Why the Introduction of Protected Cell Companies and Investment Limited Partnerships is Good News for Bahrain's Banking and Finance Sector

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While the role of the financial services sector in promoting growth in Bahrain may have been contested in the past, it is now widely recognised. A large and competitive financial services sector, together with liquid and active equity and debt capital markets that operate according to market principles and intermediating savings (domestic and foreign) for market-based investments, are strongly associated with higher growth rates.

This trend is being further encouraged by the series of reforms implemented by Bahrain in relation to its companies' law framework. A series of new laws and amendments to existing laws have been implemented over the past 12 months or so with the principal aim of promoting business in Bahrain and encouraging investors to choose Bahrain as their destination of choice when doing business in the Middle East. The most recent of these changes include the introduction of investment limited partnerships and protected cell companies.

This article provides an overview of these new types of legal entities, explains how they operate, and outlines the commercial advantages of these entities in relation to banking and finance services and products.

Protected Cell Companies ('PCC')

The Protected Cell Companies Law (Law No. 22 of 2016) ('PCC Law') was implemented on 13 October 2016 and introduced PCCs in Bahrain. This was a significant development in the area of corporate finance in Bahrain.

What is a PCC?

A PCC is a single legal entity made up of a core and one or more parts called 'cells'. Once incorporated a PCC can have unlimited cells. The cells do not have their own legal personality but do offer ring-fencing of assets and liabilities as described below. Accordingly, a PCC has one board of directors that manage the affairs of the PCC as a whole. PCCs are regulated by the CBB.

Purpose of a PCC

The purpose of a PCC is to provide a vehicle which can create cells, separate parts within which assets and liabilities can be segregated. This concept of 'ring-fencing' is fundamental to PCCs. The key principle is that the assets of a cell are only available to the creditors and shareholders of that particular cell. However, the PCC Law provides that the PCC shall be entitled to conclude an agreement with a third party whereby the third party has the right of recourse to the assets of the core for any liability that may arise from its transaction with any of the PCC's cells, in addition to the assets of the cell in question. As the PCC

Law is very recent, this provision is untested and its practical impact is unclear. Please see the diagram below for an illustration of how a PCC is structured.

Setting up a PCC

PCCs can either be a newly incorporated entity, or alternatively, an existing company can be converted to a PCC subject to CBB's approval. Since the PCC Law is fairly recent, it is unclear how efficient and straightforward the conversion option is and whether it is an attractive option where there is already an established company in Bahrain. There is no minimum capital requirement for the core or any cell; however, the CBB will determine the minimum capital requirement in each case.

Permitted activities for PCCs

PCCs cannot be used for ordinary trading activities. A PCC (and an investment limited partnership) may only undertake the following activities, namely:

- A private investment undertaking ('PIU'). A PIU is defined by the CBB as investment undertakings/funds that are registered with the CBB, and may be initiated by or offered to high net worth individuals or institutional investors, and impose a minimum initial investment/participatory interest of USD 3 million (or equivalent in any other currency);
- A collective investment undertaking ('CIU'). A CIU is defined by the CBB as undertakings
  - the sole object of which is the collective investment of capital raised from the public through private placement, including investments seeded by the operator in financial instruments, and other assets, and which operates on the basis of risk-spreading as appropriate; and
  - the holdings of which may be re-purchased or redeemed out of those undertakings' assets as appropriate;
- Securitisation. This is the process of taking an illiquid asset, or group of assets, and, through financial engineering, transforming them into security. An example of this is mortgage backed security;
- Insurance captives. A captive insurer is generally defined as an insurance company that is wholly owned and controlled by its insureds. Its primary purpose is to insure the risks of its owners, and its insureds benefit from the captive insurer's underwriting profits; and
- Any additional activities that may be later identified and added into the regulation by the CBB (collectively referred to as the 'Permitted Activities').

Illustration of a PCC's structure

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Potential practical applications of PCCs

1. Side by side portfolios

Herein, we examine a hypothetical where Bahrain Company A wishes to offer three distinct strategies (e.g., fixed Income, equity, and real estate) to investors. Each strategy entails a different level of risk. Bahrain Company A has two structuring possibilities, namely:

Option A: set up three separate funds. One fund dedicated for each strategy; or

Option B: set up a PCC in Bahrain – Bahrain Company Fund PCC.

The share capital of Bahrain Company Fund PCC is made up of shares of the following cells:

Cell	To Whom the Shares are Issued	Type of Investor
Core Cell	Investment Manager	Not Applicable
Fixed Income Cell	Risk Averse Investors	Fixed Income Instruments
Long Equity Cell	Medium Risk Taking Investors	Listed Equities
Long Short Cell	High Risk Taking Investors	Equities and Derivates

The potential comparative advantage between the two options are as follows:

- Option A clearly segregates the risks of each strategy. For example, it is not possible for any adverse exposure on the long short cell to affect investors of the fixed income cell.
- Option B is a cost efficient solution compared to option A as it avoids setting up and administering three separate entities. At the same time, it offers the same level of risk segregation as option A due to the ring fencing features of a PCC. As such, option B would likely be preferable.

2. Cost efficient asset holding

By way of another hypothetical, Middle East Asset Management Company ('MEAMC') advises a number of clients. From time to time, each client requires an investment holding company to hold specific assets and/or investments. In such a situation MEAMC has two options, namely:

- incorporate one investment holding company for each client and/or for each asset and/or investment; or
- incorporate a PCC where MEAMC holds the core cell's shares and each client is offered a cell to hold its assets and/or investments. Some clients may wish to have more than one cell to internally segregate the risk of each asset and/or investment.

Advantages of PCCs

Advantages of PCCs include cost savings and efficiency of managing certain risks. Permitted Activities (defined above) are particularly suited to the PCC structure because the vehicles required to undertake such activities (generally to set up a fund in Bahrain, (subject to CBB's approval), a corporate entity or a trust must be incorporated in Bahrain) tend to be costly to establish and operate, and so the benefit of replicating a structure through the PCC provides a clear commercial advantage.

The administrative benefits of a PCC are significant. Once a PCC structure is in place, repeat transactions can be established in a shorter timeframe. This is particularly attractive in projects such as CIU funds, where negotiating transaction documents can be a complex and lengthy process and where a successful initial structure will often lead to a demand for further, similar structures using the same key participants.

Such activities tend to have financially sophisticated creditors who are likely to understand the principles of ring fencing. In the case of investment funds, investors often want the ability to invest in a range of sub funds in the same umbrella structure or to switch their investment between sub funds.

Potentially a framework could be established that includes all of the participants in the structure, such as administrators, managers, investment managers, and custodians, and model agreements entered into governing the contractual roles of these participants. CBB approval is likely to be required in advance for the structure, and subsequently as new cells are added. The subsequent formalities may be reduced because the fundamental structure has already been agreed.

Where particular transactions are envisaged, for example, adding a fund to invest in a specific country or sector, or a new vehicle to acquire receivables in the course of a securitisation a cell may be created specifically to act in that defined role. In theory, if the functionary agreements are in agreed form and CBB approvals have been obtained with respect to the form of the transaction, a new cell can be added at lower costs and shorter time than would be required if the structure was to be established from scratch.

Disadvantages of PCCs

A potential disadvantage of PCCs is the limited pool of assets which is accessible for recourse to the creditors of a particular cell. Also, given that the PCC Law has recently been implemented and involves a relatively complicated concept of a new corporate entity (i.e. separate assets and liabilities), it is imperative that all parties involved understand how a PCC operates. More importantly, according to the PCC Law, prior to entering into a transaction with any party, the PCC must disclose to the other party that it is a PCC and the cell activity in relation to the transaction. If the PCC fails to make such disclosure, the transaction in question may be annulled at the request of the said party.

Investment Limited Partnerships ('ILP')

Partnerships under the Companies Law

Under the Commercial Companies Law, as amended by Law No. 50 of 2014 and Law No. 28 of 2015, ('Companies Law') two types of partnerships can be established, namely:

- General partnership company; and
- Limited partnership company.

The difference between the two types of partnerships is the liability of the partners.

In a general partnership company, the partners have unlimited liability for the debts of the company.

In a limited partnership company, the partners are divided into general and sleeping partners. General partners have unlimited liability, whereas the sleeping partners' liability is limited to the principal value of their shares. The general partners are responsible for the management of the company. The sleeping partners are prohibited from being involved in the management of the partnerships. If a sleeping partner breaches this provision, he/she may lose his/her limited liability and have unlimited liability for the debts of the partnership.

There are no restrictions on the activities that can be undertaken by these two types of partnership companies under the Companies Law.

ILP

The Law on Investment Limited Partnerships (Law No. 18 of 2016) was implemented on 4 August 2016 ('ILP Law'). An ILP can only undertake the Permitted Activities (which are exactly the same activities a PCC can undertake). An ILP is similar to a limited partnership company in that a general (defined as an 'Active Partner' in the ILP Law) partner's liability is unlimited and a sleeping (defined as a 'Dormant Partner' in the ILP Law) partner's liability is unlimited. ILPs are regulated by the CBB.

With partnership laws being well established in common law jurisdictions, such as London, New York, and Singapore, the ILP Law allows firms in and/or from such jurisdictions to operate in Bahrain within a legal framework with which they are familiar. The ILP Law also supports investment companies in establishing financial investment funds, and enables them to access new funding mechanisms.

Conclusion

The introduction of PCCs and ILPs are likely to enhance Bahrain's competitiveness in the financial services sector by making it easier to structure investment activities. It is hoped and anticipated that the flexibility under Bahrain law will allow continued innovation in relation to the use of PCCs. We hope that these changes boost Bahrain's position as a financial hub.