independently of any particular sub-fund. The MAS's response was that shares in an umbrella VCC would generally represent units of each sub-fund, except for those shares taken by a subscriber in order to incorporate the VCC. Accordingly, the MAS clarified that an umbrella VCC would not have shares attributed to itself independently of any sub-fund. However, there was no further clarification on whether an umbrella VCC may attribute assets to itself.

Another related issue is that, due to the lack of a separate legal personality of each sub-fund, sub-funds in an umbrella VCC will not have legal capacity to enter into agreements. An umbrella VCC will contract on behalf of each of its sub-funds, and will be required to set out the name of the sub-fund, its registration number and the fact that the assets and liabilities of the sub-fund are segregated in accordance with the VCCA. Although the VCCA does not seem expressly to contemplate an umbrella VCC entering into an agreement for more than one sub-fund, in practice it would seem necessary if a VCC were to contract for services for more than one sub-fund in the way described by the MAS.

Tiered structure VCC

One way in practice that may allow the umbrella VCC structure to be used to facilitate economies of scale in the dealings of a collection of segregated sub-funds while allowing some flexibility in the allocations between the strategies to be provided to investors is a tiered structure of umbrella VCCs as shown in the diagram below. The investors hold shares in the sub-funds in VCC1, which invest into the sub-funds in VCC2 in varying amounts. The VCC2 sub-funds allow for segregated dealings in the different asset classes

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being invested in (in this example, long equity, short equity and bonds). The VCC1 sub-funds allow for different allocations into the underlying investment strategies through variations in the amounts each of the VCC1 sub-funds holds in the VCC2 sub-funds.

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