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Special Purpose Entities – the financial maze

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Abstract

There are hushed, awed tones whenever either of the SP – Special Purpose – words are mentioned, be it in courts, boardrooms or even in polite society. Ignorance, the author argues, could be key to explaining why these terms command such respect. Even those who know key buzzwords that Special Purpose – with 'Entity' or 'Vehicle' are attached have little clue as to significance, structure, applications, origins or even purpose. Their varied and often erratic assumptions spring from newsbreaks on financial scandals, US corporate excesses and occasional related suicides, with a vague vision of prison at the end of their musings.

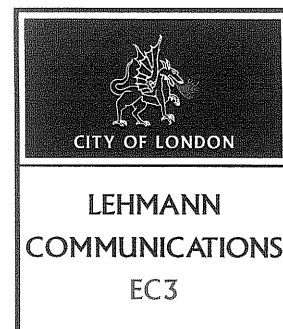
The core characteristics of SPEs the author explains are unlike orthodox trusts, companies and associations. As their very name implies, SPEs enter existence only to match individual and specific requirements, often in themselves idiosyncratic and temporary, and they vary infinitely.

Defining and examining Special Purpose Entities (SPEs) or Special Purpose Vehicles (SPVs) might bring in to play dry references to even drier textbooks, laws, and other conventions and devices which defy a rounded understanding of the more important yet simpler aspects of their natures. Perhaps the most interesting observation – and a cheeky one at that – is that most of the readers of this text are likely themselves to be originators and manipulators of SPEs. How? Why? What? A monstrous accusation: retract it or else ... The reasoning is this. You, the other readers, and I, are all people who have created and make regular use of special purpose structures (entities, vehicles; call them what you will) to help us find our way through the financial mazes and obstacles which are our daily life.

For example, picture the scene, a man has segregated his part-time earnings or unearned income in such a way that he can get away without paying tax or NI contributions on them: perhaps in an account named 'N.L.Malory' instead of 'N.L.Mallory'; or it may be at an address which is '15A, Acacia Avenue', whereas Mr Malory actually lives at 15 and knows that there isn't a 15A ... but he knows the postman will deliver the letters for 15A to 15, anyway. Amazing what these credit reference agencies do and don't come up with.

As another example, a woman has set up an additional credit card account in such a way that, when her main card statement shows she is overloaded or close to the limit, Ms Jackson can transfer balances between the two or charge a cash withdrawal to one and pay it into the other, and appease the administrators, if not her own conscience. The fact that she chose not to declare her first credit

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card when applying for the second appears to be neither here nor there – and of course they'll never find out, anyway.

A third fictitious example centres around a couple who have decided to build a nest-egg, a little bit extra for their pension, by running a clutch of small, buy-to-let flats. The mortgage for the first was based on accurate details. When it came to the uncomfortable questions, it was clearly convenient to open an extra account at the bank, or a new account at a different bank, transfer some of the savings of Mr Todd's mother to it, create some movement and supply some photocopied statements as a healthier proxy for the severely overdrafted genuine current account which the lenders were asking about ... and so on. Simpler than appeared to be the case. A lot of us have created and run our own SPEs without being aware that they are not far off a micro-version of what the papers were saying about Parmalat or WorldCom.

Paradoxically, it is this very simplicity, this instinct and this natural recourse in the face of need which ultimately explain the existence, the nature and the purpose of the SPVs and the SPEs which were visible in the apocalyptic rubble of Tyco, Enron and numerous others.

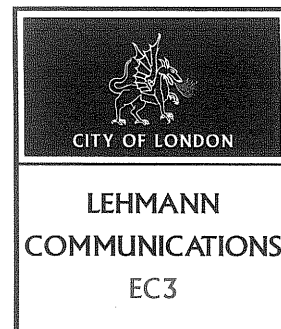
An initially moderate and plausible need to sideline cash, convince the accountant, build up a little bit extra for year-end, please the shareholder or reward the executives – all and any in small doses, of course – very easily develops in to a sustained policy of deceiving or depriving those with a right to know, to have and to hold: a way to stash profits and to vest debt. Initial ease and smoothness encourages higher risk, new objectives, more exciting expansion. Astonishingly rapidly, such facilities grow in to fully fledged entities and vehicles, which have to compound their deceit in order to remain intact and to sustain the lie.

A facility assumes the mantle of an SPE in the relevant sense of the term once it becomes a means intended deceptively to provide advantage, or limit or eliminate disadvantage. Confusingly, the words 'Special Purpose (Anything)' do not, in themselves, indicate illegality in the ways that the terms 'Scam', 'Fraud', 'Black Hole', 'Transfer Pricing', 'Off-balance sheet' or 'Accelerated Revenues' do.

Apart from the effects of the confusion itself, this ambiguity reminds one that 'special purpose' can, in theory, be a perfectly acceptable designation – so the duty of care and the burden of detection become commensurately greater where the vigilant professional is concerned. It is worth pointing out that the distinction between 'Entity' and 'Vehicle' is slight, at best. The best rule of thumb is that the former will generally be formed by an act of incorporation, by articles of some sort or by effect of charter, so forming a legal 'persona' (although inanimate, of course) in its own right. The latter is more likely to be used of an account, facility or concept which has no separate legal identity.

PRESS CUTTING

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SPEs have various common traits. First – the link to money laundering is almost automatic (indeed, money laundering laws have been developed partly as a way of detecting and discouraging the formation of SPEs). Second, the proliferation – or domino-effect procreation – of such entities is a typical effect of complex circumstances in which lies have to be compounded and expanded to retain theoretical credibility. Third, the seriousness of the circumstances expands to form a tsunami ripple which deteriorates in to downright crime and violence in no time. Fourth, the scale and complexity which such SPEs (they rarely come in ones and twos) commonly entail is noteworthy.

Add to Yukos the tails of woe from Parmalat, Tyco, Enron, WorldCom and others, the narratives woven around these have been exploited to the full by journalists and television interviewers, with lots more to come, in such a way that the entities are clearer to understand, and their nature, development, purpose – and, in many cases, destiny – become very clear. Before these names came Nick Leeson's '8888' account at Barings in Singapore. Even since that exploded in more ways than one, Singapore has done it again, with a recent comparable oil-related trading crisis involving unauthorized accounts in which 'bad trades' were hidden in increasing number. SPVs if ever there were any.

Just why do these entities exist, despite the lessons that are learnt and the risks that are run? Of the many eligible answers, three stick out by a mile: one, they can be set up without leaving a trail behind them; two, they are therefore, by definition, very hard to detect; three, they are very efficient in implementing their main functions of quiet concealment and – just occasionally – noisy masquerading. All three aspects merit exploration.

First, in a world where audit-trails are all the rage and becoming mandatory rather than optional features of running a business, those who have cause to establish an SPE will tend to ensure that not only do they not build up any audit trail linking the entity to others which it illicitly affects, but will also lay misleading trails or prevent any evidence of an original link or association from which an audit-trail might otherwise have been inferred. At the same time – and in order to give changes in that particular corporate landscape a chance to become familiar in the eye of the beholder, the auditor, the shareholder – those responsible for the existence of an SPE will typically ensure that it lies inert, or pursues normal business activities in a legitimate way, for as long as possible. The resulting familiarity and sense of well-being forms a more effective background against which gradually to convert the entity's activities to encompass those which will end up incriminate it if – when – it is found out.

Second, the natural malefactor will cover his trail and keep a low profile as a matter of course, a result of experience and in keeping with the instinct of self-preservation. In addition, an SPE will

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invariably be set up in a context which is detached from – often at odds with – the natural setting of the body which it 'serves'. Typically this is an offshore context – the names trip easily off one's pen: Bahamas, Barbados, Grand Cayman, Gibraltar, Turks and Caicos – hot, sandy, sunny places, also renown for low levels of regulatory supervision, requirements for incorporation and reporting, reciprocal agreements and obligations, favourable fiscal regimes. It goes without saying that the SPE will seek an environment in which the risks inherent in communication, reporting, declaring or responding are minimal or, preferably, non-existent, but can be satisfied, nevertheless, in a way which triggers no alarms or alerts.

Third, the key concept of efficient function – whether that degree of efficiency is enshrined in low profile and inertia or in noise and colour deliberately orchestrated to divert, distinguish or merely suggest otherwise – typifies an SPE. Such an entity is almost always the responsibility of experienced, trusted individuals, in the bosom, the pay or the confidence of the host entity.

Its function will be unremarkable, compatible with its surroundings and consistent in every way. It will not antagonize suppliers or break the local laws; will not incur debts; will renew its subscriptions and lodge its returns, and, even if it is designed passively and near-inertly to harbour off-balance sheet debt or build up profits siphoned-off from a high-tax regime or dividend-thirsty shareholders by way of managing a so-called investment fund, it will carry out its functions and duties perfectly. Typically the SPE falters not as a result of internal inefficiencies but because the controlling Godfather concern can't conduct its act without fudging the lines or missing the cues ... so 'An Inspector Calls'.

Description, definition and analysis lead on to the logical rejoinder, 'How can we detect the SPE, foil it, avoid it?' The answers could roll on for ages: there is no set solution or formula. The most effective and immediate foil to becoming the victim of SPEs is a perfectly balanced blend of animal instinct with human observation. Existence of a 'Special' in the background invariably leads a man to drive a car he can't afford, a lowly executive to own more houses than he can explain away, a company to declare earnings at variance with sector trends, or pensioners to complain that they keep receiving delayed payments. It should highlight the give-away security man who sorts the post and remarks that more and more letters seem to be coming from that place with the funny stamps ... and the Chief Executive who has golden shower curtains and taps in an apartment that isn't even his own.