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PREFACE

We are pleased to present the second edition of *Global Legal Insights – Fund Finance* at such an interesting time in the Fund Finance market. Cadwalader, Wickersham & Taft LLP is pleased to serve as the contributing editor.

2017 was a fascinating year for Fund Finance. Virtually every week, a new piece would come out from a major media outlet casting a sinister view of subscription credit facilities and the private equity fund sponsors that use them. Inflammatory headlines and factual misperceptions were the norm. The Institutional Limited Partners Association published their inaugural "Guidelines" – the talk of the market throughout the summer and fall. Even accounting behemoth PwC got into the fray. And yet, despite the constant headwinds, the market's resiliency continued. Bank portfolio growth continued its remarkable 15%+ year over year expansion. Credit performance remained perfect. The Fund Finance Association launched an inaugural conference in Asia with terrific attendance. Banks hired extensively and market participants got promoted – another truly fantastic year from a business perspective. How will this dichotomy evolve in 2018? Will the challenges finally have a tangible business impact? It seems a perfect time to hear from the market's legal thought leaders.

This book is designed to provide financial institutions, private equity fund sponsors, law firms and investors with a comprehensive review of the market and legal developments in the greater fund finance markets in a single volume. This book includes 18 product-oriented chapters, which are designed to provide an in-depth look at specific topics and product evolutions. It then follows with 20 jurisdiction-specific updates.

In producing this edition, we have gathered the views and opinions of the leading legal practitioners from around the world. The participating authors were asked to provide their views on the most important trends and recent developments in the subscription credit facility and related fund finance markets, in each case with more depth and specificity than in the 2017 edition. We think they delivered. We are thrilled with the quality of the submissions. A sincere thank you to all of the authors and their firms for their contributions.

My sincere thanks to Rory Smith and his tireless team at Global Legal Group Ltd. for supporting the Fund Finance market and publishing this edition. They are terrific to work with. Special thanks to Danyeale Chung, Associate at Cadwalader, for constantly keeping this book (and me generally) on schedule. Without her, I am not sure how anything would get done. I would love to improve future editions of this book. We encourage your comments and would be grateful for feedback.

Michael C. Mascia
Cadwalader, Wickersham & Taft LLP

INTRODUCTION

Dear Industry Colleagues,

On behalf of the Board of Directors of the Fund Finance Association (the "FFA"), I would like to thank and applaud Global Legal Group for their support and effort publishing this second edition of *Global Legal Insights – Fund Finance*. They have brought together the pre-eminent law firms across the globe, providing a virtual worldwide Fund Finance legal and market update in a single volume. The FFA was pleased to contribute to the publication and hope you find the edition helpful and interesting.

The invitation to participate in this publication was well received by the world's leading law firms which validates the continued growth and interest in the subscription credit facility and related Fund Finance markets worldwide. We thank all of the contributors for their time and expertise.

The FFA is a non-profit industry association supporting the fund finance markets. As part of our core mission, we strive to create educational events and information availability to market participants. This publication is well aligned with our mission.

Our next event is the 8th Annual Global Fund Finance Symposium on March 21, 2018 in New York City. We hope you can join us. For information on sponsorship or attendance, please email info@fundfinanceassociation.com or visit our website at www.fundfinanceassociation.com. We are also pleased to announce that the 2nd Annual Asia-Pacific Fund Finance Symposium will take place on June 13, 2018, at the Four Seasons in Hong Kong and the 4th Annual European Fund Finance Symposium will take place on October 24, 2018, at the Landmark Hotel in London.

The FFA is always looking for ways to improve and better serve the industry. If you have suggestions, please feel free to reach out to me or any other member of the Board of Directors.

Sincerely,

Jeff Johnston
Chairman, Fund Finance Association

Hybrid and asset-backed fund finance facilities

Leon Stephenson
Reed Smith LLP

Hybrid and asset-backed fund finance facilities

<u>Overview</u>

There has been substantial growth in the fund finance market over recent years, with more and more funds seeking subscription line or capital call facilities from lenders. Capital call or subscription line facilities are debt facilities provided by lenders to funds where the recourse of the lender is to the uncalled investor commitments of the fund. The bank will generally provide a short-term facility to the fund to effectively bridge the commitments of the investors of the fund. Therefore, the bank's credit risk is on the investors of the fund and their obligations to provide monies to the fund when called upon to do so. This requires detailed credit analysis by the bank on the creditworthiness of the investors they are effectively lending against, usually carried out by assigning each investor a rating together with an advance rate against each investor. Many banks have been and are still entering this market. With the rapid growth of these facilities, there have been substantial pressures on pricing as lenders compete between each other for this business.

More recently, there has been a significant growth in the market for net asset value (NAV) or asset-backed facilities. These are fund finance facilities provided by lenders to the fund or to a special purpose vehicle (SPV) owned by the fund, that are not secured against the undrawn investor commitments, but rather the underlying cash flow and distributions that flow up from the underlying portfolio investments. Therefore, lenders under these facilities are 'looking down' for recourse against the underlying investments rather than 'looking up' to the investor commitments. The credit analysis that is required to be undertaken by the banks for these types of facilities is very different from that needed for subscription line facilities. For pure asset-backed and NAV facilities, the creditworthiness of the investors of the fund is much less important than the value of the underlying assets. Nevertheless, these asset-backed facilities are still provided to the same fund managers who are also looking for subscription line facilities, and therefore this is an opportunity for lenders to widen the products they currently provide and to deepen the relationships they have with their fund clients. Providing asset-backed facilities can allow lenders to continue to provide liquidity lines to their clients, even when the investment period of a fund has terminated and there are no uncalled capital commitments remaining.

Types of fund utilising NAV and asset-backed fund finance facilities

There are a wide range of different funds focusing on different types of investments that may benefit from utilising such facilities. Secondary funds that acquire and hold limited

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partnership and other equity interests in funds can borrow from banks secured against the limited partnership interests that the secondary fund holds or is about to acquire.

Direct lending funds and credit funds that acquire and hold loans and other debt instruments may enter into such facilities and provide security over the benefit of the underlying loan portfolio.

Private equity firms which have a more illiquid portfolio of assets (perhaps only 10–20 investments in the portfolio) may also borrow from lenders, secured against the shares of the various holding companies that hold each investment. This provides liquidity to such funds outside the ring fence of the investment itself, that may have been provided as collateral for senior debt provided at the portfolio investment level.

The same facilities can be provided to other funds that focus on real estate and infrastructure assets, provided there are cashflows that are budgeted to be distributed to service interest and principal payable under such facilities.

Although very different types of funds may utilise these facilities and for different purposes, the key characteristics of these facilities are that they are generally provided at the fund level or directly below the fund level, and the primary source of repayment will be from the underlying assets.

The type of security a lender will take will depend on the structure of the relevant fund and the nature of its underlying investments. However, unless a hybrid structure, it is unlikely that the principal security given will be over uncalled capital commitments. It is much more likely to be security that allows the lender to control the underlying assets or distributions paid on such assets.

For secondary funds, it is important for a bank to ensure that it has direct rights to any distributions that are payable to the secondary fund from the limited partnership interest it holds. It may be commercially and legally difficult to get direct security over these limited partnership interests, so often security is just taken by the lender over the shares of an SPV entity that will be set up to hold all of the limited partnership interests the lender is lending against. The typical structure would involve the secondary fund first establishing an SPV vehicle. If the limited partnership interests have not yet been acquired by the secondary fund, then this SPV vehicle would directly acquire the various limited partnership interests. If the limited partnership interests are already held directly by the secondary fund, then the secondary fund will attempt to transfer all of the limited partnership interests to be financed into a new SPV vehicle. The lender will then lend directly to the SPV and take security over the shares of the SPV, and over any bank accounts of the SPV into which distributions from the underlying limited partnership interests are paid. On enforcement, the lender will take control of the SPV and enforce over the SPV's bank accounts so that it will be the sole beneficiary of any distributions that are paid up to the SPV.

For direct lending funds, the lenders will take security over the benefit of the underlying loan portfolio (not too dissimilar to the security that may be granted to a lender under a CLO warehousing facility). The lenders will analyse the underlying loan portfolio of the fund to establish what level of loan-to-value ratio it can provide. There will be eligibility criteria that will need to be met for a particular loan to be included in the asset pool that the lender is lending against. The eligibility criteria may require that the underlying loan is senior-secured, not subject to any default and is provided to a borrower located in a particular jurisdiction or geography. Furthermore, there may be certain borrower concentration limits applied to the collateral assets, so that no group of loans with the same borrower (or affiliate of borrowers) can exceed a certain percentage of the whole portfolio of collateral assets.

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Some lenders structure these facilities as a loan facility, others as a note purchase facility not too dissimilar to a securitisation structure. A lender may structure such facilities as a note purchase facility in order to facilitate its ability to sell down a portion of the debt to other noteholders who would like to participate.

Another important factor for loan-to-value ratio is the diversification of the underlying loan portfolio. Typically, the more diversified the loan portfolio, the more favourable the loan-to-value terms the borrower can expect to apply. Some lenders are able to provide facilities to a direct lending fund or one of its SPVs, secured against a single loan asset. In this instance, from an economic risk perspective, the credit fund is essentially sub-participating the relevant loan to the bank that is providing the fund finance. However, the loan-to-value ratios in these instances are likely to be very low and may be around the 5–15% range. A deeper due diligence analysis is normally required by the bank when lending against single loans, and the security package may need to be extensive to allow the bank to benefit directly from the security on the underlying loan if there is a default. This may require local security to be granted if there is security for the underlying loan, subject to different governing laws.

For private equity funds, lenders often take security over the shares in the relevant holding companies of the private equity fund that acquired the underlying investments. Usually, the lenders providing these facilities to private equity funds may be structurally subordinated to other lenders that have provided finance that is secured directly against the underlying portfolio companies. These facilities generally carry higher risk as the portfolio of assets is not as diversified as the facilities provided to direct lending funds with diversified and numerous assets. These types of facilities may also be known as 'holdco' loans and essentially amount to mezzanine financing. Providing financing to holdcos secured against the shares of the holdcos rather than the underlying assets of the portfolio companies means that the lender has less control over the assets of the portfolio assets, normally resulting in higher pricing of such loans. However, for many private equity funds that invest in emerging markets (such as Africa or Central and Eastern Europe), it may be difficult to obtain competitive financing locally against the assets of each portfolio company situated in such jurisdictions. Therefore, it is much more attractive to seek financing from lenders who are able to offer NAV facilities at the holding level, secured against cashflows of a number of portfolio companies, with the benefits that diversification provide. This is particularly interesting to lenders if the private equity fund has not put in place a lot of leverage at the portfolio company level.

Structure and terms

Unlike subscription line and capital call facilities which typically take the form of a revolving credit facility, NAV and Asset-Backed Fund Finance Facilities usually take the form of term loan facilities. If the facility is being provided to allow for a certain liquidity event or to bridge a particular exit of one of the investments, then the tenor may be quite short (e.g. six months to 18 months). However, if the fund is entering into the facility shortly following fund close as part of a leverage strategy, the facility will have a longer tenor, perhaps five years or more. The key covenant in such facilities is the loan-to-value covenant (LTV). This is the financial ratio of the amount of the financial indebtedness of the borrower against the net asset value of the portfolio that will be securing the facility. For credit funds and secondary funds, LTV ratios range from 10% to as high as 60%, depending on the diversification of the underlying assets. Such facilities may contain an "LTV grid" which allows the borrower to benefit from higher LTV ratios, and therefore a higher facility amount provided by the lender

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in the event that more assets are placed into the portfolio. Likewise, the interest rate payable on the facility may decrease, the more diversified the portfolio.

The eligibility criteria of the portfolio (i.e. the list of conditions that need to apply to the underlying assets for them to be eligible for the purposes of lending against them) will be often listed in a schedule to the facility agreement. The lender may also require a veto right on the acquisition of the assets, although there is usually strong push-back from the fund on this. The fund will argue that it alone should decide which assets can be purchased and, as long as such assets comply with the eligibility criteria, the fund should be allowed to select which assets will serve as collateral assets.

These term loans often have cash-sweep and amortisation features so that all or a portion of any distributions that are paid up to the borrower from the underlying investments go first to repay outstanding utilisations under the facility. The amount of such cash-sweep may vary depending on the LTV that exists at the point in time that such distribution is paid.

The security package is often negotiated quite hard between the lender and the borrower. It is likely that the underlying assets are located or subject to different governing laws and jurisdictions. The lender will certainly need an overriding security document (often governed by English or New York/Delaware law) that seeks to take security over all of the underlying assets. The lender may then require local security to be granted and local perfection of security to be undertaken. There will be a cost-benefit analysis at the start of the transaction to determine whether a full security package can be provided, and also a discussion about whether there are any contractual or legal restrictions on providing such security.

For facilities provided to secondary funds against their limited partnership interests, taking security over the underlying limited partnership interests usually requires the general partner of the underlying fund to provide its consent. As discussed previously in this chapter, the lender and the borrower may need to devise structures to avoid seeking this consent, or to make it more likely that consent will be given by general partners of the underlying funds. Generally, when seeking consent from general partners for security to be given for NAV facilities to secondary funds, four consents are required:

- consent to transfer the limited partnership interests from the secondary fund (if held directly by the secondary fund) into a wholly owned SPV located under the secondary fund;
- consent to the secondary fund granting security to the lender over the shares/interest it has in the SPV;
- consent to the lender enforcing its security over the shares/interest it holds; and
- consent to the lender selling the shares it owns post-enforcement to a third party.

In our experience some of these consents, if given by the general partners of the underlying funds, are likely to be conditional on items such as no adverse tax or regulatory consequences to the underlying fund, and also restrictions on the lender's ability to transfer its interest in the underlying fund to one of its competitors.

For facilities provided to direct lending and credit funds, the terms of the underlying loan agreements will need to be diligenced very carefully. The provisions relating to transfers and assignments of the loans (typically entitled "Changes to the Lenders") must be reviewed to see whether the underlying borrower has any consent or consultation rights prior to the fund transferring its loan to the lender on enforcement. In relation to facilities provided to private equity funds, if security has been granted over shares in a holding company

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that owns the underlying assets, it is important that no change of control provisions are triggered in senior facilities agreements or under material contracts entered into by the portfolio companies.

The lender will want to make sure there is tight security over the bank accounts into which the distributions from the underlying assets flow. More often than not, the lender will require a new account to be opened with itself, and require the borrower to direct that all distributions are paid into this account.

In some instances, lenders that are lending to a special purpose vehicle owned by the fund will require a guarantee or other shareholder support to be provided by the fund to further enhance the security for the asset-backed facility. However, lenders need to be careful and ensure that if this is the proposed structure, no borrowing limits of the fund are exceeded. Furthermore, if the fund has a subscription line facility, the terms of the subscription line finance documents will need to be reviewed to ensure there are no restrictions on other financial indebtedness and that there are no negative pledges included. There has been a recent trend for some asset-backed/NAV lenders requiring second-ranking security/recourse to the undrawn commitments of investors. If the fund has, or is intending to also have, a subscription line lender provide financing to the fund, this can give rise to detailed discussions on intercreditor arrangements, with the subscription line provider and asset-backed lender negotiating to get the strongest position possible with respect to the fund's assets. These intercreditor discussions focus on important issues like cross-defaults between the asset-backed facility and the subscription line facility, restrictions on payments going to and from the fund when there is a default under the asset-backed facility or the subscription line facility, and standstill periods during which one lender must wait until the other lender has decided whether to enforce.

There should be rigorous information requirements in the facility agreement so that the lender is made aware at any time of potential issues connected with the value of the underlying assets. The borrower may provide regular certificates confirming that financial covenants such as LTV ratios, leverage ratios and portfolio interest coverage ratios are met. There may be scheduled quarterly portfolio telephone calls between the borrower and the lender to discuss the performance of the collateral assets. Some lenders go further and require copies of management presentations, any rating agency reports delivered and financial information provided to the borrower in relation to the underlying assets.

These facilities typically have detailed provisions in relation to valuation of the underlying assets. A valuation agent will be appointed by the borrower (in agreement with the lender). The lender will usually want to make sure that the valuation agent owes a contractual duty to the lender (on a reliance basis) and this may be documented through a specific engagement letter with the valuation agent that is addressed to both the borrower and the lender, or through a separate reliance letter. The valuation agent will be required to provide periodic valuations (e.g. every quarter or, in some circumstances, every month) to the lender. There will also be times when the latest valuation will need to be used to determine a particular course of action under the facility agreement. For example, an LTV ratio may need to be determined prior to any acquisition or sale of an asset. Only if the LTV exceeds a given threshold will the relevant acquisition or sale of the collateral asset be permitted. In addition, there will usually be provisions in the facility agreement that allow the lender to seek an alternative valuation if the lender does not agree with the valuation provided by the valuation agent. The amount of deviation needed between the lender's calculation of the value of the portfolio and that of the valuation agent may be negotiated between the

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borrower and the lender before the lender has the right to instruct a separate valuation. Sometimes the valuation methodology is set out in a schedule to the facility agreement so that the borrower and the lender agree the principles and terms on which the underlying assets are valued. There will be further discussions between the lender and the borrower about who should bear the cost of the valuation, and in what circumstances.

Asset-backed facilities to hedge funds are structured very differently from those asset-backed funds facilities provided to closed-ended funds such as secondary, direct lending and private equity funds. The hedge fund often segregates the investments it wishes to use as collateral into separate securities accounts with a bank. The securities intermediary that holds the investments becomes the legal owner of the investments by signing the relevant subscription agreements of the hedge fund. However, the hedge fund remains the beneficial owner of the investments. The hedge fund then provides security over its entitlement or rights to the hedge fund investments, while the owner of the assets remains the same. This security can take the form of an account charge (if the account is in the UK) or a security agreement and control agreement (if the account is located in the US). This structure can avoid any restrictions on transfer that exist in respect of the underlying assets. If there is then a default under the facility agreement and the lender wants to be repaid, it can direct the account bank (as the case may be, in accordance with the control agreement or acknowledgment of the account charge signed by the account bank) to redeem the hedge fund interests, and for the proceeds once received to be paid over to the lender.

Some lenders are providing NAV facilities to debt funds that hold various debt instruments as portfolio assets. We have worked with lenders on structures that involve no direct security over the underlying assets but simply security over the bank account into which income or disposal proceeds from the underlying debt instruments are paid. The borrower then has an obligation to post cash margin, depending on the level of the NAV of the existing portfolio, to make sure there is a minimum level of cash available in the account over which the lender has security. This NAV facility structure is particularly helpful to funds that are regularly trading their debt instruments.

Key developments

There are an increasing number of new lenders that are entering this market, as the returns are generally higher than the returns available for subscription line and asset-backed facilities. These new entrants to the market are not only the existing banks that provide fund finance facilities, but also credit and special situations funds that are searching for sufficient yields. A perfect example of where this product can prove highly desirable to a private equity fund is when there is some sort of urgent liquidity required at the fund level but there are no imminent distributions from portfolio investments foreseeable. A fund may need to make distributions to its investors to, for example, ensure such investors can make new investments into the fund managers' new fund. The lenders of these facilities (that are often established as funds themselves) may provide interesting financing structures that allow them to provide capital by obtaining preferred priority distribution rights in the waterfall set out in the limited partnership agreement of funds. This allows financing to be made available other than by way of debt at the fund level. This can be an effective way of circumventing any borrowing restrictions of funds, and means that the finance provider effectively sits as preferred limited partner in the fund.

Therefore, having access to this liquidity can ensure fund managers continue to fundraise successfully. Alternatively, there may be a follow-on expense or investment needed to be

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made by the fund. If its investor commitments are fully drawn, the fund may have an urgent and pressing need for short-term liquidity until distributions come up from the investment portfolio.

Traditionally, NAV and asset-backed facilities were put in place during the later stages of the life funds, as a sort of "after care" liquidity line. This is due to the fact that these facilities generally lend themselves more to funds that have been fully or nearly fully invested and have assets to lend against. However, we are seeing some movement to funds looking to put in place NAV and asset-backed facilities at the start of the life of the fund, so that such facilities can be utilised as and when investments are brought into the portfolio. This trend is consistent with the general trend in the fund finance market for funds to be much more aware of the uses and benefits of fund finance facilities, and the desire to have the relevant financing structures in place from inception as part of the funds strategy.

On the direct lending side, it is important that leverage is applied to the fund by way of NAV or asset-backed facilities to ensure that the fund is producing the rates of return promised to its investors. The challenge then becomes making sure these facilities are provided at sufficiently low margins to ensure that they can enhance the internal rate of return (IRR) of the direct lending fund. The quality of the underlying loan assets and the security provided against such underlying loans is clearly an important factor in a financial institution determining what sort of pricing is offered for a NAV or asset-backed facility. Diversification is also very important, and so competitive pricing appears to be more available to larger senior secured direct lending and credit funds that have a large portfolio of loan assets.

There has also been some syndication of these NAV and asset-backed facilities. Pension funds and other non-bank investors who would typically invest in a fund as a limited partner, are also considering providing capital by way of fixed income by participating in these facilities. Typically a large investment bank would arrange the transaction, then go out to these non-bank lenders to sell down their participation in the loan. Investment banks are often keen on a distribution strategy that allows them to reduce their exposure, but at the same time continue to hold a majority portion of the loan and run the facility agency and security agency function. This allows the investment bank to continue to develop the relationship with the underlying fund while not being fully exposed to the facility.

There are other types of users of these facilities that seem to be active in the market including large LP investors such as sovereign wealth funds, family offices and funds of funds. These investors have a diversified pool of assets they hold (usually limited partnership interests in other funds) that can be used as collateral to secure financings provided by lenders. This provides such borrowers with liquidity if they need it without having to liquidate any of their underlying investments. Private wealth arms of investment banks, in particular, are looking to grow this business as it allows them to develop close relationships with key principals that are their current or potential clients.

Hybrid facilities

There has also been a substantial increase in 'hybrid' facilities. These are facilities provided by lenders that look down to the value of the underlying assets, but in almost all cases, there will be covenants that ensure that there is sufficient headroom of undrawn investor commitments. These facilities are particularly useful to funds that are looking for long-term financing facilities that are available from the fund's first close, until the end of the life of the fund when all of its commitments have been fully drawn down and the fund is

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fully invested. A lot of banks have found it challenging to make available such facilities. This is mainly because different parts of banks will have expertise with respect to analysis of investor commitments and the value of the underlying assets, respectively. However, some banks have been very successful in having their CLO teams and fund finance/financial institutions teams collaborate closely together to allow this offering to be put forward to their fund clients.

A hybrid facility provided by one lender may be very different to that provided by another. Some banks refer to a hybrid facility when actually it is in reality just a capital call or subscription line facility with a NAV covenant inserted and a looser financial covenant ratio of undrawn investor commitments to financial indebtedness. These facility agreements will be drafted as classic subscription line facilities but will have a NAV ratio that needs to be satisfied once the ratio of undrawn commitments to financial indebtedness reaches a certain level.

Other institutions have provided hybrid facilities when there is some sort of issue obtaining clean security over all of the relevant undrawn commitments of investors into the fund. For example, there are situations when a group of certain investors, for tax or other reasons, will invest in a fund through a separate feeder fund vehicle. In some instances, this feeder fund vehicle has not been set up by the manager of the fund and so the fund is not able to provide security over the rights of the feeder fund to draw down from the ultimate investors. To mitigate this imperfect security structure, lenders may, in addition to taking security over the rights of the fund to draw down from the feeder fund, take security over any shares in holding companies of the fund that own the assets. The lender may also take security over any intercompany loans or other receivables owed by the holding companies to the fund. This ensures that the lender can have the first right over any distributions or cash flows coming up from the underlying assets if there is a default by the fund.

We have seen the growth of hybrid facilities that are put in place when the fund is heavily invested but there are still some undrawn investor commitments remaining. The bank will provide financing against the underlying assets of the fund by way of term debt, but the fund may also need a working capital facility to finance fund expenses and follow-on investment. One of the structures we have put together involves a tranche A facility that is a revolving credit facility of a modest amount to finance the fund expenses, and a tranche B facility that is a term loan facility of longer duration. If the fund already has an existing subscription provider who provides a facility of a relatively small amount (due to a limited number of undrawn investor commitments remaining), then it may make sense to "take out" this subscription facility and replace it with the tranche A facility made available by a lender under the hybrid facility. This means that fund only needs to deal with one fund finance provider, which may have cost and execution benefits to the fund.

Some funds express the view that they would rather have a separate subscription line and NAV facility in place rather than a hybrid and that this is driven by cost. The challenge to lenders who would like to provide hybrids is to convey the benefits to the fund of certainty of funding from cradle to grave, and cost and execution benefits of having one single funds financing facility that provides both short-term and longer-term financing.

The year ahead

Significant continued growth in these types of facilities is expected over the coming years, as the demand from funds increases and the lenders' search for yield becomes more challenging. A low-interest-rate environment in the economy means that the pricing of these facilities continues to be attractive for funds. Direct lending and secondary funds are sophisticated

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investors that understand the benefits of leverage and financial engineering, and as more lenders come into this market, more facilities will be made available. Furthermore, the hybrid facilities seem to be a perfect way for lenders to develop strong relationships with funds and enables the lender to 'stay with them' from the start until the end of the fund life, increasing the chances of the lender picking up other ancillary business.

Asset-backed facilities secured against diversified loan portfolios are fast becoming another structural way of lenders providing financing against such portfolio, and then distributing risk to investors that would typically invest in securitisation structures. Provided that the asset-backed facility allows lenders to freely transfer their commitments, the asset-backed facility could an alternative to, and potentially simpler than, undertaking a full securitisation programme.

Finally, with the uncertainty surrounding Brexit and the general state of the global economy, funds may be turning increasingly to fixed income providers to ensure that such funds have the liquidity they need to manage their existing and future investment portfolios.

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Subscription line lending: Due diligence by the numbers

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Introduction

Financial institutions wishing to participate in subscription line lending must take a fundamental and systematic approach to the due diligence that is required to underwrite and consummate a lending facility for a private equity fund. After all, the foundation of subscription line lending is the strength of the commitment of the investors to fund their capital commitments when called. The diverse pool of investors is the secret sauce of the subscription lending credit, and determining the strengths and weaknesses in their obligations is the key to successful participation in these markets.

A lender's due diligence should have two broad focuses: credit and legal. A close working relationship between lender and counsel is critical to covering both of these bases; lenders will assess the overall credit quality of the mix of investors presented by the fund, and counsel will review the legal documents that make up its basket of collateral. If the contracts of the investors and the fund do not provide sufficient comfort that the obligations of the investors to the fund will be enforceable, the credit quality of the investor pool will be meaningless.

The due diligence review described below focuses on a standard subscription line facility. In the event that lenders and their fund customers are looking at a hybrid or NAV facility, the due diligence requirements will include those discussed below, but will expand into additional areas. For example, much more attention will be paid to the fund's investments. The required diligence will depend on the exact structure of the facility, and is beyond the scope of this article.

Step One of due diligence: Review organizational chart and other organizational documents

The organizational chart of the fund is the place to start the due diligence review. The fund structure will drive many of the decisions that lenders will make in structuring the credit facility. The options for fund structure are almost endless, and lenders should not assume that the next deal will look like the last one. The fund's purpose and investment strategy, the makeup of its investor pool, and various other issues will drive the structure. Lenders – and their counsel – need to know and understand fund structure at the outset, since it will impact the rest of the due diligence process, and influence the loan documents once the facility is approved.

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After reviewing the organizational chart, lenders should request the underlying documents for each key party on the chart.

The organizational and management documents of the various parties are among the most fundamental and important documents to review in connection with a subscription line facility. These documents include: the limited partnership agreement or other operating agreement of each fund (referred to here as the LPA); the organizational documents of the general partner and other obligors, such as alternate investment vehicles and qualified borrowers (the Obligor Organizational Documents); and any management or investment agreement, usually between the fund and an affiliated investment manager (the Management Agreement). Generally speaking, the LPA sets forth the relationship between the fund, the general partner and the investors; the Obligor Organizational Documents determine the authority and the ability of the general partner and the other obligors to enter into the facility; and the Management Agreement governs the interaction between the management company and the fund.

Many of the lenders' rights under a subscription line facility are derived from the provisions of the LPA, and lenders and their counsel must review and understand the provisions of the LPA in depth. As the subscription line financing market has matured, many fund-side private equity lawyers have updated their form LPAs to include provisions that lenders and their counsel require for a subscription line credit facility. Older LPA iterations, however, may either be silent on some of those items or, worse still, expressly limit certain rights or remedies lenders expect to have.

Ultimately, the interrelationship of the funds and the structure of the credit facility will determine which provisions of the LPA are particularly relevant, and lenders and their counsel should review the LPAs with an understanding of those items.

While an exhaustive analysis of the relevant LPA provisions is not possible (and counsel should be engaged to review the operative relevant documents), lenders and counsel should keep the following in mind while undertaking a review:

- **Separate LPAs.** Each fund, including each alternative investment vehicle and parallel fund, will have its own LPA. Typically, the LPA for a fund starts out as a short form that is used to establish the fund in its chosen state or jurisdiction. In connection with the first closing of investors into a fund, the LPA is typically amended and restated to include, among other things, specifics about the capital commitments, the capital call process, and the ability of the fund to enter into credit facilities and pledge fund assets, as well as specific provisions addressing concerns raised by investors. It is important to note that the LPA is a living document that likely will change with circumstances over the life of the fund, including future closings of investors into the fund.
- **Borrowing.** The LPA should clearly permit the fund to borrow (and, to the extent funds will be jointly and severally liable under the credit facility, guarantee the obligations of the other funds covered by the credit facility). The LPA may include limitations on borrowings, including on the amount a fund may borrow, on the amount of time borrowings may remain outstanding under a credit facility, and on the permissible use of the borrowings. Each of these provisions should be reviewed and a determination made as to whether the credit agreement should expressly reference these limitations.
- **Capital commitments.** The LPA should contain an irrevocable commitment of the investors to fund capital when called (subject to certain limitations that may be set forth in the LPA or other governing documents), expressly allow the fund (or the related general partner) to call capital to repay borrowings, to pledge the unfunded capital

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commitments of the fund's investors, to assign the right to make capital calls and to enforce the obligations of the fund's investors to fund their capital commitments. In situations where the LPA does not expressly permit this pledge and assignment, the fund should confirm to the lenders that the fund's counsel will give a clean legal opinion on these powers or, in the alternative, the lenders should determine if an amendment to the LPA may be necessary. If neither of those options is available, acknowledgments from the investors (especially the investors included in the borrowing base, if that is the intended loan structure) should be required whereby the investors acknowledge and consent to the pledge and assignment. Of course, if the LPA expressly prohibits the assignment of the rights of the fund and the general partner, the LPA will need to be amended to eliminate the prohibition.

- **Waiver of counterclaim, defences and setoffs.** Lenders and their counsel should review the LPA for a waiver of counterclaim, defences and setoff from the investors. The inclusion of this provision in the LPA (or in the subscription agreement, where it may also appear) gives additional comfort to the lender that an investor will not (or that a court will not permit an investor to) deduct amounts the investor believes it is owed by the fund from the investor's required capital contributions under the LPA and the subscription agreement.
- **Third-party beneficiary provisions.** LPAs typically contain a provision that expressly prohibits those not party to the LPA from having the benefit of the provisions of the LPA. Lenders and administrative agents should seek to have the lenders and agent under a credit facility carved out from that prohibition, so that they are third-party beneficiaries of the LPA. If the fund balks at such a broad carve-out, lenders should, at a minimum, seek modifications such that they are beneficiaries of the provisions governing the right to call capital, the right to enforce remedies against defaulting investors and the right to pledge assets to secure borrowings of the fund. Therefore, the lenders may enforce the provisions of the LPA independently in their own capacities, which would supplement the general partner's assignment to the lenders of its rights under the LPA (whereby the lenders step into the shoes of the general partner upon a default to exercise those rights).
- **Investment period.** Generally, LPAs contain an investment period, during which the fund and the general partner have the ability to call capital from the investors for certain purposes. The review of the provisions governing investment period should focus on when capital calls are permitted and for what purpose. A lender will want the right to call capital to repay fund indebtedness at all times, whether before or after the termination of the investment period. Some LPAs (whether because they are older-vintage LPAs or based on previous iterations of an LPA, or because of investor negotiation or otherwise) do not expressly permit capital calls to repay fund indebtedness after the expiration of the investment period, but instead permit capital calls only after the expiration of the investment period for follow-on investments, payment of fund expenses and for investments that have been committed to prior to the expiration of the investment period.
- **Investment period termination or suspension.** Lenders should review LPAs to determine in what circumstances their right to call capital or the investment period may be terminated. One provision that may impact the investment period is the so-called key man provision, which provides that the investment period may be terminated or suspended if certain named individuals are no longer involved in the day-to-day operations of the fund. While an investor vote may reactivate the investment period under the terms of the LPA, the agreement may also provide that, in the period prior to

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that vote, capital calls are permitted only to the extent they would be permissible after the expiration of the investment period. Lenders should determine whether the termination or suspension of the investment period should result in a default of the subscription line, a suspension of borrowing or some other limitation on the credit facility.

- **Excuse or exclusion provisions.** LPAs usually also contain excuse or exclusion provisions, which permit investors to be excused or excluded from making capital contributions for certain investments or in certain circumstances. Lenders should understand these excuse and exclusion provisions and account for them in the credit facility, including by ensuring that the capital commitments of the excused or excluded investors are not included in the relevant borrowing base.
- **Overcall provisions and percentage limitations.** LPAs may also contain overcall provisions, which limit the ability of the fund to call capital from its investors to cover shortfalls created by other investors' failure to fund their capital commitments when called. These provisions generally work in one of three ways: (1) a limitation based on a percentage of the original capital called from that investor; (2) a limitation based on a percentage of the capital commitment of the investor; or (3) a limitation based on the investor's *pro rata* share of the concentration limit of the fund in that investment. LPAs (or investors) may also limit the percentage of a fund's aggregate capital commitments or capital contributions that a single investor's capital commitment or capital contributions may comprise. For example, an investor's capital commitment may be limited to no more than 10% of a fund's aggregate capital commitments. Overcall and concentration limits restrict the ability of the lenders to seek capital on a fully joint and several basis among the investors, increasing the risk that an investor default may affect the lenders' ability to be fully repaid. Ultimately, the strength of the fund investors, the advance rates with respect to investors included in the borrowing base, and the number and aggregate commitments of the investors not included in the borrowing base, among other things, may help allay those concerns.
- **Remedies against investors.** LPAs should provide for strong remedies against investors that have failed to satisfy capital calls, in order to strongly deter investors from failing to fund capital, and also to provide a mechanism for addressing investor defaults.
- **Manager.** Finally, LPAs often permit the general partner to engage an investment manager (usually an affiliate) to source and advise on potential investments. The role of an investment manager may be substantially broader, however. Under the Management Agreement, the investment manager may be delegated or assigned the right to call capital from investors, pledge the assets of the fund, and exercise remedies against defaulting investors. Lenders and counsel should review any Management Agreement to understand the precise role and powers of the investment manager. If an investment manager has been delegated or assigned the rights of the general partner under the LPA, that entity should be included as a party under the applicable security agreement and, potentially, the credit agreement, in order to cover each entity or person that has rights in the collateral securing the subscription line call facility.

Next Step: Review investor subscription agreements and disclosures for material information about the investor and its investment in the fund

Subscription agreements are generally form agreements entered into by each investor in a fund. Typically, an investor will subscribe to a fund as a limited partner, although an investor may also subscribe as a member or other equity holder depending on the type

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of entity. No matter how an investor subscribes to a fund, the subscription agreement will provide key information regarding the investor, which a lender should confirm in its diligence review.

In addition, investors typically must fill out an investor qualification statement or other investor questionnaire, confirming that the investor is qualified under applicable laws to invest in the fund, and providing supplementary information and appropriate representations required by the sponsor. By executing a subscription agreement and providing investor disclosures, an investor is agreeing to its rights and obligations in a fund's LPA, and is making representations and warranties to the fund, including confirmation that it is qualified to invest in the fund. Lenders and counsel should review subscription agreements and investor disclosure documents for material information about the investor and its investment in the fund:

- **Legal name of the investor.** The legal name of the investor should be provided in the subscription agreement. Occasionally, investor lists provided by a fund manager include abbreviated names, which lenders should cross-check with the subscription agreement and confirm with the fund manager, to ensure the list is consistent with the subscription agreements. While a discrepancy may be the result of a typo or abbreviation, it may also reflect that the investor is actually a different party from the one expected by the lenders.
- **Capital commitment amounts.** The amount of capital committed by the investor is provided in the subscription agreement, and the list of investors provided by the fund manager typically indicates the total commitment pledged by each investor. This commitment amount on the list of investors should be verified by checking the investor's subscription agreement, and any discrepancies should be addressed by the fund manager.
- **Acceptance of pledges.** The general partner of the fund should expressly accept the capital commitment pledged by an investor, usually by countersignature to the subscription agreement. To that end, lenders and their counsel should ensure that they have copies of the fully executed and completed subscription agreements. Without general partner acceptance, the investor commitment may not be enforceable.
- **Parallel or feeder funds.** A fund may occasionally have parallel or feeder funds that may be parties to the credit being extended by a lender. A subscription agreement should identify to which fund the investor made its capital commitment. Sometimes, an investor may have more than one subscription agreement if it is investing in multiple funds that will be borrowers under a credit agreement.
- **Subscription agreement review.** Lenders and counsel should perform a general review of the subscription agreement to ensure that there are no provisions in the subscription agreement that may be adverse to a lender, such as any limits to an investor's obligations to fund its commitment. While many of these limitations are more often found in side letters (discussed below), they may seep into subscription agreements.

Remember to check for and review side letters

A side letter is an individual agreement between an investor and a fund that alters the general terms of the investor's investment in the fund by superseding some of the applicable terms in the LPA or subscription agreements, or by adding additional terms to the agreements and commitments between the fund and the investor. Certain investors require side letters because of regulatory or tax requirements that are specific to such investor. Other investors,

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particularly investors with large capital commitments, may request special economic or other benefits as a condition of their investment.

Due diligence review of side letter agreements should focus on terms that could adversely affect the lender's rights to payment under a credit facility with the fund. Terms in side letters that restrict an investor from funding, or that limit its obligations to fund, its capital commitment are of particular concern. The most commonly found provisions that could affect an investor's obligations to contribute its capital to a fund include:

- **MFN provisions.** Most Favoured Nation provisions specify that the fund agrees to give the investor the best terms it makes available to any other investor. Lenders should be certain to review all agreements to determine which side letters provide the most favourable terms and whether other side letters, as a result of their MFN provisions, automatically adopt the more favourable terms. MFN provisions will often specify exceptions or will limit their application. For example, they may: restrict the time that an investor has to adopt provisions from another side letter; provide that an investor must accept all provisions of a negotiated package of provisions; or limit adoption of certain terms of another investor's side letter that are specific to such investor's tax, legal, regulatory or policy requirements.
- **Capital commitment size.** Certain investors seek to maintain a minimum amount of voting power within a fund. To accommodate these investors' needs, side letters provide that the amount of an investor's total commitment will be determined by the total amount of capital commitments provided to the fund or in comparison with other large investors' capital commitments. Typically, the side letter will require that an investor's capital commitment be maintained no lower than a determined percentage of the total size of the fund, up to a certain amount.
- **Investment policy exceptions.** Different investors have policy considerations when committing capital to a fund, and will require side letters to memorialise these policy exceptions. Typically, but not exclusively, government pension funds will have state-specific restrictions on contributing capital for investments in companies that directly or indirectly do business with certain countries or certain industries that may be politically controversial. Other investors may have internal policies or other limitations regarding investments in which they may participate. These concerns can be addressed in the loan documentation by, among other things, providing for the exclusion of such investor's capital commitment from the borrowing base calculation for loan requests that are based on investments in such excepted investments.
- **Transfers to affiliates.** Most side letters will allow an investor to transfer its interests to its affiliates. These transfers are typically subject to the satisfaction of the general partner of the fund and the general partner's subsequent consent to the transfer, however. The transfer provisions will also typically provide that satisfaction by the general partner will be determined by, among other things, the general partner's reasonable determination that the affiliate transferee is financially capable of committing capital to the fund. Transfer provisions in the side letter may also accommodate circumstances in which state legislation may trigger the transfer provisions of the limited partnership agreement and, under such circumstances, deem the general partner to have consented to such transfer.
- **Sovereign immunity.** Government entities, such as public pensions and sovereign wealth funds, may have immunity from contract claims and other lawsuits unless they waive their immunity. Sovereign immunity provisions may provide for a waiver or may reserve the rights of such investors to waive their immunity. Some jurisdictions

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may not permit waivers of sovereign immunity except through legislation. Other jurisdictions waive sovereign immunity if an investor is engaging in "commercial acts". Lenders should be mindful of different jurisdictions' sovereign immunity laws and how they may affect an investor's obligations to contribute capital to a fund.

- **Pay-to-play.** As a response to corrupt practices in the use of placement agents in connection with governmental investors, state legislatures and other regulatory agencies have begun to restrict or ban the use of such placement agents to limit "pay-to-play" abuses that have resulted from their use. Pay-to-play schemes typically result in the payment to placement agents or other intermediaries by a fund to steer investors to the fund, which can sometimes violate laws or regulations, particularly when the investor is a government entity. Typically, side letters will provide a representation from the fund that it has not used a placement agent to obtain the investor's investment, and that no payments were made to any employee, affiliate or advisors of the investor to obtain an investment. Different jurisdictions will vary in the remedies available in the event of a pay-to-play violation, but these remedies could be as severe as providing the investor the right to cease making capital contributions.
- **Overcall and concentration limits.** Overcall provisions (discussed above in the context of LPAs) limit the amount an investor is obligated to fund to cure the shortfalls created by another investor's failure to fund its called capital commitment. Concentration limits restrict a single investor's total capital commitment or capital contribution to a percentage of the aggregate capital commitments or capital contributions of all investors. Like an overcall provision, a concentration limit could restrict a lender's expectations that the commitments of all investors are available to repay an extension of credit under a loan facility.
- **ERISA.** ERISA regulations restrict how much of an interest an employee retirement pension plan can own in any class of equity interests in a fund before the fund is considered a "plan asset" under ERISA. If the fund is a plan asset, the manager of the fund is deemed a fiduciary of each ERISA investor in the fund, which would require the fund manager to comply with additional regulations under ERISA that could significantly curtail its investment strategies. Investors may have provisions in side letters that provide them with the right to exit a fund in the event that the fund is deemed a plan asset.

Evaluate creditworthiness of investors and consider requesting guarantees from creditworthy affiliates, if appropriate

Lenders should confirm the credit ratings of each investor. On occasion, an investor in a fund may be an affiliate or subsidiary of a more creditworthy entity. If, after its diligence on the creditworthiness of the investor, a lender is concerned with the investor's ability to contribute its capital to the fund, the lender should request support from a more creditworthy affiliate, ideally in the form of a guarantee agreement that ensures that the more creditworthy affiliate will be obligated to contribute capital to a fund in the event its affiliate investor is unable to make the requisite contribution. Creditworthy entities may balk at these guarantees, however, and may agree only to provide comfort letters affirming the relationship of the entities to the investor or their acknowledgment of the investor's obligation. Jurisdictions differ on the enforceability of these letters, and a lender should consider whether (and to what extent) to include an investor in its borrowing base calculations, depending on the amount of support that its more creditworthy affiliate is willing to give.

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Additional due diligence: Review private placement memorandum, financial statements, SEC filings; conduct UCC and other searches

Lenders should consider reviewing other materials that can help assess a given fund's creditworthiness and enhance the credit and risk analysis of the underwriting process.

- **Offering or private placement memorandum.** While the offering or private placement memorandum is not executed by any investor in the fund and is not a source of any of the obligations, rights or privileges associated with an investor's investment in the fund, lenders will typically include a review of this memorandum as part of their initial due diligence because it provides a broad overview, in plainer language, of the fund's business, objectives, strategies and material terms. The memorandum, part of the marketing materials provided to potential investors, typically includes the fund's investment strategy and objectives; the past investment performance of the general partner or investment manager or advisor; a broader discussion of the fund's applicable market; the management structure of the fund; key and/or material terms of an investor's investment in the fund; risk factors associated with an investment in the fund; and certain legal and tax considerations for investors considering investing in the fund.
- **Financial statements and communications.** If the fund is already operating, lenders should review available financial statements of the fund and request copies of communications sent to investors. Similarly, once they provide a fund with a subscription credit facility, lenders commonly require that they be provided copies of all financial reporting and other communication provided to investors by the fund, general partner, investment manager or investment advisor.
- **SEC filings/other searches**
  - The Dodd-Frank Wall Street Reform and Consumer Protection Act obligates the manager or investment advisor of certain funds to make particular filings with the SEC, which are also a valuable source of information for lenders both before and during the term of a subscription facility. In particular, the SEC requires that fund managers register as investment advisors under the Investment Advisors Act, unless exempt from registration under either the private fund exemption or the venture capital fund exemption (both of which apply to domestic fund advisors). The private fund exemption is available to managers that manage only private funds (defined as having either 100 or fewer beneficial owners, or beneficial owners all of which are qualified purchasers) and that have no more than $150m under management in the United States. The venture capital fund exemption applies to funds that represent to their investors that they pursue a venture capital strategy and meet certain technical requirements.
  - Private fund managers and venture fund managers must file a Form ADV annually and are subject to SEC examination. The form includes extensive information regarding: the advisor; its business, business practices, personnel and clients; and the people whom it controls and who control it. In addition, the form requires disclosure of the disciplinary history of the advisor and its personnel for the previous 10 years.
  - *Uniform commercial code searches*. At an absolute minimum, lenders should order UCC searches from the applicable governmental authority in each jurisdiction in which a pledgor of the subscription facility's collateral is organised to confirm that there are no intervening liens on said collateral.

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- *Other information searches*. Lenders often will conduct searches of other public and governmental filings, databases, and records, including non-UCC lien searches (that is, tax and other liens), bankruptcy filings, judgment filings, litigation filings, PATRIOT Act filings, and certificates of status/standing and qualification to do business. These searches are all part of a comprehensive risk and credit analysis.

Request standard loan closing documents

In addition to reviewing the organizational documents of the fund and its agreements with its investors, lenders typically require that certain standard loan closing documentation be delivered in connection with any closing of a subscription credit facility. Very generally, these deliveries serve to confirm that the fund, and those of its affiliates that are party to the various loan documents, have the power and authority to enter into and perform under the documents, and that the documents have been duly authorized and executed. In particular, a lender will typically require:

- **a standard secretary's or closing certificate** by the fund and each applicable affiliate, which includes, among other things, resolutions and/or consents of the fund and the applicable affiliates, whereby the fund and its applicable affiliates are authorized to enter into the loan documents and perform thereunder;
- **copies of all the organizational documents of the fund** and the applicable affiliates, along with a representation and warranty that such organizational documents have not been modified or amended in any manner;
- **incumbency certificates** for each person who is authorized to execute the loan documents on behalf of the fund and its applicable affiliates;
- **opinions from counsel** to the applicable funds, general partners and other entities covered by the credit facility, covering, among other things, due authorization, execution and delivery and enforceability of the credit facility documents and perfected liens in the collateral securing the credit facility; and
- **certificates of good standing or status** from the applicable governmental authority in the fund's and applicable affiliates' respective jurisdictions of formation or organization.

Conclusion

As these summaries of the various due diligence tasks illustrate, subscription lending is a document-intensive endeavour. Lenders and their counsel look to build a complete structure of legal agreements to give lenders a clear path to realization of the underlying basis of their credit: the unfunded capital commitments of the fund's investors. While due diligence involves quite a bit of work, these facilities are so strong, and the credit so diverse, that no major subscription credit facility lender has had to enforce its rights in a default scenario. This is a testament to the inherent strength of this lending product. As long as lenders and counsel dot the i's and cross the t's in the due diligence process, it should stay that way.

* * *

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Derivatives at fund level

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Overview

This chapter considers a number of structural and documentary legal issues to be considered by a fund that is thinking about entering into derivative transactions at fund level. The observations made in this chapter are drawn from experience in the European fund finance and derivatives markets and are not tailored to any particular derivatives strategy.

This chapter does not provide detailed legal and regulatory analysis in relation to particular issues by reference to the laws of any particular jurisdiction. Any fund that intends to enter into derivatives at fund level should obtain legal and regulatory advice under the laws applicable to the proposed parties to the transaction and to the transaction itself, which should be tailored to the particular characteristics of the parties, the fund's constitutional documents and the circumstances of the transaction. The international nature of the funds and derivatives markets, and the growing tide of regulation in the derivatives space, means that increasingly this legal and regulatory advice will need to consider laws from multiple jurisdictions.

Introduction

There are a wide variety of reasons why a fund may consider entering into derivatives, but derivative use can generally be split between derivatives of a speculative nature used by a fund to target investment return, and derivatives of a hedging nature which are designed to protect against the economic impact of a particular risk faced by that fund.

Basic examples of risk that a fund may wish to mitigate with derivative use are foreign exchange (forex/FX) exposure (for example, covering the currency exposure for a USD fund that will be drawing USD amounts from investors to fund a particular investment that is denominated in GBP) and interest rate exposure (for example, covering the risk of an adverse movement in interest rates increasing the amount required to be paid on borrowings made by the fund). For some funds, FX and interest rate hedging will be all that the derivative strategy needs to cover. At the other end of the spectrum, funds that use derivatives in the active pursuit of investment return can be expected to enter into a wide array of sophisticated derivative instruments.

Sometimes a fund's exposure to a particular risk is indirect and it is more appropriate for the relevant derivative to be entered into below fund level. A common example in the private equity fund space is interest rate hedging for an acquisition finance facility. The buyer under the relevant acquisition transaction will be a vehicle set up by the fund to make the acquisition. It is this vehicle that would enter into any acquisition finance facility to assist in funding the acquisition. Consequently, it is this vehicle that is directly subject to any interest rate fluctuations on that facility; the fund is only indirectly exposed through

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its ownership of the vehicle. As such, it is this vehicle, not the fund that would enter into a derivative to hedge the interest exposure on the acquisition finance facility. The lenders under the acquisition finance facility expect to see this derivative in place, in the acquisition vehicle, as an important part of their protections against a payment default. They know that, if interest rates increase, their borrower will have the benefit of the derivative to help fund the increased interest payments that it owes to them. It would not make sense for the lenders if this derivative were entered into at the private equity fund level. The benefit of the derivative would be in the wrong place.

The legal issues considered in this chapter are potentially relevant in respect of any derivative use by a fund.

Potential advantages and disadvantages of entering into derivatives at fund level

Any fund deciding whether or not it should enter into derivatives at fund level will need to consider its specific circumstances carefully. In addition to legal considerations, it will want to understand the accounting treatment, regulatory consequences and tax impact of the derivatives. It will also want to consider the operational impact of the derivatives upon the fund.

Potential advantages of entering into derivatives at fund level

The primary benefit of entering into a derivative at fund level is, of course, that the fund will have the direct benefit of the derivative and the potential return, or risk protection, that the derivative provides. Where a particular risk directly affects a fund, it may not be commercially possible to hedge that risk at anywhere other than the fund level.

The fund may also be able to obtain better pricing for the relevant derivative by entering into it directly rather than via a fund-owned vehicle. The counterparty to the derivative may welcome the financial strength and risk profile of the fund, as that will enable it to enforce its rights directly against the fund.

The taxation treatment of the derivative may be better if the derivative is entered into at fund level rather than in an investment vehicle owned by the fund. This will depend upon the tax rules applicable to the structure.

Having an agreed derivatives platform (for example, having International Swaps & Derivatives Association (ISDA) Master Agreements and Schedules negotiated and signed with one or more counterparties) at fund level means that the fund can enter into multiple derivative transactions using the same centralised documents, rather than having the cost, complexity and delay of negotiating bespoke documentation – as would be required if each new derivative were instead to be entered into, on a case-by-case basis, by separate investment vehicles owned by the fund.

Potential disadvantages of entering into derivatives at fund level

There are possible disadvantages, however, for a fund in entering into derivatives directly. Although derivatives are entered into with the intention of increasing performance or mitigating risk, they often carry a downside exposure which the fund must manage.

The fund must monitor any permissions required under its constitutional documents to ensure that its use of derivatives does not fall outside its powers. This may be operationally burdensome, depending upon the scope of any such requirements. Permissions requirements are considered in more detail later in this chapter.

Additional operational burden may arise as a result of the increasing levels of international regulation of derivatives over recent years in response to the financial crisis – regimes

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such as the European Markets Infrastructure Regulation (EMIR) and the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) have seen significant obligations imposed on parties entering into derivatives to report on, and actively mitigate the risk of, their derivatives. Even more onerous are regulatory obligations to clear specified classes of derivatives through approved clearing houses, and to post assets as credit support (margin) in respect of specified classes of derivatives. A requirement to post margin pre-supposes that a fund can monitor and respond to margin requirements, which may be on a daily basis. Some funds do not have the treasury resource to manage such processes and many do not have ready access to the sorts of assets that can be posted as margin collateral (not least, those which would need to rely on calling unfunded commitments from their investors – which typically have a 10 business day notice period – to fund margin calls). Even for those funds that do have access to this kind of resource, the deployment of assets as margin may have an adverse impact upon fund returns, and this impact may be significant.

Consequently, careful analysis of any regulatory obligations needs to be made by any fund that is considering entering into derivatives. This is a complex and dynamic area. Good examples of the pace of regulatory change are the proposed amendments to EMIR that will broaden the definition of "Financial Counterparties" (parties that are in-scope for material obligations such as mandatory posting of variation margin) so that it will extend to a broader range of funds than is currently the case; and changes to EMIR to take physically-settled FX forwards entered into by funds outside the scope of the mandatory variation margin regime. Sometimes regulatory impact can be reduced by careful structuring of the derivative or by using an appropriate vehicle to enter into the trade. This needs to be assessed on the facts.

The use of derivatives at fund level also adds a layer of complication in relation to other fund-level transactional documentation. As analysed in more detail later in this chapter, a fund that is using leverage will need to consider carefully the interaction between its loan facility documentation and its derivatives documentation.

Some of these issues might be mitigated by entering into the trade via a separate vehicle established by the fund. Whether particular legal or regulatory obligations then apply will depend upon the particular rule sets and facts involved. However, the use of a separate vehicle itself brings potential structural complication, particularly if the derivatives counterparty is not satisfied that the vehicle alone represents an adequate covenant and therefore requires some level of recourse against the fund itself (for example, by way of a guarantee by the fund of the vehicle's obligations). The impact of any such recourse to the fund would need to be carefully considered.

Constitutional considerations when entering into derivatives at fund level

A fund that is considering entering into derivatives at fund level will need to ensure that it has the power and authority under its constitutional documentation to do so (taking into account any limits on quantum/type of its derivative exposure – which may be contained in side letters with its investors).

Optimally, the question of whether, and in what circumstances, the fund is entitled to enter into derivative transactions should be considered at the formation stage with any permission, together with any parameters around that permission, clearly addressed in the constitutional documentation when the fund is established.

<u>Constitutional limitations in relation to entering into derivative transactions</u>

An express prohibition on entering into derivatives in the constitutional documents is usually the end of the matter, unless there are clear commercial justifications for seeking

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an alternative method of authorisation, such as an express investor consent. Such express prohibitions are, however, relatively rare, although beware side letter provisions which may (deliberately or inadvertently) restrict the use of derivatives. More likely is that the constitutional documentation is silent on derivative use, which may create its own issues – particularly if the fund's legal counsel are required to give a capacity opinion on the fund's ability to enter into the derivatives documentation.

Examples of less terminal restrictions that may appear in fund constitutional documents are:

(a) *Prohibition from entering into speculative derivatives.* Here, the fund manager will need to consider carefully the nature of the derivatives to be entered into by the fund and whether, on a correct construction of the limitation language, they could be caught. For example, a derivative entered into to hedge interest rate exposure on a fund-level loan may not be speculative, as it is hedging a genuine risk faced by the fund. However, if the loan is repaid but the hedge remains outstanding (or if the nominal value hedged under the derivative is not reduced in line with repayments of the loan), then has the derivative become speculative? What if (as is the case with almost every subscription facility) the facility under which the loan has been drawn and repaid is revolving and it is likely that the facility will be redrawn? Similarly, if a derivative entered into at fund level is not hedging a risk to which the fund is directly exposed, but instead hedging a risk to which the fund is only indirectly exposed – for example, a risk to which an investee company is exposed – then would this alone cause the derivative to be categorised as speculative?

(b) *Limitation on wagering or gaming contracts.* This sort of limitation, sometimes seen in investor side letters, must be considered carefully on its terms. There could be an argument that derivatives, particularly those that are not simply hedging a risk to which the fund is directly exposed, may be characterised as wagers or gaming contracts.

(c) *Limitation on the level of financial indebtedness that the fund may incur.* If the constitutional documents contain limits upon the financial indebtedness that the fund is permitted to incur, then the fund will need to consider whether actual or contingent exposures under derivatives will constitute financial indebtedness and, if so, how the exposure under the derivatives will be valued for the purpose of modelling compliance with the relevant provisions.

<u>Constitutional limitations in relation to granting credit support for derivative transactions</u>

If the derivative transaction will require an element of credit support, whether by way of the posting of margin collateral or by way of the provision of a fund guarantee (if the derivative is being entered into by a fund vehicle), then the fund will need to ensure that giving that credit support is permitted under the fund's constitutional documentation:

(a) *Giving security.* Fund documentation will frequently circumscribe the fund's ability to grant security. This may be prohibited or limited by reference to either the value of collateral that may be posted or the assets over which security may be granted. There may also be limitations on giving security in respect of the liabilities of an investee company. The fund will need a clear understanding of how any such limitations operate and will need to design and monitor its derivatives usage to ensure that the limitations are not breached. The question of how any collateral is valued for this purpose is likely to be key.

    Security under derivative contracts may be effected in a number of ways, including by the creation of security interests over collateral (as under the 1995 ISDA Credit Support

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Deed (Security Interest – English law)) or by way of title transfer of collateral (as under the 1995 ISDA Credit Support Annex (Transfer – English law)).

(b) *Giving guarantees.* The fund may be required by a counterparty to guarantee the obligations of a fund-owned vehicle which has entered into derivative transactions. In these circumstances, the fund will need to consider whether its constitutional documents limit its ability to do so. A limitation could take the form of a direct limit on the giving of guarantees or, more commonly, it could be indirectly effected by including exposure under the relevant guarantee within another limitation (for example, a limitation on financial indebtedness).

If guarantees are so limited, then the fund will need to understand how the guarantee obligation is to be valued for the purpose of ensuring compliance with the limitation. For example, is the maximum contingent exposure used, or is the accounting value placed upon the guarantee used? The specific terms of the relevant constitutional provisions will need to be considered to answer these questions.

(c) *Giving indemnities.* Similarly to guarantees, the fund will need to consider whether its constitutional documents limit its ability to give indemnities in respect of derivatives and, if so, how the contingent liability under any such indemnity is to be valued for the purpose of the limitation. For example, indemnity language appears in the standard form 2002 ISDA Master Agreement.

<u>Constitutional limitations on the ability to draw investor commitments to meet derivative payments</u>

The fund will also need to consider what ongoing requirements there may be under the proposed derivative to make payments or to post collateral. The proposed source of any required cash or assets will need to be identified. If the fund wishes to use investors' uncalled commitments as a possible source, then the fund will need to confirm that commitments can be drawn down for this purpose. If the fund also has a subscription facility or other fund-level borrowing where the available facility is calculated by reference to uncalled commitments, the fund will also need to factor into its use of such a facility the effect of payments funded from undrawn commitments.

Other contractual permissions required for the fund to enter into derivatives at fund level

In addition to restrictions under its constitutional documents, a fund will need to consider the impact of any existing contractual restrictions to which the fund is subject – in particular, existing loan facilities.

The extent of any contractual restrictions will be a matter for the fund to determine by reference to the specific finance documents that it has in place. However, it is reasonable to assume that any fund-level loan facility will restrict the fund's ability to incur debt, give guarantees and grant security – subject to a relatively narrow suite of "permitteds" and a general permission "basket". This is now considered in more detail.

<u>Contractual limitations under fund finance facility documentation in relation to entering into derivative transactions</u>

Limitations commonly appear in fund finance documents that directly address the ability of the fund to enter into derivatives:

(a) *Restriction on entering into derivatives.* The underlying facility documentation should be reviewed for a restriction on entry into derivative transactions. Although a blanket

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ban is unlikely, other restrictions are more common, such as limits around speculative derivatives and around derivatives lasting beyond a maximum duration.

(b) *Restriction on incurring financial indebtedness.* Fund finance facility documents will invariably restrict the fund's ability to incur financial indebtedness. The exposure of the fund under derivative transactions will often be treated as financial indebtedness – whether it is, or is not, is a matter of interpretation of the particular finance document. If derivative exposure needs to be treated as financial indebtedness, then the next question is how the exposure should be measured. The common measure is the mark-to-market value of the derivative from time to time, but again this is a question of interpretation of the contractual provision (other valuation measures may include mark-to-model or the notional value of the derivative). A fund may be able to mitigate this risk by negotiating a sufficiently large permitted "basket" in the limitation to allow for anticipated fluctuations in derivative exposure. It may also be possible for the fund to protect against unexpected movements in derivative exposure by including terms in the derivative that cap the fund's maximum exposure under that derivative at a pre-agreed level.

<u>Contractual limitations under fund finance facility documentation in relation to granting credit support for a fund-level derivative</u>

Fund finance documents will also commonly contain provisions that limit the fund's ability to give credit support in relation to derivatives, so if the fund may need to post margin collateral or give any guarantee in respect of the proposed derivatives, then those provisions will need to be considered:

(a) *Giving security.* Fund finance documents will invariably include a negative pledge that limits the fund's ability to grant security. This restriction will certainly apply to security over the investors' uncalled commitments and any collateral or deposit account into which any investor commitments are paid when called, but it will usually apply to the creation of other security as well. The fund will need a clear understanding of how any such limitation operates.

A fund that may be required to enter into security arrangements in relation to derivatives should seek to include appropriate permissions in its fund finance documentation to allow this activity. Whilst a subscription lender, for example, is unlikely to entertain any suggestion that the fund be permitted to grant bilateral security over its investors' uncalled commitments, it may be prepared to allow the fund to enter into an ISDA Credit Support Annex as credit support for exposure under any permitted derivatives activity. It may also consider allowing a derivative counterparty to share in its security package where adjustments are made to the borrowing base to reflect the fund's exposure to that derivative counterparty. This is considered in more detail below. A NAV lender, on the other hand, is likely to be more resistant to such arrangements as it usually has to look to fund assets other than uncalled investor commitments – including cash which is upstreamed from portfolio companies – for repayment. Any such lender would generally expect cash distributions to be applied in repayment of its facility rather than being used to collateralise derivatives exposure.

(b) *Restriction on giving guarantees.* If the fund proposes to give a guarantee in relation to the derivative, then it will need to ascertain whether its finance documents limit its ability to do so. This could be by way of a direct limitation on the giving of guarantees, or an indirect limitation where another restriction is broad enough to apply to guarantees (such as guarantees being designated as financial indebtedness for the purposes of the limitation on financial indebtedness or for any leverage-style financial covenant). If

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so, the fund will need to understand how the guarantee will be valued for the purpose of the limitation. Equally, to the extent that it is commercially agreed that a derivative counterparty can share in the subscription lender's security package, the benefit of any guarantee given under the finance documents may extend to that derivative counterparty. In each case, the specific terms of the relevant finance documents will need to be considered.

(c) *Restriction on giving indemnities.* As with guarantees, careful thought must be given as to whether indemnities are limited directly or indirectly through any other limitation (such as a limitation on financial indebtedness) and if so, how the indemnity liability is to be valued for this purpose.

(d) *Priority arrangements.* As a precondition to the fund successfully negotiating permissions under its finance documents for the fund to enter into derivatives (and any related security or guarantees), the finance documents may require that the derivative counterparty joins into a priority agreement that regulates the relative ranking of the rights of the lenders under their loans and of the derivative counterparty under the derivative. Such priority arrangements are, however, rarely seen – probably because subscription lenders are prepared to rely on their security over the investors' uncalled commitments (and may not allow a derivatives counterparty to take bilateral security – second ranking (noting the conceptual difficulties under English law with second ranking assignments) or otherwise – over those uncalled commitments) and NAV and other lenders at the fund level would satisfy themselves that any such exposure was limited by ensuring that any baskets permitting such activities were relatively low. To the extent that a derivative counterparty is permitted to share in a lender's security package, which is considered in more detail below, this can usually be dealt with by including some relatively simple intercreditor-style provisions in the facility agreement.

A shared security package between a fund's lenders and its hedge counterparties

If a fund wishes to enter into derivatives on a secured basis – for example, to take advantage of cheaper pricing – it may find that its lenders are prepared to share their security package with the derivatives counterparties. The security package would be granted in favour of a security agent, which holds that security on trust for both the lenders and the derivatives counterparties. The benefit of any guarantee granted in favour of the lenders under the facility documents would also be extended to the derivatives counterparties. The lenders may be more likely to agree to such an arrangement if the derivatives counterparties which are entitled to share in the security package are also lenders (or affiliates of lenders) under the fund's facility.

Typically, the facility documents would contain a mechanic which allows the fund to allocate a portion of its borrowing base to either (i) a specified hedging transaction which is designated by the fund as a secured hedging transaction or (ii) any hedging transaction entered into under a specified hedging agreement which is designated by the fund as a secured hedging agreement. As any secured hedging transactions are documented under separate derivatives documentation – and do not therefore constitute utilisations of the debt facility – lenders would expect the aggregate amount of the borrowing base which can be allocated to all secured hedging transactions to be capped. Otherwise, the risk for the lenders is that a substantial proportion of the borrowing base is used for secured hedging transactions, resulting in a significant reduction in the lenders' income from the debt facility.

The onus is on the fund to allocate a sufficient portion of the borrowing base to the secured hedging transaction or transactions under a secured hedging agreement. In determining

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how much to allocate, the fund will need to balance the need for headroom (to take account of potential mark-to-market fluctuations) with the fact that any headroom will (further) reduce the borrowing base for the purposes of its debt facility.

If the fund's exposure under a secured hedging transaction or series of secured hedging transactions exceeds the amount of borrowing base allocated to that transaction or series of transactions, it would typically be required to: (i) increase the amount of borrowing base allocated to that transaction (or series of transactions); (ii) post collateral for the excess (on a bilateral basis in favour of the derivatives counterparty); or (iii) close out transactions to eliminate the excess. Option (i) assumes, of course, both that the fund has capacity within its borrowing base to do so and that by doing so it would not exceed the overall cap on the amount of its borrowing base which can be allocated to secured hedging transactions. Option (ii) requires careful analysis of where the relevant collateral will be sourced from and the impact of applying that collateral for that purpose. From the lenders' perspective, it is critical to ensure that any claims of a derivatives counterparty under a secured transaction (or series of transactions) which are in excess of the borrowing base allocated to that transaction (or series of transactions) rank behind those of the lenders. The relevant derivatives counterparty should only rank *pari passu* with the lenders to the extent its claim is equal to or less than the borrowing base allocated to its trade or series of trades.

Further issues to consider under fund finance documents in relation to the fund entering into derivatives

There are a number of other potential points of interaction between a fund's debt facility documents and its derivative documents. These need to be considered by reference to the terms of the relevant documents, but common issues are:

(a) *Cross-default.* The fund should be live to any provision under the fund finance documents that will trigger an event of default under the fund finance documents if default occurs under the derivative documents. It is potentially explosive if, for example, a minor breach of a technical nature under the fund's derivative documentation, which is not a concern for the derivative counterparty, nevertheless triggers an event of default under the fund finance documents – potentially resulting in the loss of the fund facility. This is exacerbated by the standard form nature of the events of default under ISDA documentation – there may not be opportunity to negotiate the events of default so that they match the relevant triggers under the fund's debt facility.

If the fund has to give such a cross-default trigger under its debt facility, the fund should seek to include language in the clause to mitigate its effect – for example, by limiting triggers to material breaches only (like a payment default); to breaches in respect of exposure in excess of an agreed threshold amount; to actual events of default rather than just potential events of default; or to events of default in respect of which the derivative counterparty actually takes enforcement action.

(b) *Financial covenants.* The fund will also need to consider the impact of any derivatives on the financial covenants (if any) contained in its fund facility. Whilst a pure subscription facility is unlikely to be preoccupied with anything other than uncalled commitments cover, NAV facilities (for example) are likely to contain a more comprehensive suite of covenants. When negotiating its fund finance documents, the fund should seek to tailor the terms of any financial covenant definitions and ratios so that anticipated derivative use does not erode headroom and, as the fund moves through its life cycle, the financial covenants do not inappropriately dictate the fund's derivative strategy.

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Derivative use may impact upon a number of financial covenants:

1. *Uncalled commitments cover.* This financial covenant measures the level of financial indebtedness incurred by the fund against the quantum of its uncalled commitments. As noted above, the fund will need to understand to what extent derivative exposure (including any related guarantee) is included within financial indebtedness for the purpose of this covenant and how that exposure is measured.
2. *Interest cover.* This financial covenant, often seen in NAV facilities, measures the level of finance charges that the fund must pay under its financial indebtedness against net cashflow generated by its portfolio of investments. The fund will need to determine to what extent payments and other charges on its derivatives will constitute finance charges for the purpose of assessing compliance with the covenant.
3. *Loan to value.* This financial covenant, usually found in NAV or other "aftercare" facilities, compares the level of financial indebtedness to fund NAV. The fund will need to identify the extent to which the derivatives will either need to be included in the financial indebtedness calculation or will impact upon the NAV figure for the purpose of this covenant. Impact on NAV is more likely in circumstances where the derivatives have been taken out below fund level.

(c) *Availability of subscription facility.* The use of derivatives may impact upon the availability of a subscription facility (or other debt facility where the facility limit is dictated by the level of uncalled commitments). This is because the terms of the debt facility may require that – when calculating the borrowing base – the uncalled commitments are reduced by the amount of any derivative liabilities (and any guarantee given in relation to derivatives).

More generally, if the fund proposes to use the subscription facility to fund payments, or to source collateral under its derivatives, then the fund will need to ensure that the subscription facility allows such use.

Issues to consider under the derivatives documentation

The fund will need to negotiate its derivatives documentation by reference to its own circumstances and needs. Among the matters that the fund should consider are:

(a) *Recourse.* The fund will want to ensure that its derivative documents reflect the correct separation of liability and recourse across its fund structure.

(b) *Cross-default.* The fund should carefully consider the extent to which a default under its fund finance documents could give rise to a termination right under its derivatives (for example, under paragraph 5(a)(vi) (Cross-Default) of the 2002 ISDA Master Agreement). The fund should seek to include language to mitigate the effect of any such trigger.

(c) *Additional termination events.* Derivative counterparties will sometimes seek to include additional termination events (ATEs) in their derivative documents, where their counterparty is a fund that can have serious repercussions for that fund:

1. *Uncalled commitments cover.* This termination event is triggered if the financial indebtedness of the fund exceeds an agreed ratio of the fund's uncalled capital commitments. Borrowings under any fund level facility will almost always fall within the definition of financial indebtedness.

   The problem with this ATE is that a reduction in the fund's uncalled capital commitments is by no means necessarily a sign that it is in financial difficulty. Indeed, funds will be positively seeking to draw down investor commitments

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in order to invest them! A focus on uncalled commitments makes sense in the context of a subscription facility, but careful consideration is required when such provisions appear in derivative documentation. For example, where commitments have been invested, it may be appropriate for a component of fund NAV to be counted in the test in place of the deployed commitments, similar to the mechanics used in hybrid fund finance facilities.

2. *NAV floor*. This termination event is triggered if the fund NAV drops below a particular level. The problem with this ATE is that a successful fund expects to reduce its NAV as it realises assets and returns value to investors. Conversely, "zombie" funds which continue well beyond their scheduled termination date, or which are not being actively managed, may not trigger this ATE. Any trigger based on a NAV floor means that the fund should not plan to have derivative transactions outstanding with the relevant counterparty significantly beyond the point where it expects to enter into the realisation and distribution phase.

   In crude terms, whilst the need for derivatives may reduce as the fund's life cycle moves to the realisation and distribution phase, it often does not disappear entirely. If a particular counterparty refuses to agree to there being appropriate flexibility in the NAV floor trigger (for example, a step down following the realisation of assets in line with the fund's strategy), the fund would want access to one or more alternative counterparties who do not insist on a NAV floor trigger that would prevent derivative use towards the end of the fund's cycle.

3. *NAV movement*. This termination event is triggered if the fund's NAV decreases by more than prescribed amounts (or percentages) over particular periods. This trigger is difficult for a fund if it has not been calibrated to deal with expected NAV movements – particularly where it is seeking to return cash to investors during the realisation and distribution phase, or where it wishes to "flip" an asset early in its investment period (which could trigger a dramatic decrease in NAV if it is the only, or one of a handful of, investments made by the fund at that date). The fund should seek to mitigate any such trigger appropriately (for example, adjusting the trigger movement thresholds to reflect different stages of the fund's life; adding back distributions to investors which remain eligible for recall; or applying the trigger only to decreases that have a material adverse effect upon the fund's ability to perform its payment obligations under the relevant instrument).

(d) *Use of collateral*. In addition to the issues relating to collateral highlighted above, funds should note that to the extent the fund is required by regulation to post collateral in respect of its derivatives, it may not be possible for the fund to control the amount and frequency of collateral by setting large transfer threshold amounts and minimum transfer amounts. The ability of funds to use such mechanisms is increasingly limited by derivatives regulation such as EMIR.

Conclusion

Any fund that is thinking about the use of derivatives at fund level needs to consider its position very carefully. Although the analysis for any particular fund is fact-specific, the points discussed above are recurrent issues that it would be helpful for any fund to bear in mind when carrying out its assessment.

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Charlie is recommended by *The Legal 500 UK* for his work in Acquisition Finance and Bank Lending and is a key member of the sponsor, lender and borrower facing teams at Travers Smith which are highly ranked in *Chambers & Partners UK*.
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One size does not fit all:

Subscription facilities as a global financing tool for investment funds of various types

Jan Sysel, Jons F. Lehmann & Sabreena Khalid
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Introduction

The subscription line facility has become a significant and useful financing tool for numerous investment funds not just in the U.S., but globally. Borrowers utilise subscription line facilities in a variety of ways, ranging from short-term borrowings that bridge liquidity needs between investor capital calls, and/or delay or avoid making frequent capital calls on the one hand, to long-term leverage, which may potentially influence the fund investors' return profile, on the other hand.

As the number, variety and complexity of investment funds have grown, subscription line facilities have adapted to the changing landscape, with fund sponsors and lenders working together to develop financing solutions designed to address the evolving needs of fund borrowers and their investors. The subscription facility market today is a robust and sophisticated one, which affords borrowers effective and efficient access to capital in a low-interest environment. The product is no longer limited to its original roots in the U.S. real estate space, but is implemented by funds investing across the full range of asset classes, as well as gaining increasing popularity geographically, both in the European market (and the UK, in particular) and additional jurisdictions, including Asia and others. This article looks at the breadth of types of subscription financings currently in the marketplace by examining aspects of facilities for various kinds of investment funds in the U.S. and UK markets.

Background – Understanding subscription facilities

Subscription line facilities are effectively a form of "asset-based lending", where the ability to borrow is determined principally by reference to the value of certain eligible assets that the borrower (or a related entity) provides as collateral for its loan and which count towards the "borrowing base" against which a bank will advance loans. A subscription line facility's collateral package is anchored by the commitments of the fund's investors that have not yet been funded and is thus typically secured by way of a pledge by the borrower/fund of: (i) the unfunded capital commitments of the investors; (ii) the right to make capital calls from investors, and receive proceeds of such capital calls in the form of contributions; (iii) the bank accounts into which the capital contributions are funded; and (iv) certain rights related

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to the foregoing (including the right to enforce against such investors) and the documentation evidencing the same (including subscription agreements of the investors and organisational documents of the fund).

From an underwriting perspective, lenders scrutinise the investor base of the fund/borrower and the legal relationship between the investors and the fund/borrower, because the collateral for a subscription facility is intrinsically tied to the ability of the investors to make capital contributions. After determining the basic composition of investors who will form the borrowing base of the subscription line facility, the parties typically discuss appropriate advance rates and applicable concentration limits. Advance rates are the basic measure of the amount of credit a lender will advance against a particular investor's commitment. While advance rates generally depend upon a relatively standard convention of investors being classified as either an "included investor" (usually institutional investors with certain rating and/or of sufficient financial strength) or a "designated investor" (other investors meeting certain criteria) and typically fall within a commonly accepted market range for each of those investor categories, there are other potential approaches (and it should be noted that a segment of the U.S. market functions on the basis of a "simplified" borrowing base with a "flat" advance rate against an aggregate investor pool that generally encompasses all of a fund's investors). Concentration limits present a further refinement of how the overall borrowing base credit is distributed among various classes of investors, and are generally determined based upon the makeup of a particular fund's investor base. Lenders often look to reduce risk through diversification and thus aim to calibrate the classes of investors within the borrowing base in order to achieve a level of diversity and ensure that, from their perspective, a disproportionate amount is not advanced against any investor of a particular class, either individually or in the aggregate for such class.

From a legal perspective, close attention by sponsors and lenders alike needs to be paid to the organisational documents of the fund/borrower, which (within the statutory framework applicable to the particular fund/borrower entity in question) set forth the contractual obligation of the investors to fund capital if and when called. A lender's diligence is mainly concerned with its ability to enforce its rights over the collateral package (i.e., the unfunded capital commitments and the ability to call capital), which is one of the most significant factors for determining the legal structure of a subscription line facility. Typically, lenders' counsel will need to review the formation and operating documents of the borrower (and any other entities that will be pledging collateral as part of the subscription line facility) and the related agreements between each investor and such entities, including the subscription documents and side letters, if any.

As a starting matter, lenders are looking for provisions authorising the borrower (and, more specifically, the general partner, manager or other controlling person) to, without further consent or action by the investors, incur debt and grant liens, including granting a pledge of the investors' capital commitments (including, if applicable in more complex structures, on a cross-collateralised basis). Further, lenders typically require comfort in the form of language that evidences an absolute obligation for investors to fund capital contributions without setoff, counterclaim or defence (including bankruptcy) and certain other "borrowing provisions" and acknowledgments by the investors that relate to the ability of the borrower (and potentially, should the borrower ever default on the subscription facility, the lender) to call capital both during and after the investment period in order to repay the borrower's debt under the subscription facility.

Given the importance of the organisational documents, lenders are sensitive to amendments

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of any provisions thereof that would impact their collateral or related rights, and so funds/borrowers are often required to, at minimum, notify the lender of such changes and/or obtain consent for such amendments that would adversely affect a lender. Accordingly, many fund sponsors, with assistance from counsel, now incorporate the appropriate provisions into their organisational and offering documents. Additionally, in some cases, lenders may seek to also have investors enter into consent letters with lenders, which address the pertinent issues and establish direct privity of contract between such investors and the lender. We will address certain situations in which obtaining such letters may be beneficial for structuring the subscription facility from both the borrower and lender perspective in more detail below.

Subscription line facilities for differing fund structures – Varied flexibilities

The variety of fund structures and underlying investor pools can result in differing considerations and often requires customised loan documentation for specific subscription facilities. Below, we illustrate this diversity, highlighting some of the potential practicalities that sponsors, lenders and their respective counsel may encounter when dealing with subscription line facilities entered into by different types of funds in the context of: (i) so-called SMAs (which may have only a single investor); (ii) complex commingled funds (which may have hundreds or more investors and utilise numerous entities that are part of one fund family); and (iii) funds in the UK.

Separately Managed Accounts (SMAs) – Addressing the single investor

As discussed above, the investor base of a fund is a determining factor for lenders in establishing the borrowing base for a subscription line facility, particularly in the U.S. The credit quality of the investors, and their ability to meet their capital commitments, are aspects that can influence the commercial terms of the facility, including margins and fees, concentration limits, events of default resulting from investor defaults and exclusion events. When there is only a single investor, as is the case for SMAs, there are unique considerations for the related subscription line facility, including those stemming from an increased concentration risk.

In our experience, SMAs continue to increase in popularity for a host of reasons, in particular among large institutional investors (such as state and private pension funds, educational endowment funds, insurance companies and sovereign wealth funds). They have become more commonplace in recent years as investors increasingly desire greater customisation of the product they are investing in (e.g., with respect to fees, leverage, investment guidelines, and reporting). In addition, learning from the lessons of the financial crisis of 2008–2009, investors are more sensitive to the risk of other investors potentially defaulting (which could have a detrimental effect on the fund's returns). There are also certain benefits to the fund sponsor of establishing SMAs for its investors, for example, the fund sponsor's administrative burden of operating an SMA is significantly less compared to operating a commingled fund of the same size.

While from a financing perspective SMAs present some specific challenges, there are also advantages and indeed it appears that, with the increased number of SMAs in the marketplace, there has been a corresponding uptick in subscription line facilities for these investment products. Like any other fund, the terms of the organisational documents of an SMA need to satisfy the general requirements of lenders of subscription line facilities. As such, they should expressly authorise the general partner or manager to enter into credit facilities on behalf of the SMA and its investor, to pledge the unfunded capital commitments of such investor as collateral for the financing, and include other provisions and acknowledgments

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discussed above. To the extent, however, that some or all of those provisions are not included in a manner satisfactory to a lender, it may be easier for the sponsor and the investor to adjust the organisational document accordingly, since this process does not require a consent solicitation from multiple investors.

In the alternative (or in addition) to incorporating such provisions in the organisational documents, it is fairly common for lenders to request that the investor in the SMA enter into an investor consent letter to provide the lenders with an increased comfort level by establishing contractual privity and addressing any other specific issues which may arise in a particular context (for example, as many investors in SMAs are government pension plans or sovereign wealth funds, there may be sovereign immunity issues that such investors can potentially present to lenders). Understandably, the treatment of such issues is a highly individualised analysis that needs to be performed on a case-by-case basis.

As compared to subscription line facilities for multiple-investor funds, advance rates for the single-investor SMAs tend to be more customised and negotiated with lenders. While banks will generally lend based on the creditworthiness of each investor, and thus should be able to assign an advance rate for an investor in an SMA that is substantially equivalent to the advance rate such investor would receive if it were investing in a commingled fund, there are other relevant factors that may necessitate a different approach. For example, lenders cannot rely upon a diversified investor base that, in the aggregate, reduces the exposure to an individual investor funding failure. Further, in many commingled funds' facilities, there are investors whose credit quality or other circumstances do not qualify for the inclusion of such investors in the borrowing base. Even though there is no credit for those investors' commitments, they are still pledged as collateral and so a lender might be able to offer an advance rate that ultimately recognises such "overcollateralisation". However, if the obligation to fund capital commitments rests on a single investor, and lenders are not entirely comfortable with that investor (for example, because of lack of ratings, insufficient financial information and/or known investing track record), they may price such factors into the terms of the fund's subscription line facility, offer a lower advance rate, or potentially may not be able to lend in such situations.

There may be other terms in SMA subscription line facilities that are unique and differ as compared to commingled fund subscription line facilities, including with respect to enforcement rights and exclusion events, for which lenders may seek a stricter regime in some respects. For example, certain exclusion events (i.e., events that, if they were to occur with respect to an investor, would trigger removal of such investor from the borrowing base) under a commingled fund subscription facility may be characterised as events of defaults (i.e., events that give the lender a right to accelerate the amounts outstanding under the facility and pursue remedies) under an SMA subscription facility. For some exclusion events, such treatment would stand to reason: if the single investor in an SMA defaults on its obligation to fund a capital call, because there are no other investors in the borrowing base, it makes sense conceptually that such occurrence may be an event of default under the SMA subscription facility, even though if the same failure to fund capital by such investor were to occur in a commingled fund, the typical subscription facility would simply no longer allow for borrowing against such investor's commitment – and only if that investor's capital commitment was material (i.e., as a percentage of overall commitments) and/or if other significant investors (with commitments in the aggregate above agreed-upon thresholds) also defaulted, would an event of default be triggered under a commingled fund's facility. Further, for a number of exclusion events (e.g., a breach of the representations and warranties made by investors under their subscription documents), there may be negotiated cure periods and/

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or other mitigating qualifiers before such occurrences result in removal from the borrowing base in a commingled fund subscription line facility – but lenders may look more stringently at these events in an SMA subscription facility.

Outside of specific concerns as to the terms and structuring of SMA subscription line facilities, sponsors with multiple SMAs may be able to utilise the straightforward nature of the single-investor vehicle in order to achieve greater efficiency with respect to the facility documentation. Indeed, some sponsors have found that SMAs are generally well-suited for employing the so-called "umbrella" technology, pursuant to which the same lender provides individual and separate loan commitments to multiple borrowers under one credit agreement. Under these instruments, many of the terms are shared by all of the SMAs that are parties to the loan document, but investor-specific terms, such as the advance rate and the loan amount, can be different for each SMA, and each SMA remains severally (and not jointly) liable for its own borrowings. Additionally, the distinct facilities are not cross-defaulted or cross-collateralised, so that potential issues under one SMA's facility will not impact another SMA's facility, even if they are both party to the same credit agreement. Umbrella facilities allow sponsors to negotiate just one set of documentation while putting multiple facilities in place and, while this may not be a universally applicable approach, in our experience it can be successfully utilised under the correct circumstances (e.g., for SMAs with comparable tenor).

Multi-layered commingled funds – Financing solutions for complex structures

At the other end of the fund spectrum, there are pooled investment fund vehicles with diverse investor bases, which may include a variety of both institutional investors, as well as private wealth management clients, their family offices and, at times, the sponsor's management and employees. Depending on the composition of the investor base, such fund structures often require, due to various tax, regulatory and other considerations, multiple entities through which the investors can access the underlying investments, resulting in structures that can be quite complex. While fund sponsors may have different preferences in the structuring of their funds, there are some commonly used approaches in the market that we describe below.

A frequently used technology is a multi-tiered structure, sometimes referred to as the "master-feeder" structure. This arrangement utilises two or more separate entities on top of each other; investors contribute capital through a "feeder" fund, which then invests (feeds) the capital through a "master" fund, which in turn invests the capital in investments, either directly or indirectly through subsidiaries. In certain situations, there may be some investors who invest through the feeder fund, and other investors who invest directly into the master fund.

The characteristics of the master fund and the related feeder funds are driven in part by the nature of the investors and their related tax considerations. For U.S.-based sponsors, the master fund is often formed as a Delaware or Cayman Islands limited partnership that is treated as a pass-through entity for U.S. federal income tax purposes. Taxable U.S. investors generally prefer to invest in the master fund either directly or through an "onshore" feeder fund that is typically a Delaware (or sometimes Cayman Islands) limited partnership, treated as a pass-through entity for U.S. federal income tax purposes. When the investor pool includes non-U.S. investors and/or certain tax-exempt U.S. investors, one or more separate "offshore" feeder funds, which are treated as non-U.S. corporations for U.S. federal income tax purposes, are often formed in various jurisdictions (often Cayman Islands, but increasingly, and in particular for European-based investors, also other jurisdictions such as Luxembourg, Ireland and Scotland) in order to provide these investors with protection from direct U.S. federal income tax filing and payment obligations as a result of their investments in the master fund. In some circumstances, a separate fund structure may be formed for

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different types of investors without there being an aggregating master fund (sometimes referred to as a "parallel fund" structure).

Regardless of jurisdiction and/or legal form, all the entities in these types of structures are part of one fund family, and are managed by a common investment manager, which can be accomplished in a variety of ways, including by utilising multiple affiliated entities and/or independent managers. Each of the various vehicles is typically a separate legal entity, though the exact characteristics may depend on how the relevant legal forms of the vehicles are treated in their applicable jurisdictions and, in some cases, may statutorily be required to act through another entity (for example, a Cayman Islands limited partnership acts through its general partner).

The considerations that determine the characteristics of each entity can contribute to the complexity of the structures in terms of which entities need to be party to the subscription facility documentation. Most multi-tiered funds need to ascertain at which level borrowings will be made (in other words, which entity will be the borrower under the subscription facility). This choice of borrowing entity may be affected by any number of different factors, including tax and regulatory considerations, administrative ease and operational requirements of the sponsor. To the extent that investor capital commitments are not made directly to the borrowing entity, consideration must be given as to how to mechanically ensure, through the legal documentation, that a security interest in the collateral has been properly granted for the lenders' benefit. Accordingly, the analysis of the underlying legal structures forms a key part of the lenders' diligence and often requires assistance by both lenders' and borrowers' counsel in the preparatory and documentation stages.

A "cascading pledge" structure is one potential method utilised to assure that lenders have an appropriate "path" to the ultimate source of capital commitments. In this scenario, the upper-tier feeder fund pledges the capital commitments of its investors to the lower-tier master fund, in order to secure such feeder fund's obligations to make capital contributions into the master fund. The lower-tier master fund then, in turn, pledges the capital commitments of its "investors" (i.e. the upper-tier feeder fund(s)) to the lenders to secure such master fund's obligations as a borrower under the subscription line facility. This can be a beneficial arrangement from both a borrower and a lender perspective, in particular in situations where, for example, due to regulatory reasons, the feeder fund may not be permitted to be in direct privity with the lenders. From a documentation perspective, this structure typically includes a separate security agreement between the master fund on the one hand and the lender on the other hand, and a separate "back-to-back" security agreement between the feeder fund on the one hand, and the master fund on the other hand.

Other possible alternatives include an arrangement where (if permissible) the feeder fund may become a party to the subscription line facility agreement and/or security agreement with the lender. Under this approach, the feeder fund may become a co-borrower of the loans, become a guarantor of the indebtedness incurred by the master fund, or just provide a "naked" pledge of the investors' capital commitments directly to the lender.

Because of the highly structured nature of complex commingled funds featuring multiple tiers and/or parallel "silos", there are sometimes circumstances where additional work is required in order for the sponsor to be able to take as full advantage as possible of all the investor capital commitments available to the fund family. For example, due to tax, regulatory or other considerations, it may not be possible to have the parallel entities jointly and severally liable for repayment of the loans and, in some instances, the "onshore" and "offshore" entities may be required to enter into separate credit agreements. Such separate credit agreements

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may or may not be permitted to be cross-collateralised, whether for tax and/or regulatory reasons or because of an understanding with the investors in the separate vehicles. This effectively means that each of the parallel vehicles must rely on a borrowing base comprising only capital commitments of its own (either "onshore" or "offshore") investors.

As discussed above, the investor composition will likely vary as between such vehicles and, because banks will typically provide different advance rates and concentration limits based on their underwriting criteria, the borrowing capacity of one silo may be different from the borrowing capacity of the other silo(s). Since sponsors ordinarily aim to manage borrowings on a consistent level across the various vehicles in a fund family, the ability to borrow might then be dictated by the vehicle with the lowest borrowing capacity. One potential solution may be to, where permissible, provide for a cross-guarantee and/or cross-default between the individual credit agreements, which might allow the borrowing base to be calculated on an aggregate basis. Another possible alternative is the use of investor consent letters, whereby a lender may be able to relax concentration limits that it would have otherwise imposed on investors, thereby allowing for a more generous separate borrowing base in the silo(s) where it is most needed.

European perspective – Looking across the pond

The internationalisation of the subscription finance market, on the buy-side as well as the sell-side, has influenced the documentation and transaction terms of subscription line facilities in the European market. The European market has seen a steady inflow of U.S.-based sponsors expanding their investment activities across the Atlantic and seeking subscription line transactions similar to what they have been accustomed to in the U.S. This phenomenon is likely to have contributed to the increase in European and U.S.-based lenders offering subscription line facility terms in the European market similar to those we have seen in the U.S. market. Nevertheless, despite a trend for convergence of the terms of subscription line facility documentation in the two markets, certain differences persist due to differing approaches to credit evaluation, and local law requirements with respect to the creation and perfection of security interests in collateral.

Subscription line facilities in the UK market were historically almost exclusively the product of "relationship" deals, with lenders primarily focusing on the success record of the larger sponsor group when determining whether to offer a subscription line facility to an individual fund. While there certainly are (sometimes important) relationship aspects that come into play in the U.S. transactions as well, the modern U.S. subscription credit facility is highly focused on the creditworthiness of individual investors in a fund.

This difference in approach is reflected in some of the terms typical of subscription line facilities in the UK market. For example, subscription line facilities in the UK market frequently use the "coverage ratio" to limit the amount that may be drawn under the facility at any given time. The coverage ratio is the ratio of the uncalled capital commitments of the included investors to the aggregate indebtedness of the fund, and is typically set at no less than 1:1. Notably, the coverage ratio approach does not typically involve applying advance rates to the uncalled capital commitments of included investors, meaning that once an investor is deemed an "included investor", the borrower receives credit for 100% of that investor's uncalled capital commitment.

In the U.S., advance rates are much more common – as discussed above, U.S. subscription line facilities typically use a borrowing base calculation to limit the amount that may be drawn under the facility at any given time, and lenders will only advance a certain percentage

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of the uncalled capital. The advance rate allocated to individual investors as part of this U.S. approach typically depends on the credit-worthiness of those investors and while these rates often fall within a range that is considered "market" for the investor being assessed, they are determined by a lender on the basis of its own credit analysis, undertaken in respect of the investor on a case-by-case basis (however, as noted above, a "flat" advance rate isn't uncommon either in a segment of the market).

Increasingly, and as an example of an indication of the convergence of facility terms in respect of facilities in the UK market with those used in facilities in the U.S. market, the U.S. model of a borrowing base methodology is becoming more frequent. Parallel to the development of the borrowing base methodology, investor exclusion events have also been refined. These events are typically narrower in scope for facilities that apply a borrowing base methodology, but since they are often tailored to particular investors, they can be greater in the number of events they seek to address.

On the other hand, other trends in the U.S. market are less often seen in the UK market, for example, investor letters are rarely required.

Whilst the internationalisation of the subscription finance market is in certain instances leading to a convergence of terms of subscription line facilities in U.S. and European markets, there are certain aspects of subscription line transactions that remain specific to the jurisdiction applicable to the relevant fund, particularly with respect to the granting and perfection of security interests. Granting and perfecting security interests over the uncalled capital commitments of the funds' investors, the rights of the general partner to call capital commitments and the bank accounts into which any capital commitments called from investors are funded are, for many transactions, key elements for the creditors under the relevant subscription facilities. As discussed above, the foregoing property interests often form the principal collateral base of the subscription line facilities secured in favour of the lenders.

The creation and perfection of security interests in subscription facility collateral differs by jurisdiction. In the U.S., security interests over the rights to call uncalled capital commitments are created when the lender is given value by the borrower, the grantor has rights over the collateral, and the grantor pledges that collateral by entering into a signed security agreement sufficiently describing the collateral. At this point, the security interest is "created and attached", and the lender may enforce the security interest against the borrower per the terms of the transaction. In order to perfect the security interest and enforce the lender's rights against third parties, the parties must file a UCC-1 financing statement, typically on or shortly after creation of the underlying security interest. Thus, for perfection, it is typical for the security agreement to contain an authorisation by the borrower or general partner, as applicable, for the filing of such financing statements (and without appropriate provisions a filing by the lender might not be authorized).

By comparison, under English law, for example, the security interest of lenders in the rights of the general partner to call capital from the limited partners is typically created pursuant to an assignment by way of security. The perfection of such security interest occurs upon the delivery of a notice to the investors in the fund, informing them that the general partner has entered into a subscription line facility on behalf of the partnership and assigned its right to call capital under the partnership agreement to the lender. As the notice is not required to create the security interest, the timing of the delivery of these notices is often heavily negotiated. From a relationship perspective, borrowers often prefer not to notify investors of the grant of the applicable security interest until the occurrence of an event of default or other triggering event, and are also highly sensitive to the form and timing of any such notifications.

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The increasing complexity of fund structures and jurisdictions involved, which serves to attract an increasingly global investor base, frequently requires parties to consider local law requirements in multiple jurisdictions in connection with the granting and perfection of security interest required by the credit providers. In addition, potential conflict of laws issues also need to be considered, as no single method of granting security and perfection under one law may be effective for the purposes of another jurisdiction.

Conclusion

The finance group at Fried Frank continues to see a sustained and steady increase in the volume and number of fund financing transactions and subscription line facilities. We believe that the popularity of this product is driven in part by the strong performance which these loans have demonstrated over extended periods of time, including through the economic downturn. In our practice, we have not seen an event of default under any of the subscription facilities that we have worked on. In light of this stability, and the continued ability of sponsors and lenders to craft solutions that meet the growing needs and complexities of funds being developed, we anticipate that the popularity of subscription line facilities will continue to remain strong.

Moreover, we expect to see convergence of the larger fund financing market – where we are observing an increasing appetite for a combination of subscription facilities and so-called asset-based facilities (collateralised by the underlying fund investments), whether in the form of hybrids (with a collateral package that consists of both uncalled capital commitments and underlying investment assets) or other bespoke instruments (for example, where a traditional subscription-based borrowing base is enhanced by a component based on value of the underlying investment assets, but without a corresponding pledge).

This article is not intended to be exhaustive and address every structuring alternative (which would be practically impossible), but simply to illustrate that the industry has been able to respond and find solutions to many of the challenges that it has faced over the years, and continues to search for ways to deliver the subscription facility product to all those who have an interest in it, as efficiently as possible.

We are pleased to note that the subscription facility market appears to remain very active even as it has taken in recent political developments both in the U.S. and globally. While the uncertainty caused by Brexit and a new administration in the U.S. has put its imprint on global markets in many ways, the fund financing space has largely remained stable. In addition, the increasing presence of U.S.-based sponsors in the UK market has fuelled the demand for subscription line facilities with characteristics typical to those in the U.S. Of note is the recent guidance on the usage of subscription facilities issued by the Institutional Limited Partners Association, which we believe is likely to influence various aspects of how the facilities are utilised and communications with investors about them. We remain cautiously optimistic about the future outlook for the industry, while we wait to see how the broader political and economic situation plays out in the longer term.

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Common ground: Achieving a commercial result for borrowers and lenders

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Introduction

Initially, subscription facilities were most commonly seen as bilateral, relationship loans to real estate funds for the purpose of bridging capital calls to a diverse group of large, highly rated, institutional investors for a short period of time. Such facilities were typically put in place after the final closing of a fund and terminated at the end of its investment period. As the subscription facility market has evolved, a wider range of funds (with varying investment strategies, investor bases and borrowing needs) have sought access to financing at the fund level. Not only are a wider range of funds and fund sponsors accessing the fund finance marketplace, but they are seeking subscription facilities that may be used at any time during the life of the fund and for any purpose permitted under the fund's partnership agreement. As fund borrowing needs have increased, so too have facility sizes, tenors, available currencies, the number of lenders in a facility syndicate, the range of lenders participating in the market, and the complexity of the loan documentation.

Despite these significant changes, at their core, subscription facilities remain relationship deals where borrowers and lenders have a common goal of implementing a facility that accommodates the fund's borrowing needs while at the same time protecting the lenders. Even when syndicated, these facilities tend to be club deals where the lenders have close relationships with the borrowers. This article aims to highlight how subscription facilities can be structured to accommodate fund borrowing needs, address lender concerns and sensitivities, and achieve a commercial result that works for all participants.

Flexibility

Subscription facilities offer fund sponsors and investors a variety of administrative, operational and economic benefits. Administrative benefits to the fund and its investors include bridging capital calls and other sources of capital that may not be available at the time of an investment, avoiding the need to rebalance during the period between the initial and final closings of the fund, quicker access to cash (as compared to the time it takes to call capital from investors), and not having to call capital in advance of an investment or return that capital to investors if the investment falls through or is significantly delayed.

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Investors further benefit from an operational standpoint as the fund may use its subscription facility to smooth out investor capital calls by grouping them on a periodic basis (rather than calling capital multiple times for each investment and fund expense). Economic incentives include mitigating the J-curve effect, enhancing the fund's internal rate of return, providing loans and letters of credit for portfolio companies, with a fund-level guarantee, at cheaper rates than might otherwise be available at the portfolio level, and obtaining more favorable pricing on hedges to the extent that the hedging exposure is secured by the pool of uncalled capital commitments that secures the subscription facility obligations. When exploring whether a subscription facility will provide these benefits to a particular fund and its investors, sponsors will focus on the flexibility that a lender can offer, especially as it relates to borrowing base calculations, facility size and tenor, types and currencies of credit extensions and which entities are permitted to borrow under the subscription facility.

Borrowing base capacity

When considering a subscription facility, the first question a fund sponsor should ask a potential lender is what the fund's borrowing base will look like. Most subscription facilities measure availability against a borrowing base of eligible investor commitments. In determining eligibility, a lender may diligence the fund's investors (including their subscription agreements, side letters, ratings and available financial information) and assign advance rates to the uncalled capital commitments of only those investors that are deemed by the lender to be the most "creditworthy". In some cases, a lender will impose concentration limits so that no single investor, or type of investor, comprises more than a certain percentage of the borrowing base.

While advance rates are often 90% for the highest rated investors (and, if necessary to achieve the desired borrowing base, 60% to 65% for certain other investors), lenders may have differing viewpoints on specific investors, including whether they should be in the borrowing base at all, which advance rate should apply and whether a concentration limit should be imposed. For example, one lender may be unable, as a credit matter, to lend against the uncalled capital commitment of an investor whose side letter contains withdrawal rights or a reservation of sovereign immunity, whereas another lender may be able to lend against the uncalled capital commitment of such investor. As a result, different lenders may look at the same investor base and yet arrive at different borrowing base calculations. Given the possibility of divergent lender views with respect to an investor base, once a potential lender has signed a non-disclosure agreement but prior to entering into extensive credit facility negotiations, it is critical that a fund sponsor share the fund's investor documentation and request that the potential lender provide an indicative borrowing base.

Although it is important to request indicative borrowing base calculations from potential lenders, there are a number of things a fund sponsor can do, during both fundraising and initial discussions with lenders, to maximize its borrowing base. Those actions include the following:

- First and foremost, ensure that investor side letters include top-of-market language to give lenders comfort from a legal perspective that uncalled capital may be called by the fund (and, in the event of enforcement, by the lender) to repay subscription facility obligations. For example, if an investor requests a side letter provision entitling the investor to withdraw from the fund and/or cease making capital contributions upon the occurrence of a triggering event, ask that the withdrawal and/or cease-funding right be conditioned on the repayment of debt incurred prior to the triggering event.

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Similarly, if an investor requests that its identity be kept confidential, ask that there be an exception for disclosure, on a confidential basis, of such information to lenders.

- Draft the relevant partnership agreements to authorize a main fund and its parallel fund to cross-collateralize each other's obligations under a credit facility. By providing authority under the partnership agreements to cross-collateralize, lenders have the comfort that, regardless of whether loans are made to the main fund or its parallel fund, both pools of capital support the loans. As a result, lenders should be willing to loan to both fund borrowers, on a several basis, against a single borrowing base that is comprised of the uncalled capital commitments of the investors in the main fund and the investors in the parallel fund. From a reporting standpoint, it is simpler for borrowers to calculate a single borrowing base than to calculate separate borrowing bases for each of the main fund and its parallel fund. In addition, a combined borrowing base may result in greater borrowing capacity for a smaller parallel fund with a more concentrated investor base than it would have had with a separate borrowing base calculation.
- If a lender seeks concentration limits, consider whether those limits should be relaxed: (a) during the fundraising period when the fund has fewer investors and, hence, greater investor concentration than it will at the completion of fundraising; and (b) later in the life of the fund when investors will have funded enough capital such that they have "skin in the game" and have more of their investment to lose should they fail to fund capital.
- Consider a "hurdle investor" concept to allow for investors that might not otherwise be included in the borrowing base (whether as a result of sovereign immunity, problematic side letter provisions or otherwise) to be included after they have funded a certain minimum percentage of capital.
- Seek lenders that offer credit for investors who historically may not have been included in a borrowing base but who have a good track record of funding capital contributions, such as high-net-worth investors or investors with sovereign immunity.

Historically, it was challenging for funds-of-one, and funds with significant investor concentrations, to find lenders willing to provide subscription financing. However, as the market has evolved, more lenders are willing to provide financing to these funds. In these scenarios, given the lack of investor diversity, the fund and its counsel will need to ensure that the fund's partnership agreement and side letters contain robust language to address a potential lender's underwriting needs. Also, it is important to note that some lenders will not lend to a fund-of-one without an investor consent letter. As a gating item, the fund sponsor will want to discuss with the investor the potential need to deliver such a consent letter if the fund is to have a credit facility. From an efficiency perspective, it may be helpful to negotiate such a consent letter with the investor during negotiations of the fund's partnership agreement and any related side letter with the investor.

Financing for open-ended funds may also be challenging because the investor composition changes as new investors are added in subsequent closings and existing investors may have the option, subject to the terms of the partnership agreement, to exit the fund. When marketing an open-end fund and drafting its partnership agreement, consideration will need to be given to balancing the flexibility for investors to enter and exit the fund against preserving the flexibility for the fund to enter into a financing. As a result, the fund sponsor may seek to build into the partnership agreement appropriate notice periods and other conditions that must be satisfied before an investor may exercise its withdrawal right from the fund.

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Facility size, currencies and tenor

In addition to making sure that the borrowing base is sufficient to support a fund's borrowing needs, fund sponsors also seek flexibility on the credit facility terms, including the ability to increase the facility size (whether on a permanent or a temporary basis), extend the stated maturity of the facility, and borrow in dollars and foreign currencies. This emphasis on flexibility is a departure from older lines that often had a 364-day tenor, were renewable annually in the lender's discretion, terminated at the end of the fund's investment period, and were available only up to a stated amount in dollars.

In light of the trend toward putting a subscription facility in place as soon as possible after the initial closing of the fund, it can be advantageous for a sponsor to close a credit facility at a lower amount and build in the ability to upsize the facility on a permanent basis as fundraising progresses and the investor base grows. Facility increases may be requested by the borrowers from time to time, often in minimum increments and subject to delivery of an increase request, the absence of credit facility defaults and the payment by the borrowers of an agreed increase fee. Increases are typically subject to the consent of increasing lenders, though some credit facilities provide for a committed increase, at the option of the borrowers, up to a specified amount. To the extent that a requested upsize is not provided by existing lenders, the credit agreement may provide for the ability to join additional lenders that are willing to provide all or a portion of the increased commitment amount.

Similarly, there may be times during a fund's investment period when its borrowing needs may be quite high, such as in anticipation of a particularly large investment. In those cases, it can be helpful to the fund to temporarily increase the facility to accommodate the increased short-term borrowing needs. Such temporary increases are generally uncommitted and, like permanent increases, subject to the delivery of an increase request, the absence of credit facility defaults and the payment of a fee for the temporary increase. Temporary increase loans are also usually subject to the same terms and conditions as other loans under the facility, other than the maturity. Due to the earlier temporary increase maturity date, the credit agreement will need to permit the non-*pro rata* payment of the temporary increase loans at their maturity.

Incorporating flexibility for both permanent and temporary upsizes into the loan documentation can allow for streamlined, cost-efficient and faster execution as and when increased borrowing capacity is needed. A further benefit to providing these features in a credit facility is that, by timing permanent and temporary increases in the facility size to the fund's investment needs and borrowing base, the fund can avoid paying upfront and unused commitment fees on a larger facility size than either its borrowing base can support or its borrowing needs warrant.

As the subscription facility market has evolved, facilities are now commonly offered with longer tenors and with the flexibility to extend the stated maturity date for one or more additional periods. Similar to the upsize features, these maturity extension options are subject to the absence of defaults and the payment of an agreed fee and are often subject to the consent of the extending lenders. However, some facilities offer a committed extension feature or a combination of committed and uncommitted extensions. Whether the fund chooses to extend the full amount of its facility, or only a portion, will depend on its borrowing base and borrowing needs. For example, if a fund is later in its life, has already deployed significant capital and is nearing the end of its investment period, it may request that only a portion of its facility be extended. Additionally, a fund borrower may want the flexibility to extend

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the maturity of its facility even after the fund's investment period has terminated, so as to finance follow-on investments and any fund expenses. The key in such a circumstance is to ensure that the fund's partnership agreement permits the fund to call capital after the end of the investment period to repay any such new borrowings as well as borrowings incurred prior to the end of the investment period.

Additionally, providing capacity in the loan documents for borrowings and letters of credit to be made available in multiple currencies can be an essential element for fund sponsors with global investment strategies. With a multi-currency option, a fund can borrow and repay in foreign currencies and thereby better manage its foreign currency exposure. At the same time, however, lenders will want to protect against currency movements by reducing the borrowing base by an agreed foreign currency reserve to the extent that there are foreign currency loans and letters of credit outstanding under the subscription facility. The amount of the reserve and the frequency with which it is calculated should be carefully negotiated by the borrower and its lender. For example, although it is reasonable to calculate the foreign currency reserve at the time an alternative currency loan is made, and on a periodic basis while such alternative currency loan is outstanding, it is not reasonable to recalculate the borrowing base daily or with each currency fluctuation. Also, in the event that a borrowing base deficiency were to result from a significant currency fluctuation, as with any mandatory prepayment, the borrower should be given sufficient time to call capital to cure such deficiency. Borrowers should also be cognizant that borrowing requests in alternative currencies may require additional time for lenders to process and that not all lenders have capacity to lend in all currencies.

Types of credit extensions and timing of credit extension requests

For certain funds, particularly those that make investments in the infrastructure, real estate and energy sectors, it is helpful if the subscription facility provides flexibility for the issuance of letters of credit in order to support those investments and advance the fund's investment strategy. If there is such a letter of credit sub-facility, the fund sponsor will want to consider the rating of the letter of credit issuer to ensure that a proposed beneficiary will accept a letter of credit issued under the subscription facility. Also, in the event of a drawing under a letter of credit, the borrower will want the credit facility to include a mechanic whereby any such drawing may be repaid or automatically converted into a loan without the need to submit a notice of borrowing or satisfy any minimum borrowing amounts.

A fund may also want the flexibility to borrow on a same-day basis under its credit facility. Although loans under a subscription facility are typically made available in one to four business days (which is far less than the 10 to 15 business days necessary for the fund's general partner to call capital from investors), having same-day borrowing capacity can be a particularly helpful feature for some funds. Even if not all lenders can offer same-day borrowings, or cannot offer same-day borrowings in certain foreign currencies, the borrower will want to discuss with its lenders whether a portion of the subscription facility can be made available on a same-day basis, which lenders are able to make same-day loans, and the currencies in which such same-day loans will be available.

Other fund sponsors may wish to build in secured hedging capacity. Hedge providers benefit because the hedges are secured by the same collateral that secures loans and letters of credit under the subscription facility. At the same time, the fund may benefit because the pricing for the secured hedge will be more favorable than would be available without such collateral security. In discussing a secured hedging option, the borrower and its lenders will want to

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consider whether to impose caps such that neither the aggregate hedging exposure, nor any single lender, receives a disproportionate benefit from such collateral sharing.

Borrowers under the subscription facility

As fund sponsors have broadened their investor base, fund structures have grown increasingly complex. Funds that used to operate as a single limited partnership now encompass various entities, including parallel funds, alternative investment vehicles, and funds-of-one. As a result, fund sponsors want flexibility to join many of these other entities as borrowers under a single subscription facility as well as holding or portfolio companies (i.e., "qualified borrowers") that sit below the fund level.

In order to address the preferences of certain investors, including, for example, tax sensitive investors, a fund sponsor may offer investors the option of investing in a parallel fund. Such parallel fund has a separate pool of investor commitments and typically invests on a *pro rata* basis with its related main fund. The fund sponsor will want flexibility to add these parallel funds as borrowers, on a several basis, so that they may borrow under the subscription facility to pay for their share of a particular investment. Lenders are generally amenable to parallel fund joinders, subject to customary loan and security documentation and deliverables such as authorizing resolutions and legal opinions.

The limited partnership agreement of a fund will often contemplate that, whether due to tax, regulatory or other reasons, investments may be made through one or more alternative investment vehicles ("AIVs"). Each AIV has the same ability to call capital as its related main fund or parallel fund and may have the same borrowing needs. If the subscription facility is secured by uncalled capital, lenders may want AIVs to join the credit facility as borrowers so as to avoid collateral leakage. Similarly, the fund will often want the flexibility to join its AIVs as borrowers, each on a several basis, so that each AIV can borrow to make its investments. However, in some cases, the fund may not need an AIV to join as a borrower. For example, an AIV may have been formed to make a single investment that will be funded with capital contributions, rather than borrowings. In such a case, having the flexibility not to join an AIV as a borrower benefits the fund by avoiding the unnecessary expense of a joinder and the attendant security documents and deliverables. Given the tension between the possibility of collateral leakage against the expense of joinder, a possible compromise is to agree on a "non-borrower AIV basket" such that the aggregate amount of capital contributions that can be made to non-borrower AIVs does not exceed an agreed percentage of total capital commitments to the fund borrowers.

A qualified borrower does not have the ability to call from the fund's uncalled capital and, as a result, does not provide collateral to secure its obligations as a borrower under the subscription facility. Instead, the lenders look to the applicable fund-level borrower (whether the main fund, a parallel fund or one of their respective AIVs) to guarantee the qualified borrower's loans and letter of credit exposure. That fund-level guarantee is secured by the same collateral that secures the guarantor's direct obligations as a borrower under the subscription facility. Due to this secured, fund-level guarantee, lenders are willing to extend loans and letters of credit for the benefit of qualified borrowers under the fund's subscription line, often at more favorable pricing than the qualified borrowers could have obtained outside of the subscription facility. The ability to add a qualified borrower can also be especially useful as a bridge to a more permanent financing at the portfolio company level.

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Efficiency

Subscription facilities are not a one-size-fits-all product, and each fund will need a tailored subscription facility to address the specific features of that fund, including its investor base, investment strategy, and borrowing needs. Similarly, what a lender can offer a fund sponsor will vary greatly depending on the particularities of the fund borrower and the terms necessary for the lender to obtain internal credit approvals. However, by starting with an agreed form of loan documentation as a precedent, fund sponsors and lenders can facilitate the timely execution and implementation of a subscription facility and streamline the negotiation process as well as ongoing compliance.

Agreed precedent

For sponsors with multiple funds, each with its own subscription facility, it is important from an efficiency perspective to standardize, as much as possible, the ongoing reporting requirements and other covenants included in the facilities. It is in all parties' interests to ensure that, once a subscription facility is implemented, the fund borrower complies with all of its obligations thereunder. Using the same template for loan documents across multiple funds will not only ease the administrative burden on the sponsor, it will also help to facilitate compliance across different fund subscription facilities and thereby avoid a "foot-fault" that could result in a technical event of default. The ramifications of an event of default under a subscription facility are significant. During an event of default, the fund borrower will not be permitted to borrow or make distributions to its investors. Further, the fund's investment activities will be limited, as it will only be able to call capital and withdraw funds from the pledged collateral account in order to repay its outstanding obligations under the subscription facility.

Along these lines, the key for fund sponsors and lenders is to focus on how to streamline reporting obligations under a subscription facility so that the lenders receive useful information in a timely manner while not imposing an undue burden on the credit parties to provide such information. If aggregate investor commitments are substantially larger than the subscription facility size, the parties may wish to consider limiting fund reporting regarding changes in the fund's investor base to a quarterly obligation unless there has been a significant change during such quarter. For example, the fund would report investor transfers on a quarterly basis with the delivery of its financial information but, if during such quarter more than an agreed percentage of the fund's investor capital commitments were transferred, the fund would promptly report such transfers to the lender.

In the unlikely circumstance that the fund's lender elects to exercise its remedies during an event of default, it is in all parties' interests to incorporate a standstill period so that, following notice from the lender that it intends to issue a call capital notice, the fund's general partner is given the first opportunity to do so. During the standstill, the fund's general partner would be permitted to issue a capital call notice, collect investor capital contributions into the collateral account that has been pledged by the fund to the lender, and apply those amounts to the fund's outstanding subscription facility obligations. This approach is more efficient because the fund's general partner has the processes in place to issue capital calls expeditiously, and investors are accustomed to receiving capital call notices from the general partner on a regular basis. Moreover, all parties want to avoid the possibility of spooking investors with a capital call issued by the fund's lender. Notwithstanding a brief standstill before the lender may issue a capital call to investors, there would be no limitation during the standstill period on the lender's authority to take control of any pledged collateral account during an event of default.

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In addition to facilitating compliance by starting with an agreed form of credit agreement, negotiating certain forms of exhibits up front can help to keep legal costs down during the term of the subscription facility and allow for easier and quicker execution. For example, fund sponsors and lenders may consider negotiating forms of loan documents at the initial closing of the subscription facility that can be used for: (1) future temporary and permanent upsizes, (2) extensions of the stated maturity date, and (3) joinders of parallel funds, AIVs and other entities as new borrowers. If the resolutions and legal opinions that are delivered at the initial closing of the subscription facility authorize and cover future facility increases and tenor extensions, fund sponsors can save some costs and streamline the documentation needed to implement such changes to the subscription facility. Similarly, lenders may be willing to forego legal opinions for AIV borrower joinders if the jurisdiction of formation and fund structure of the new AIV borrower is identical to, and the partnership agreement is substantially consistent with, that of an existing borrower for which a legal opinion was previously delivered.

Other creative solutions

Umbrella documentation may be another creative solution for a fund sponsor that is focused on limiting costs associated with implementing separate subscription facilities for similarly situated funds that do not invest in parallel. With an umbrella facility, the initial fund borrower and its lender, together with their counsel, negotiate a base credit agreement that sets forth the borrowing mechanics, representations, covenants and defaults that apply to the initial borrower and each other fund entity that may be added as a borrower. As future funds are formed, each may adopt the same base credit documentation, together with a loan addendum that provides for the economic and other terms that are specific to such new fund borrower, including its facility size, pricing, tenor and borrowing base. This approach can facilitate execution for future funds as the base credit agreement and exhibits are not re-negotiated for each new fund, and can be adapted to address different lender syndicates for each new fund. At the same time, to the extent the lenders require modifications to take into account changes in law or operational requirements, the lenders and borrowers may agree to an amendment to the base credit agreement that will be effective for all or any subset of fund borrowers thereunder.

Another concern of fund sponsors is minimizing the time and expense associated with adding offshore entities as borrowers under their subscription facilities. As funds have broadened their investor bases to European, Asian and other foreign investors, it is common for a fund structure to include one or more Cayman, Canadian, Luxembourg or other offshore entities, all of which may have borrowing needs. In those cases, local counsel are engaged to review the loan and security documents (which, in US deals, are often governed by New York law), prepare customary authorizing resolutions and provide legal opinions as to the offshore entities. In addition, to the extent that a lender feels strongly that local law pledges are necessary in a particular jurisdiction, local counsel will need to be involved in the preparation and negotiation of that security documentation as well. These additional agreements should be considered "belt-and-suspenders" for lenders to ensure the creation and priority of their security interests under the applicable local law as well as the ability to enforce locally in the unlikely event of an exercise of remedies.

Absent any specific local law requirements for the creation and perfection of the security, the collateral package, covenants and reporting obligations in any local law security agreement should not extend beyond what has been negotiated in the credit agreement or New York

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law governed security documentation. For example, if the parties have agreed during the subscription facility negotiations that investors are not required to provide investor consent letters to lenders, any notice to investors that is sent out to comply with local law perfection requirements should not require countersignature by investors. In order to simplify and streamline the preparation and execution of these local law security documents, and facilitate fund compliance, it may be more efficient to use the negotiated New York law documentation as the base for such local law documentation. That base document would then be revised to change the governing law and incorporate such other changes as are necessary to address applicable local law collateral requirements. In that way, the parties may avoid inadvertently agreeing, in a local law document, to a substantive provision that is inconsistent with the negotiated, business arrangement.

Conclusion

Fund sponsors want subscription facilities with terms that take into account each fund's unique investor base, investment objectives, structure and borrowing needs. Fund sponsors also seek efficiencies, across fund types and facilities, in order to streamline execution, minimize costs, avoid undue administrative burdens and facilitate compliance. As a result of ongoing dialogue among fund sponsors, lenders and their counsel, subscription facility terms have continued to evolve to take into account these objectives. Subscription facilities now routinely include features to add new borrowers, extend tenors and increase facility sizes using pre-agreed forms, thereby giving borrowers the flexibility and efficiencies they require. At the same time, lenders have broadened their relationships with fund sponsors as they are now lending to multiple fund entities and related borrowers, in larger amounts and over a longer tenor. As it adapts to these changes, the subscription facility market remains a relationship-centered business where all parties can find common ground as they craft creative solutions to address the complexities of fund structures and financing needs while achieving a commercial result that works for both borrowers and lenders.

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Investor views of fund subscription lines: The ILPA guidelines and the market response

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In recent years, the use by private investment funds of capital call subscription facilities has increased dramatically. Fund managers who previously did not use subscription facilities have begun setting them up for their newer funds, and managers who were already using such facilities have been relying on them more extensively, leaving advances outstanding for increasingly long periods. In 2017, a number of articles appeared in the financial press questioning whether the use of subscription facilities truly benefits fund investors, or whether managers rely on them in ways that distort reported investment returns and increase risks to investors.

The more pessimistic view gained significant traction in June when the Institutional Limited Partners Association (the **ILPA**) published guidelines on fund subscription facilities that expressed concerns about their widespread use and recommended that investors negotiate limitations on their use where possible. This chapter explores the recent debates over the use and potential misuse of subscription facilities, the practical ways in which such debates have influenced negotiations between fund managers and investors, and the likely impact of such negotiations on the ways that subscription facilities will be used in the future.

Recent discussions on the pros and cons of subscription facilities

The Marks memo

Although investors and fund managers have discussed the pros and cons of subscription facilities for several years, widespread public debate on the topic intensified in the financial press after the publication in April 2017 of a memo titled "Lines in the Sand" by Howard Marks, the founder and co-chairman of Oaktree Capital. In his memo, Marks outlined the potential advantages of subscription facilities to private funds before exploring a range of potential disadvantages that, in his view, suggested a need for caution in the use of such facilities.

Marks identified two key advantages to fund investors. First, subscription facilities give funds the flexibility to close investments on short notice because a fund with a subscription

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facility can fund an investment by borrowing the money (typically on no more than three business days' notice) instead of waiting weeks to receive the proceeds of a capital call to its investors. The ability to close investments more quickly reduces execution risk and puts the relevant fund in a competitive position relative to potential buyers who need more time to obtain the cash necessary to pay the purchase price.

Second, the ability of a fund to use a credit facility to pay the purchase price of an investment or an unexpected expense reduces the need to make frequent capital calls. Rather than calling capital from investors every time that a fund needs additional cash flow, a fund manager can limit capital calls to once every one or two quarters. Fewer capital calls increases predictability for investors and reduces the need for them to keep significant levels of liquid assets on hand in case of an unexpected capital call.

Counter-balancing the benefits of subscription facilities, Marks saw a number of potential drawbacks for investors. These drawbacks fall into four general categories:

- *Cost*: Although the interest rates that banks typically charge on subscription loans are low, given the perceived low risk associated with lending against uncalled capital, the interest paid on these loans, together with related fees and legal expenses, constitutes an incremental cost to the relevant fund that otherwise would not be incurred had the fund relied solely on capital calls to provide cash flow. Marks noted that in contrast to portfolio-level leverage, subscription facilities do not increase the amount of money that a fund can ultimately invest; they merely postpone the timing of capital calls. Over the life of a fund, using a subscription facility will not generate additional profits that offset the associated costs.
- *Effect on IRR*: If a manager borrows under a subscription facility to fund an investment and waits several months to call the capital necessary to repay the loan, the number reported as the relevant fund's internal rate of return (**IRR**) will vary depending on whether the manager calculates IRR based on the date that the investment was made or the date that capital was called from investors. As a result, investors will have difficulty comparing the performance of one manager's funds against another's. In addition, Marks suggested that by funding an investment with borrowed money, delaying the related capital call and calculating IRR based on the date that capital was called rather than the date the investment was made, an unscrupulous manager could try to boost its returns artificially, thus ensuring that it meets the preferred return hurdle for the payment of its incentive fees earlier than it would otherwise have.
- *Effects on specific investors*: Apart from the cost and IRR implications noted above, there are other reasons why investors may object to the use of subscription facilities. Some investors may want to put their cash to work quickly and to have capital called as soon as an investment is made rather than waiting for it to be called on a pre-set schedule facilitated by borrowing. Others object to the restrictions that loan documents place on transfers of their limited partnership interests (which could take the form of an express requirement that the bank consent before the general partner permits the transfer but could also apply less directly, in the sense that a general partner may not agree to a transfer if it believes that the transfer will reduce its borrowing base) or to what they view as intrusive levels of bank diligence with respect to a fund's investors while a facility is being negotiated.
- *Systemic risks:* Marks expressed concern that an over-reliance on subscription facilities might pose risks for the financial system as a whole. In particular, he worried about loans that are repayable upon the lender's demand and about the possibility that during

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a financial crisis, multiple subscription facilities might be called for repayment at once, triggering multiple capital calls by funds on the same investors. In an environment where investors have become used to having capital called less frequently, Marks warned that investors might not have sufficient liquid assets to meet concurrent capital calls. Other investors might refuse to make a capital contribution to repay a loan if the underlying fund investment had declined in value (which would be increasingly likely during a financial crisis). In such cases, funds might have to liquidate assets at fire sale prices in order to repay their subscription debt, further exacerbating the systemic crisis.

The ILPA Recommendations

Two months after the publication of Marks' memo and in an effort to protect investor interests in the face of increased capital call activity, the ILPA issued a set of guidelines for the use of subscription facilities, titled "Subscription Lines of Credit and Alignment of Interests: Considerations and Best Practices for Limited and General Partners", that proposed a solution to the problems that Marks had identified. (To be clear, the ILPA's guidelines were rooted in discussions among fund investors that pre-dated Marks' memo, and were not explicitly drafted as a response to Marks. Most of the issues that the ILPA identified with subscription facilities, however, are the same as the ones highlighted by Marks.)

The ILPA's guidelines included the following recommendations for funds that use subscription facilities:

- *Calculation of IRR*
  - For purposes of determining when the preferred return hurdle has been met for a fund manager's incentive compensation, a fund's IRR should be calculated starting on the date that the subscription facility is drawn, rather than on the date when capital is called from the investors.
- *Disclosure to investors*
  - When a new fund is being formed, the manager should disclose to all potential investors:
    - The IRR of its previous funds, calculated with and without giving effect to the use of any subscription facilities.
    - Its policy on the use of subscription facilities.
  - During the lifetime of the fund, the manager should disclose:
    - Its IRR with and without giving effect to the use of its subscription facility.
    - The cost of the facility (e.g., rates of interest and fees).
    - The purpose of each advance made under the facility and the making of any investment (even if capital has not yet been called).
    - The number of days that each advance is outstanding.
- *Terms of the fund's limited partnership agreement*
  - The fund's limited partner advisory committee should consider discussing the fund's use of credit lines at its meetings, including whether the terms of any subscription facility then in effect are "market".
  - The fund's ability to borrow under its subscription facility should be subject to a cap (e.g., 15–25% of uncalled capital).[1] The ILPA also suggests placing a cap on total interest expense.
  - Any advances made under the facility should be repaid within 180 days.

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    - Advances should not be used to fund distributions prior to the fund's sale of the relevant portfolio company investment.
    - The limited partnership agreement should permit investors who don't want to participate in a financing to fund their capital calls in advance of other investors or otherwise contain mechanisms to enable investors to opt out of subscription financing.
- *Terms of subscription facilities*
    - A fund's borrowing base (i.e., the calculation of the amount that the fund is permitted to borrow at any given time) should be based on its uncalled capital, rather than the net asset value of its portfolio assets.
    - The only collateral granted to the lenders should be the fund's right to call capital from its limited partners. The fund should not pledge its portfolio assets or any assets belonging to its limited partners.
    - The loan documents should specify a fixed maturity date for the advances, rather than enabling the lender to call for them to be repaid upon demand.
    - The fund's limited partners should not be required to enter into any agreements relating to the facility other than an acknowledgment of the lender's security interest in their capital commitments, and lender diligence on the limited partners should be limited to publicly available information.

Market response

Although some speculated after the publication of the Marks memo and the ILPA guidelines that fund investors would insist on the wholesale adoption of the ILPA's guidelines for new funds and that lenders would follow suit in engaging these terms in new subscription facilities, this has not turned out to be the case. Rather, discussions between investors and fund managers on the use of subscription facilities have focused on a handful of key points while the terms of the actual credit facilities remain substantially unchanged.

There are a couple of key reasons for this measured response. First, certain ILPA guidelines suggest a misunderstanding about the ways that subscription facilities work. For example, implementing the ILPA's proposal that advances under subscription lines should be capped at 15% to 25% of a fund's uncalled capital would slash borrowing capacity by 50% or more, since market advance rates (i.e., the rate at which a lender will lend to a fund) typically range between 50% and 90% of a fund's uncalled capital. Putting such a restriction in place would dramatically curtail fund managers' ability to take advantage of subscription lines even for short-term purposes that unquestionably benefit investors, such as providing liquidity in anticipation of an imminent capital call. In our firm's work representing investors and fund managers, we have not heard of any investors actually requesting such a Draconian cap on borrowings. Some investors have asked for new funds to limit their debt to 15% to 25% of *committed* capital. This is not a new concept, however, as many existing funds are already subject to such a cap under their limited partnership agreements. In addition, limited partnership agreements that include a cap of fund-level debt sometimes include a carve-out that permits bridge financing pending receipt of a capital call in amounts that exceed the cap.

Several of the ILPA's other recommendations seem equally misplaced. The concern, for example, that a fund might pledge the assets of its limited partners as collateral for its subscription facility is unfounded. This pledge is almost never required by lenders and

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would not be obtained unless the relevant limited partner expressly agreed in the loan documentation to pledge its assets. Pledging the fund's asset portfolio, as opposed to its right to call capital from its limited partners, is also rare except in the context of extremely small funds or mature funds that have called virtually all of their committed capital already. The ILPA's proposal, meanwhile, to limit investors' involvement in subscription facilities to the execution of acknowledgments that the relevant fund has pledged its right to call capital, is merely a reflection of a market practice that exists already. For large funds with a diversified investor base, most lenders do not require investor acknowledgments.

The second major reason for the limited response to the Marks memo and the ILPA guidelines is that, although the financial press has at times suggested that the interests of fund managers and fund investors are inevitably opposed on the use of subscription facilities, the real situation is more complicated. Although some investors dislike subscription facilities, either because they want to put their cash to work as soon as possible or because they are concerned that the excessive use of fund-level debt distorts the calculation of IRR, other investors actually prefer to invest in funds that use subscription lines because this enables capital calls to occur on a more predictable schedule. In addition, the boost to IRR that use of a subscription facility can provide may actually benefit certain investors, for instance funds of funds, that report the returns on their investments to their own constituents. On the other side of the table, not all fund managers insist on the unfettered right to use their funds' subscription facilities. Some are happy to agree to constraints in the hopes that the evolution of a more consistent set of market standards on the use of subscription facilities will prevent competitors from using fund-level debt to boost their IRRs artificially.

Against this background, we have seen two major trends in negotiations between fund managers and investors on the use of subscription facilities. The first is greater disclosure. Fund managers are increasingly providing investors with two IRR calculations, one reflecting usage of the relevant fund's subscription facility and the other backing this usage out. There is also more disclosure of the costs associated with a fund's subscription line, in particular interest and fee rates, and of mandatory prepayment triggers and events of default, especially any events outside a fund's control that could trigger early repayment. Note that although the ILPA guidelines discourage the use of demand loans, some fund managers continue to use such loans on the reasoning that their lower cost outweighs the risk of an unexpected demand for repayment from the lender. It is also worth noting that notwithstanding the ILPA's recommendation that managers disclose the use of each advance made under a fund's subscription facility, investors in general seem uninterested in this level of detail. Many investor demands for greater disclosure on subscription facilities, in fact, pre-date the release of the ILPA guidelines, suggesting that the guidelines are in many ways a reflection of discussions between investors and fund managers rather than their inspiration.

The other major trend in investor demands relates to the length of time that advances under subscription facilities remain outstanding. Some fund managers are agreeing to strict time limits on borrowings while others have agreed that in calculating a fund's IRR, they will start the clock on the earlier of the date that capital is called, and a specified number of days after the loan was made to fund the relevant investment (thus preventing the manager from boosting IRR artificially by keeping the loan outstanding for a longer period). Where such restrictions exist, the current market trend seems to be for an actual or implicit limit of 180 days. Some investors are insisting on a limit of 90 days, however, while a few managers have been successful in pushing for 364 days. In addition, many funds do not have any formal time limits on borrowings. The managers of these funds would argue that they already are

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required under the funds' limited partnership agreements to keep borrowings short-term in order to avoid unrelated business taxable income (**UBTI**) for tax-exempt investors, but that a strict deadline for repayments could limit their flexibility in ways that could be detrimental to investors – especially if it meant increasing the frequency of capital calls.

Outlook

While it is always difficult to anticipate how market terms will evolve, it seems unlikely that the ILPA guidelines for subscription facilities will be adopted wholesale. As of the writing of this chapter, the ILPA is said to be revising and refining its guidelines. We would expect the trends identified above to continue. In particular, fund managers are likely to continue to provide investors with greater disclosure about the terms and use of these facilities, including, increasingly, by providing calculations of both a levered and an unlevered IRR. It is also possible that as new funds are formed, more limited partnership agreements will contain caps on fund-level debt and/or actual or implicit limits on the duration of fund borrowings, the latter probably averaging around 180 days. Another possible development would be the evolution of mechanisms in limited partnership agreements to enable investors to opt out of participating in subscription facilities by funding their capital calls in advance of other investors.[2] We have not seen many investor requests for such a mechanism so far, but this could become more prevalent in the future if interest rates increase.

Overall, while investors generally want to be kept informed about the ways that fund managers avail themselves of subscription facilities, and some investors are insisting on formal restrictions to prevent fund-level debt from being used in ways that could be detrimental to investors, most investors recognize the benefits to such facilities when used responsibly by fund managers to provide short-term liquidity and ensure more predictable capital calls. While some fund managers would prefer to keep restrictions on the use of debt informal rather than incorporating explicit limitations into fund documentation, most of them welcome investor calls for greater transparency and the evolution of market standards for the use of subscription facilities. Within these limits, funds seem likely to continue to make active use of subscription facilities for years to come.

* * *

Endnotes

1. As noted below, it is possible that the ILPA meant to refer to committed capital, rather than uncalled capital.
2. Certain funds already use such mechanisms for the benefit of investors concerned about the risk of UBTI, but to date they have not become widespread.

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Enforcement: Analysis of lender remedies under U.S. law in subscription-secured credit facilities

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Introduction

Lenders must have a sound understanding of their legal rights in regard to, and the process of, enforcing remedies against a borrower and its limited partners under a subscription-secured credit facility in order to assess risk, price the risk, and properly document the facility. Lenders who adequately plan for an event of default and exercise of remedies are more likely to prevail against the borrower and its investors when enforcing rights. Lenders must be prepared to execute every step of their enforcement strategy, beginning with the occurrence of an event of default, through the decision to accelerate the obligations, to the exercise of remedies, and, finally, to recovery of payment.

Establishing an event of default; issues of jurisdiction and service of process

Before a lender can exercise its remedies, there must first be a legally undisputed event of default under the facility documents. In many cases, the occurrence and continuation of an event of default will be clear (*e.g.*, failure to make payment or failure to timely act under the terms of the facility documents). However, if a borrower contests the existence of a default, the lender should consider immediately filing a declaratory judgment action in an appropriate court to establish that an event of default has occurred. A declaratory judgment filing does not set forth a cause of action for damages, but instead seeks a declaration from the court establishing existing rights, status or other legal relationships under the terms of a contract. It provides a remedy to a party that is uncertain of its rights and wants an early adjudication without having to wait for its adversary to file suit.

The court must have jurisdiction over the parties and the subject matter to issue a declaratory judgment. Typically, the borrower agrees to submit to jurisdiction in a particular forum in the facility documents, which establishes personal jurisdiction over the borrower. Subject matter jurisdiction is the court's jurisdiction over the nature of the case and the type of relief sought. A U.S. federal court has the power to hear a declaratory judgment action under 28 U.S.C. § 2201(a) if the case is within its subject-matter jurisdiction and involves an actual controversy. A lender seeking a declaratory judgment has the burden of establishing, by a

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preponderance of the evidence, that there is an actual controversy. Similarly, under most state laws, a declaratory judgment is only proper when there is an actual controversy and the existence of the controversy is not "contingent upon the happening of future events which may never occur".

In federal court, service of process on domestic entities is governed by the Federal Rules of Civil Procedure. *Rule 4* provides that a corporation, partnership, or other type of business association may be served by delivering the summons and complaint to an officer, managing or general agent, or an agent authorised by appointment or law to receive service. New York and Delaware courts have similar service of process rules. If the borrower agrees in the facility documents that service of process may be effected by registered or certified mail sent to a specific address, the state or federal court will recognize such service as effective.

Several additional issues must be considered when the defaulting borrower is a non-U.S. ("***foreign***") entity. First, lenders must decide whether to pursue the foreign entity in the United States or in its home country. A number of factors favour suit in the United States. First, a judgment from any American court, state or federal, is relatively easy to register and enforce throughout the United States. Second, a U.S. court will be more familiar with the contractual obligations at issue. Finally, depending upon the applicable foreign jurisdiction, there may be considerable local bias in the foreign jurisdiction in favour of the foreign defendant that must be overcome.

Establishing personal and subject matter jurisdiction over a foreign entity requires the same analysis. Once jurisdiction has been established, the lender must effectively serve process on the foreign entity. If a foreign borrower has agreed in the facility documents to accept service of process by certified or registered mail, this manner of service will be enforceable unless the borrower demonstrates that such service is precluded by foreign laws.

If the manner of service in the facility documents fails, is impractical, or is deemed unenforceable, the Hague Convention on the Service Abroad of Judicial and Extra-Judicial Documents (the "***Hague Convention***") provides an additional method of service on a defendant residing in any nation that is a signatory to the Hague Convention, such as the United States, the United Kingdom, or the Cayman Islands. Therefore, knowledge of the Hague Convention procedure for service of process is useful as it provides the most foolproof manner of service in applicable jurisdictions.

The Hague Convention provides for formal service through the foreign defendant's government's designated "*Central Authority*", where the process is sent to the Central Authority with instructions to forward it to the defendant. Alternatively, in *Article 10(a)*, the Hague Convention states that, unless the foreign government has lodged an official objection, service by international registered mail directly to the defendant in the foreign nation is adequate.

As a practical matter, lenders should seek the advice of local counsel in the applicable jurisdiction to confirm the best methods to effect service. The outcome may be simultaneous service by different methods. Full compliance with the formal Central Authority process under the Hague Convention may be slow and cumbersome, but it should yield nearly unimpeachable service. At the same time, service by registered mail should be attempted, as it does not add any significant cost and there is always the chance the defendant will respond to it and appear in the lawsuit.

Once jurisdiction has been established and the foreign entity has been properly served, the lawsuit may proceed just as any other, and a declaratory judgment may be obtained. Under U.S. law, a declaratory judgment issued by a court has the force and effect of a final judgment or decree.

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Recovery from borrower and investors

Once an event of default is established, lenders may either direct the borrower to make a capital call on the investors for repayment of the obligations, or issue a capital call directly on the investors. If the borrower files for bankruptcy, a motion to lift the stay will be required prior to the lender taking action. In well-documented, subscription-secured facilities, the obligations of the borrower and the rights of lenders *vis à vis* the investors should be so well-defined that even if the borrower challenges the lender's right to call capital, the fundamental obligation of the borrower to repay the obligations, and the lender's rights to call capital, are likely to be resolved in summary judgment. By contrast, more complicated issues regarding recovery arise with respect to enforcement against the investors. Under most subscription-secured facilities, each investor enters into agreements or makes acknowledgments that run to the lender, either in an "***Investor Letter***" or in the partnership agreement, wherein the investor expressly acknowledges and confirms, *inter alia*, its obligation to make capital contributions without defence, setoff or counterclaim when called to repay the facility. These agreements, together with the nature of the collateral securing subscription-secured facilities, constitute the foundation for recovery from the investors.

Legal theories of recovery against investors

If, after an event of default has occurred and has been legally established, any investor fails to pay a required capital contribution in response to a capital call, resulting in a payment deficiency, lender's recourse is to file a lawsuit against the defaulting investors to enforce remedies. The lender should consider its rights under statutory law, the facility documents, any Investor Letter, and the borrower's partnership agreement (collectively, the "***Relevant Documents***").

Depending on the language of the Relevant Documents and the factual circumstances, the lender should be able to establish liability against the investors for the capital contributions through claims of reliance, breach of contract, unjust enrichment or promissory estoppel.

Reliance claims arise out of statutory principles contained in the Revised Uniform Limited Partnership Act, as applied in each state, and are based on the lender's actions taken (*e.g.*, to advance loans) in reliance upon any of the Relevant Documents.

Breach of contract claims may be based on:

- enforcement of lender's rights under the collateral documents, by which the rights of the partnership to demand capital contributions from investors were pledged to the lenders, and perfected in accordance with the Uniform Commercial Code (the "***UCC***");
- the agreements and acknowledgments made by investors in the partnership agreement or Investor Letters, in particular the agreement to fund capital contributions for the purpose of repaying the facility without defence, setoff or counterclaim; and
- the lender's status as a third-party beneficiary of the partnership agreement.

If there is no express contract between the lender and the investors, or if a contract between them is unenforceable or unproven, the lender may be able to assert a claim for unjust enrichment on the equitable principle that the investors should not be permitted to enjoy the benefit of the lender's extension of credit if the lender is provided no remedy for an investor's subsequent default. The lender may also be able to assert a promissory estoppel claim based on the investors' capital commitment promise.

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Creditor enforcement under limited partnership law based on reliance

(a) *Rights of lenders*

In Delaware, the Revised Uniform Limited Partnership Act ("***DRULPA***") provides a statutory basis for asserting a reliance claim for the benefit of a lender. Under DRULPA, unless otherwise provided in the partnership agreement, the obligation of investors to make contributions may be "compromised" only by the consent of all investors.

The practical effect of DRULPA is to confer the benefit of the obligations of investors to a borrower on a lender who reasonably relied upon the capital call rights contained in the partnership agreement (*i.e.*, the lender would not have extended credit to the fund but for the fund's right to call capital from its investors). There is limited guidance as to what constitutes reasonable reliance; however, some courts have found reliance simply by virtue of the fact that the capital contribution obligations were contained in a publicly-filed certificate of limited partnership. It has also been suggested that evidence of reliance may include:

- references in the lenders' credit files to the capital contribution obligations as a source of repayment of the loan;
- references to the capital contribution obligations in the facility documents or solicitation materials;
- communications with the general partner and limited partners regarding the basis on which the loan will be repaid;
- review of the partnership's books and records, such as capital accounts and financial statements; and
- execution of an undertaking pursuant to which the general partner agrees to issue, and/or the limited partners agree to make, capital contributions to repay the debt.

In *In re LJM2 Co-Investment, L.P. Ltd. Partners Litig.*, 866 A.2d 762 (Del. Ch. 2004), the Delaware Court of Chancery held that the bankruptcy trustee of the limited partnership adequately demonstrated that the bank creditors reasonably relied, for the purposes of DRULPA, on the limited partners' representations that they would honour their capital commitments, which allowed the creditors to enforce the capital commitments.

Specifically, the trustee alleged that the bank creditors reasonably relied on *Section 3.1* of the partnership agreement to extend credit to LJM2 because: (i) under that section, the limited partners were obligated to contribute their commitments only when called for by the general partner; and (ii) the bank creditors removed this solitary condition by creating interrelated agreements compelling the general partner to make capital calls if LJM2 defaulted (through the combination of the Credit Agreement and the General Partner Undertaking to the effect that, if LJM2 defaulted on the Credit Agreement, the [general partner] would be bound to issue Drawdown Notices to the limited partners to the extent necessary to cure such payment default).

(b) *Defences*

Generally, if a limited partner's obligation to make capital contributions is not subject to conditions in the certificate of limited partnership (or in Delaware, the partnership agreement), the circumstances in which payment will be excused are few and narrow because third parties and other limited partners have a right to rely on receipt of such capital contributions. However, limited partners *may* be able to raise one or more of the following defences.

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First, under Delaware law, a limited partner's obligation to make capital contributions to a limited partnership may not be enforced unless the conditions to funding obligations have been satisfied or waived.

Second, one court applying a state analogue of *Section 502* of DRULPA has suggested that contribution obligations may be excused – even as to partnership creditors – where there has been a "profound failure of consideration such as repudiation of, or fraud incident to, the essentials of the venture to which the [partnership] was made". The court provided two examples: (i) the general partner had absconded with the limited partners' initial contributions, without putting any money into the construction of a proposed apartment project; and (ii) a failure by the general partner to take any steps at all in furtherance of the apartment complex venture.

However, a "material breach of the limited partnership agreement – including mismanagement, negligence, diversion of some assets, or unauthorized acts of the general partners, or disappointed expectations, or failure to perform certain elements of the agreement – would not excuse a limited partner's commitment to contribute additional capital", and thus would not constitute a valid defence to a *Section 502* claim. One court held that proof of the general partner's fraudulent activities did not excuse the limited partners' capital contribution obligations and did not provide adequate defence to a creditor's claim under *Section 502* because the fraud had not resulted in a total failure of consideration.

Third, another court has suggested that when loan proceeds are not used for partnership purposes, lenders may not be able to recover from those limited partners that lacked knowledge of such use.

Finally, a limited partner may deny that it had the authority to execute a subscription agreement, partnership agreement, or Investor Letter as a defence to payment. However, the evidence of authority (in the form of an opinion of counsel or a secretary's certificate) that typically accompanies Investor Letters may estop the investor from asserting such a defence in transactions with Investor Letters.

Creditor enforcement based on breach of contract under a *security agreement*

Under typical facility documents, lenders may "step into the shoes" of the general partner to enforce rights under the partnership agreement.

(a) *Application of the UCC and right of recovery against investors*

Because the investors are obligated to make capital contributions under the partnership agreement, and the collateral pledged to the lenders constitutes general intangibles, investors are considered "*account debtors*" under the UCC. Under UCC § 9-406, after a lender delivers notice to investors that the amount due or to become due has been assigned ***and*** that payment is to be made to the assignee, the investors may discharge their obligations to make capital contributions only by paying the lender. If the investors fail to fund their capital contributions, the lender may assert a breach of contract claim against the investors as an assignee under the security agreement.

While no particular form of notice is mandated under UCC § 9-406, other than that the notice must be authenticated, notice will be effective so long as the lender's chosen method of notifying the investor is sufficiently specific and direct. Conversely, if the notice of the assignment does not reasonably identify the rights assigned, then it will be deemed ineffective.

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The courts uniformly hold that, if the notice simply informed the investors that the right to payment has been assigned to the lender – without also informing the investors that future payments are to be made to the lender – then the investors, by paying the borrower, are discharged and need not pay the lender as well. It is not clear whether the notice requirement is satisfied by delivery of notice to investors at the closing of a facility, which notice would presumably disclose that payments would be required to be made to the lender upon an event of default and issuance of a capital call notice by the lender, both of which are conditions subsequent that may never occur. Thus the prudent lender will deliver a notice, upon an event of default, that the right to payment has been assigned and that future payments must be made to the lender, so that any payment by the investors to the borrower will not discharge any liability to the lender – investors must pay the lender directly.

After sending notice, the lender may exercise remedies under the partnership agreement *in lieu* of the general partner. Under UCC § 9-404(a) this means that, unless the investors have agreed to fund capital contributions without defence, the lender's rights are subject to any claims or defences the investors have against the borrower. This principle is an "application of the 'elementary ancient law that an assignee never stands in any better position than his assignor. An assignee is subject to all the equities and burdens which attach to the property assigned because he receives no more . . . than his assignor.'"

(b) *"Waiver" of defenses*

The key provision in any Investor Letter or partnership agreement addressing a subscription-secured facility is the agreement by investors to fund capital contributions to repay the facility without defence, setoff or counterclaim. This agreement is often referred to, in shorthand, as a "waiver of defenses", but it is, in most cases, simply an agreement to fund capital contributions to repay the obligations under a subscription-secured facility, without raising, against the lender, any defences that may exist as between the investor and the borrower, while retaining rights to make claims against the borrower and the other investors.

Creditor enforcement based on breach of contract under an *Investor Letter*

In a facility with Investor Letters, the lender should also assert a breach of contract claim as a party to the Investor Letter.

In its Investor Letter, each investor will acknowledge and confirm that the lender, by extending the credit facility to the partnership, is relying on the obligation of the investor to make capital contributions to the partnership. Facility documents typically permit the lender to issue capital calls directly to the investors, and the investors will have agreed to fund capital contributions without defence, setoff or counterclaim. If any investor fails to fund its capital contribution when called by the lender, it will have breached the terms of its Investor Letter, and the lender may bring a breach of contract claim. After discovery, the lender may be able to move for summary judgment, since proof of the executed Investor Letter and its terms and provisions will likely eliminate many issues of fact that may otherwise prevent the lender from obtaining summary judgment against such investor. Even short of an actual agreement, if an investor, by execution of an Investor Letter, *acknowledges and confirms* its obligations under the partnership agreement, such acknowledgment and confirmation may constitute an enforceable contract.

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Creditor enforcement based on breach of contract under a *partnership agreement*

If the partnership agreement expressly grants the lender the right to directly demand payment of capital contributions from the investors, the lender will be an intended third-party beneficiary of the agreement; often, partnership agreements make the third party beneficiary status of the lenders explicit. The lender should then be able to enforce the investors' capital call obligations for its benefit. In *Chase Manhattan Bank v. Iridium Africa*, the limited liability company agreement at issue gave the lender the right to directly demand payment of the members' capital call obligations. In that case, the court granted the lender's summary judgment request on its breach of contract claim (as a third-party beneficiary of the LLC agreement) based on the members' refusal to comply with the lender's demand for payment under the limited liability company agreement. However, it appears the court granted summary judgment based solely on the relevant provisions of the limited liability company agreement (which gave the lenders the right to directly demand capital contributions from the members), without reviewing the lender's rights under the security agreement.

Relevance of "waiver of defenses"

Good litigation strategy often dictates that a lender should assert as many legitimate claims as possible against an obligor – in this case, the investors. Initial pleading requirements are, in most U.S. jurisdictions, liberal, and a lender is not limited to pursuing only its best claim. Any such strategy should also take into account, however, potential affirmative defences that may be asserted by investors, in the context of the "waiver of defenses" discussed above.

Although lenders may have the right to require investors to make capital contributions through the security agreement, partnership agreement or *Section 502* of DRULPA (as enacted in Delaware and many other states), the limited partners may have defences at their disposal. However, if the partnership agreement, the subscription agreements or the Investor Letter contain the customary waiver of defenses language, the investors should be estopped from raising those defenses and the lenders may be able to obtain summary judgment against the investors.

(a) *Enforceability of waiver of defenses under general contract law*

Parties to a contract may contractually agree to waive certain rights. A party may waive a defence to a contract, and courts have enforced such waivers if the waiver language is manifested in some unequivocal manner.

For example, in *Relational Funding Corp. v. TCIM Services, Inc.*, the Delaware District Court dismissed a lessee's counterclaims due to the following waiver in the lease agreement: "Lessee's obligation under the Lease with respect to Assignee shall be absolute and unconditional and not subject to any abatement, reduction, recoupment, defense, offset or counterclaim[.]" The court held that this provision was enforceable based on the degree and specificity to which it explicitly waived the defendant's rights.

As to whether fraud (especially, fraud in the inducement) as a defence is waivable, the Third Circuit in *MBIA Ins. Corp. v. Royal Indemnity Co.* noted that "[W]e predict that when sophisticated parties have inserted clear anti-reliance language in their negotiated agreement, and when that language, though broad, *unambiguously* covers the fraud that actually occurs, Delaware's highest court will enforce it to bar a subsequent fraud claim." However, the same court also pointed out that the standards for effective waiver would be stricter, if waiver is possible at all, if fraud in the factum was raised as a defence.

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In 2007, the Sixth Circuit endorsed and adopted the *MBIA* court's analysis regarding waivers of defenses. In *Commercial Money Center, Inc. v. Illinois Union Insurance Co.*, the Court of Appeals for the Sixth Circuit, applying California law, enforced a contractual provision waiving an insurance company's right to assert the defence of fraud. In doing so, the court noted that the parties had negotiated for and "sculpted" provisions containing anti-reliance language and explicitly waiving the right to assert defences relating to "all issues of fraud".

An exception to the enforceability of a waiver of defenses may exist when public policy concerns arise. Principally, some courts have refused to enforce a waiver of defenses provision when the defendant was fraudulently induced to enter into the agreement. Other courts have permitted waiver when sophisticated parties agree to clear any unambiguous waiver language covering the fraud that occurred. Generally, courts will not permit waiver under any circumstances when a contract is procured by fraud in the factum, such that the waiving party does not even know the "true nature" of what it is signing. If investors have not agreed to an enforceable waiver of defenses, then the lender's breach of contract claim will be subject to any valid affirmative defences the investors can assert.

(b) *Enforceability of waiver of defenses under the UCC*

If a lender is enforcing its rights under a security agreement, UCC § 9-403 provides guidance as to: (i) the enforceability of the investor's waiver of defenses; and (ii) what types of defences may be waived, and what types of defences may not be not waived.

Under UCC § 9-403, a waiver by an account party, in favour of an assignee, of defenses that such account party may otherwise have against the assignor, is enforceable. If a waiver of defense clause in favour of an assignee is recognized as enforceable under UCC § 9-403, the assignee will be subject to only those defences that could be asserted against a holder in due course (which are not waivable under the UCC), which may include defences (among others less relevant) based on:

- duress, lack of legal capacity, or illegality of the transaction which, under other law, nullifies the obligation of the obligor;
- fraud in the factum (*i.e.*, fraud that induced the obligor to sign the instrument with neither knowledge nor reasonable opportunity to learn of its character or its essential terms); or
- discharge of the obligor in insolvency proceedings.

On the other hand, the assignee will *not* be subject to the defence of:

- failure of consideration;
- nondelivery of goods;
- fraud in the inducement;
- breach of warranty; or
- the lack of a meeting of the minds between the parties and, accordingly, no valid contract.

(c) *Lack of waiver of defenses*

In the event that no waiver of defenses has been entered into, the circumstances under which an investor's capital call obligation will be excused should still be few and narrow. Courts are reluctant to excuse capital call obligations, because third parties and other investors generally rely upon them.

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(d) *Enforcing judgments*

The last step in the litigation process, after a judgment is obtained, is to enforce the judgment against the investors' assets. This process can be time-consuming and difficult; however, Federal Rule of Civil Procedure 69 provides for very broad post-judgment discovery of a judgment debtor's assets. All of the discovery tools under the Federal Rules of Civil Procedure are available to locate a debtor's assets, including requests for documents, interrogatories, and depositions. Federal courts have broad authority to sanction judgment debtors that refuse to comply with post-judgment discovery. Once a judgment debtor's assets have been located, Federal Rule of Civil Procedure 69 provides that execution of those assets proceeds in the manner of the state where the federal court is located. Depending on the jurisdiction, common judgment enforcement mechanisms include garnishments, attachments, turnovers, and execution on property.

Moreover, transferring an American judgment from one U.S. jurisdiction to another so that it may be locally enforced is a relatively simple matter. Federal law provides for the registering of a federal judgment in a different federal district simply by filing a certified copy of the judgment. In state courts, the Uniform Enforcement of Foreign Judgments Act ("***UEFJA***") has been adopted by every state except California (which has adopted a similar procedure). The UEFJA allows enforcement of a judgment from another state upon the simple filing of the judgment with the clerk of court.

(e) *Registering a U.S. judgment abroad against foreign investors*

Unlike many countries, the United States has no treaty or agreement with any other country respecting the enforcement of judgments. Therefore, a country-by-country analysis is required to determine how to enforce a U.S. judgment against assets of an investor outside of the U.S., or against a non-U.S. investor. Common criteria to consider include the following:

- whether the court of origin had jurisdiction over the judgment debtor;
- whether the judgment debtor was properly served in the original action;
- whether enforcement of the judgment would violate local public policy; and
- whether the judgment is "final".

As a practical matter, registration and enforcement of a judgment outside of the U.S. will involve collaboration with local counsel, who will be able to advise on strategies specific to each applicable jurisdiction.

Conclusion

Although material borrower defaults in the subscription lending universe have been rare, the few that have occurred are instructive. In each known case, a facility default has resulted in the borrower's full repayment of the facility, usually from proceeds of a capital call on the investors. In the *Chase Manhattan Bank v. Iridium Africa* case, the lenders recovered from investors as well. However, the rarity of defaults means that there is little guidance from case law that confirms the legal analysis relating to enforcement and recovery. Thus, it is critical to a lender's adequate risk-management strategy and credit analysis to understand the issues and anticipate a strategy for enforcement of remedies against a borrower and its investors, should the need arise.

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* * *

Endnotes

1. We will refer to funds as "limited partnerships", and make corresponding reference to limited partners, partnership agreements and partnership-related terms, which may be read to also refer to limited liability companies, their members and corresponding organisational documents, or to other types of entities that may be borrowers under subscription-secured credit facilities. In addition, as to analysis of the application of Delaware law, the Delaware Limited Liability Company Act is generally similar to the Delaware Revised Limited Partnership Act.
2. The decision on whether to file in state versus federal court will depend on several factors, including the citizenship of the parties and the amount in controversy. One other consideration is the relative speed with which a judgment can be obtained. In some jurisdictions it is possible to obtain a quicker resolution in state court rather than federal court.
3. *See Wilton v. Seven Falls Co.*, 515 U.S. 277, 288 (1995).
4. *See In re Gantt*, 70 N.Y.S.2d 55 (N.Y. Sup. Ct. 1947) ("The parties to a contract may confer jurisdiction by consent." (citation omitted)); *see also Cambridge Nutrition A.G. v. Fotheringham*, 840 F. Supp. 299, 303 (S.D.N.Y. 1994).
5. Also known as "The Declaratory Judgment Act".
6. For an actual case or controversy to exist, the dispute must be definite and concrete (not hypothetical) between parties who have adverse legal interests of sufficient immediacy and reality. *See MedImmune, Inc. v. Genentech, Inc.*, 549 U.S. 118, 126-27 (2007); *Aetna Life Ins. Co. v. Haworth*, 300 U.S. 227, 240-41 (1937).
7. *See Shell Oil Co. v. Amoco Corp.*, 970 F.2d 885, 887 (Fed. Cir. 1992).
8. *Town of Coeymans v. City of Albany*, 237 A.D.2d 856, 858 (N.Y. App. Div. 1997); *see* N.Y. C.P.L.R. § 3001 (2009) (stating that the court may issue a declaratory judgment "as to the rights and other legal relations of the parties to a justiciable controversy") (New York law); *Burris v. Cross*, 583 A.2d 1364, 1371 (Del. 1990) (holding that an action under the Delaware Declaratory Judgment Act must meet the threshold requirements of an actual controversy) (Delaware law).
9. Fed. R. Civ. P. 4(h). The general test is that service on an organisation should be to someone at the organisation who stands in a position of authority so it would be reasonable to assume that person would know what to do with the papers. *See* 4A Charles Alan Wright & Arthur R. Miller, Federal Practice and Procedure § 1101 (4th ed. 2017); *see also Direct Mail Specialists, Inc. v. Eclat Computerized Techs., Inc.*, 840 F.2d 685, 688 (9th Cir. 1988). In practice, domestic organisations are required to maintain a registered agent for service of process, and service on this agent would be effective. *See, e.g.*, 8 Del. C. § 132 (2017) (providing that every corporation shall maintain a registered agent that shall "[a]ccept service of process and other communications directed to the corporations for which it serves as registered agent and forward same to the corporation to which the service or communication is directed . . . ."). Note, however, that the lender may also obtain a waiver of formal service requirements from the defendant under the federal rules. Fed. R. Civ. P. 4(d). The federal rules provide an incentive for a defendant

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to waive formal service in the form of 60 days to answer the complaint as opposed to 20. Fed. R. Civ. P. 12(a)(1). The option to seek a waiver is in the lender's discretion, however, and the lender may not wish to give the defendant more time to answer.

10. *See, e.g.*, N.Y. C.P.L.R. § 311 (2016) (service on a corporation may be made by delivering the summons to an officer or managing or general agent or other agent authorised by law to receive service); N.Y. C.P.L.R. § 310-a(a) (2016) (service on a limited partnership may be made by delivering the summons to any managing or general agent or general partner of the limited partnership). 8 Del. C. § 321(a) (2017) "Service of legal process upon any corporation of this State shall be made by delivering a copy personally to any officer or director of the corporation in this State, or the registered agent of the corporation in this State, or by leaving it at the dwelling house or usual place of abode in this State of any officer, director or registered agent (if the registered agent be an individual), or at the registered office or other place of business of the corporation in this State.").
11. *See Nat'l Equip. Rental, Ltd. v. Szukhent*, 375 U.S. 311, 315-16 (1964) ("[I]t is settled . . . that parties to a contract may agree in advance to submit to the jurisdiction of a given court, to permit notice to be served by the opposing party, or even to waive notice altogether." (citations omitted)); *Comprehensive Merch. Catalogs, Inc. v. Madison Sales Corp.*, 521 F.2d 1210, 1212 (7th Cir. 1975) (applying New York law) ("It is well-settled that parties to a contract may agree to submit to the jurisdiction of a particular court and may also agree as to the manner and method of service."); *Greystone CDE, LLC v. Santa Fe Pointe L.P.*, No. 07 CV. 8377(RPP), 2007 WL 4230770 at *3 (S.D.N.Y. Nov. 30, 2007) ("The parties in this case agreed as to the methods by which service of process is valid and effective. Such agreements are permissible and upheld by courts in the event of litigation . . . . The parties' contractual language, and not the Federal Rules of Civil Procedure, governs what constitutes proper service in this case." (citations omitted)).
12. Note that this will likely necessitate retaining local foreign counsel.
13. The analysis will be the same as with a domestic entity. *See supra* notes 4-7 and accompanying text.
14. *See, e.g., Mastec Latin America v. Inepar S/A Industrias E Construcoes*, No. 03 Civ. 9892(GBD), 2004 WL 1574732 at *2 (S.D.N.Y. July 13, 2004) (Brazilian defendant specifically agreed by contract to service of process upon its designated agent in New York. Because New York law permitted such an agreement on service of process, the court held that the method of service was valid absent a showing by the defendant that such an agreement was precluded by Brazilian law.). It is interesting to note that New York courts hold that a New York plaintiff is not required to comply with foreign service of process requirements absent a treaty. *See Morgenthau v. Avion Res. Ltd.*, 898 N.E. 2d 929, 11 N.Y.3d 383, 391 (N.Y. 2008). *See also infra* note 16.
15. *See* HCCH Members, https://www.hcch.net/en/states/hcch-members (last visited Nov. 29, 2017).
16. *See* Fed. R. Civ. P. 4(f)(1) (providing that service of process abroad is proper under the Hague Convention). Note that if the defendant or an agent (i.e. subsidiary) of the defendant can be found in New York, service under New York law may be effective against the defendant itself, with no need to resort to the Hague Convention. *See Volkswagenwerk Aktiengesellschaft v. Schlunk*, 486 U.S. 694, 707 (1988) ("Where service on a domestic agent is valid and complete under both state law and the Due Process Clause, our inquiry ends and the Convention has no further implications.").
17. The Cayman Islands are a British Overseas Possession, and as such are not an independent nation. However, they will be considered separately because certain financial privacy legislation presents special difficulties with enforcing a judgment

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there. See Cayman to Welcome Third Party Rights Rules, Appleby (July 2014), http://www.applebyglobal.com/publication-pdf-versions/e-alerts/2014---07---update-changes-to-the-cayman-islands-exempted-limited-partnership-law---bh-sr-jb-ig-bw.pdf; see also Changes to the Cayman Islands Exempted Limited Partnership Law, Appleby (April 2014), http://sites.appleby.vuturevx.com/18/2890/uploads/2014---04---changes-to-the-cayman-islands-exempted-limited-partnership-law-(bhunter--sraftopoulos--igobin--jblack).pdf; Changes to the Cayman Islands Exempted Limited Partnership Law, Appleby (May 2009), https://www.applebyglobal.com/publication-pdf-versions/e-alerts/changes-to-the-cayman-islands-exempted-limited-partnership-law-may-2009.pdf).

18. *See* 1965 Convention Outline, http://www.hcch.net/index_en.php?act=publications.details&pid=2765&dtid=28 (last visited Nov. 29, 2017) for a practical outline of service of process under the Hague Convention. Each participating government designates its own "Central Authority". For example, the United States' Central Authority is the Office of International Judicial Assistance, a part of the Justice Department. *See* U.S. Dep't of State, http://travel.state.gov/content/travel/en/legal-considerations/judicial/service-of-process.html (last visited Nov. 29, 2017). England's Central Authority is the Senior Master of the Royal Courts of Justice, in London. *See* Central Authority, https://www.hcch.net/en/states/authorities/details3/?aid=278 (last visited Nov. 29, 2017).
19. Hague Convention art. 10(a), Nov. 15, 1965, 20 U.S.T 361, 658 U.N.T.S 163. Note that the United Kingdom and the Cayman Islands have made no objection to service by mail. *See McCarron v. British Telecom*, No. CIV A. 00-CV-6123, 2001 WL 632927, at *1-2 (E.D. Pa. June 6, 2001) (holding that mailing documents via certified mail to the defendant's business address in London, England was sufficient under the Hague Convention).
20. *See* 28 U.S.C. § 2201(a) (2010).
21. In some facilities, borrowers negotiate a short standstill period to permit time for the borrower to make a capital call before the lender may act. Lenders sometimes agree to this provision under the theory that the investors may be more inclined, as a practical matter, to respond to an "ordinary course of business" capital call than one issued by a lender. However, in most subscription-secured facilities lenders have an immediate right to make capital calls upon a payment default or acceleration of the debt following an event of default.
22. Note that investors typically agree to fund capital contributions for the repayment of the facility without defence, setoff or counterclaim, whether called by borrower or the lender. Strictly speaking they do not waive defences against the fund, but this mechanism keeps the risk of mistake, fraud or bad investments between the investors and the fund.
23. Many states and the District of Columbia preclude recovery for unjust enrichment if there is an express contract between the parties. *See, e.g., Nemec v. Shrader*, Nos. 3878-CC, 3934-CC, 2009 WL 1204346, at *6 (Del C. Apr. 30, 2009) ("Delaware courts, however, have consistently refused to permit a claim for unjust enrichment when the alleged wrong arises from a relationship governed by contract."); *Schiff v. American Ass'n of Retired Persons*, 697 A.2d 1193 (D.C. 1997) (no claim for unjust enrichment when an express contract exists between the parties); *Marshall Contractors, Inc. v. Brown University*, 692 A.2d 665 (R.I. 1997) (same); *W&W Oil Co. v. Capps*, 784 S.W.2d 536 (Tex. App.—Tyler 1990) (same). Note that if there is only an express contract between the investors and the fund (such as the partnership agreement), this may not bar a claim for unjust enrichment between the investors and the lender. *See Leasepartners Corp. v. Robert L. Brooks Trust Dated November 12, 1975*, 942 P.2d 182 (Nev. 1997) (permitting claim for unjust enrichment by

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leaseholder against owner because the only express written contract was between the owner and tenant).

24. *See, e.g., Shapiro v. Solomon*, 126 A.2d 654 (N.J. Super. Ct. App. Div. 1956) (New Jersey law) (permitting quasi-contractual recovery after action was brought on an unenforceable express contract); *Kennedy v. Polar-BEK & Baker Wildwood Partnership*, 682 So. 2d 443 (Ala. 1996) (noting the law may recognize an implied contract for the purposes of unjust enrichment when the existence of an express contract on same subject matter is not proven).
25. A common law promissory estoppel claim in most states is subject to the same requirement that there is no express or enforceable contract. *See, e.g., Tripoli Management, LLC v. Waste Connections of Kansas, Inc.*, No. 10-1062-SAC, 2011 WL 2897334, at *13 (D. Kan. July 18, 2011) (opining that "it is hornbook law that quasi-contractual remedies, such as unjust enrichment and promissory estoppel, are unavailable when an enforceable express contract regulates the relations of the parties with respect to the disputed issue").
26. Lenders may also consider recovery against limited partners pursuant to the so-called "control rule", which provides that limited partners can be liable for partnership obligations if they "participate in the control" of the business of the partnership. *Id.* Although the control rule was eliminated in the most-recent amendments to the Uniform Limited Partnership Act, it remains the law in many states, including the State of Delaware. *See* 6 Del. C. § 17-303 (2017). However, limited partners typically do not act in a management role, and participation in control may be difficult to prove.

    Limited partnership law also sometimes recognizes lenders' rights to sue the limited partners to recover distributions that were made to such limited partners when the partnership was insolvent or in the zone of insolvency, or to recover returned capital contributions to the extent necessary to satisfy partnership obligations. Thomas J. Hall and Janice A. Payne, *The Liability of Limited Partners for the Defaulted Loans of Their Limited Partnerships*, 122 Banking L.J. 687 (2005). In jurisdictions that recognize this right, an action to recover such distributions or returned capital contributions may be asserted by the lenders themselves, obviating the need for the lenders to rely on the partnership to pursue such claims. *Id.*
27. The DRULPA is based on the 1985 version of the Revised Uniform Limited Partnership Act ("RULPA"), which was adopted in most states. Because the financial provisions of most limited liability company statutes have been modeled on the RULPA, lenders should also generally have the right to enforce contribution obligations against member investors. *See* 1 Ribstein and Keatinge on Ltd. Liab. Cos. § 5:7, 5:9 (2008).

    Hierarchically speaking, the court will first look to the unambiguous language of the contracts at issue to determine the parties' respective rights, before resorting to statutory law to fill in any gaps. As explained by the Delaware Court of Chancery:

    "Consistent with the underlying policy of freedom of contract espoused by the Delaware Legislature, limited partnership agreements are to be construed in accordance with their literal terms. 'The operative document is the limited partnership agreement and the statute merely provides the 'fall-back' or default provisions where the partnership agreement is silent.' Only 'if the partners have not expressly made provisions in their partnership agreement or if the agreement is inconsistent with mandatory statutory provisions, ... will [a court] look for guidance from the statutory default rules, traditional notions of fiduciary duties, or other extrinsic evidence." In other words, unless the partnership agreement is silent or ambiguous, a court will not look for extrinsic guidance elsewhere, so as to 'give maximum effect to the principle of freedom of contract' and maintain the preeminence of the intent of the parties to the contract.

    Twin Bridges Ltd. Partnership v. Draper, No. Civ. A. 2351-VCP, 2007 WL 2744609 at *12 (Del. Ch. Sept. 14, 2007) (internal citations omitted).

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28. 6 Del. C. § 17-502(b)(1) (1995). The same holds true for creditors of limited liability companies. *See also* Ribstein and Keatinge, *supra* note 27 at § 5:8 ("The [LLC] statutes also generally provide that creditors who rely on the original contribution may enforce original contribution obligations notwithstanding an intervening compromise." (citing, *inter alia*, 6 Del. C. § 18-502(b) (1995), which says: "Notwithstanding the compromise, a creditor of a limited liability company who extends credit, after the entering into of a limited liability company agreement or an amendment thereto which, in either case, reflects the obligation, and before the amendment thereof to reflect the compromise, may enforce the original obligation to the extent that, in extending credit, the creditor reasonably relied on the obligation of a member to make a contribution or return.")).
29. Hall & Payne, *supra* note 26 (citing *Partnership Equities, Inc. v. Marten*, 443 N.E.2d 134, 136 (Mass. App. Ct. 1982)). To the extent that there is an Investor Letter, the acknowledgment/agreement contained therein should substantiate the lender's reasonable reliance claim against the investors under 6. Del. C. § 17-502 (1995).
30. Hall & Payne, *supra* note 26.
31. 866 A.2d 762.
32. *Id*. at 781. Section 3.1, as part of the Partnership Agreement, was attached to the Confidential Information Memorandum given to the bank creditors. *Id*. It provided, *inter alia*:
    - that each limited partner made an initial capital contribution of 15% of its overall Commitment;
    - that the Commitment means "the aggregate amount of cash agreed to be contributed as capital to the Partnership by such limited partner as specified in such limited partner's Subscription Agreement...";
    - that the limited partners need to make additional capital contributions to the Partnership "at such times as the General Partner shall specify in written notices (each, a 'Drawdown Notice')";
    - that each partner's funding obligation would expire upon the "termination of the Commitment Period" but, nevertheless, required contributions thereafter "to pay or provide for payment of Partnership Expenses, including Partnership funded indebtedness"; and
    - that there is no obligation by the limited partners directly to creditors, as follows: (the provisions of this Agreement (including this Article III) are intended solely to benefit the Partners and, to the fullest extent permitted by applicable law, shall not be construed as conferring any benefit upon any creditor of the Partnership (and no such creditor shall be a third party beneficiary of this Agreement), and no limited partner shall have any duty or obligation to any creditor of the Partnership to make any Capital Contributions or to cause the General Partner to make a call for Capital Contributions.
    - *Id*.
33. *Id.* at 762 ("To the extent a partnership agreement requires a partner to make a contribution, the partner is obligated, except to the extent such obligation is modified by the terms of the partnership agreement, to make such contribution to a limited partnership"); *see also* 6 Del. C. § 17-502(b)(1)(1995).
34. *Partnership Equities, Inc. v. Marten*, 443 N.E.2d 134, 136 (Mass. App. Ct. 1982); *see also* 59A Am. Jur. 2d Partnership § 871 (2003).
35. Conditional obligations include contributions payable upon a discretionary call of a limited partnership or general partner prior to the time such call occurs. *See* 6 Del. C. § 17-502(b)(2) (1995). *See also supra* notes 31-32 and accompanying text.

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36. *Partnership Equities, Inc.*, 443 N.E.2d at 136.
37. *Id*. at 138-139.
38. *Id*. *See also Stobaugh v. Twin City Bank*, 771 S.W.2d 282 (Ark. 1989); 59A Am. Jur. 2d Partnership § 871 (2003).
39. *In re Securities Group 1980*, 74 F.3d at 1108-09 (11th Cir. 1996) (holding that any fraud on part of Chapter 11 debtor-limited partnerships and their general partners based upon general partners' convictions for income tax fraud arising out of activities related to limited partnerships, including use of "rigged straddles" and "rigged repurchase agreements" to create fraudulent income tax losses, which were then passed through to investors such as limited partners and subsequently disallowed by IRS, was not sufficient to permit limited partners to avoid their liability, under New York partnership law, to make additional capital contributions to partnerships upon capital call by Chapter 11 trustee, given strong statutory purpose of New York partnership law to favour creditors over limited partners).
40. Liability for contribution obligations – Liability to partnership creditors for unpaid contributions, *See* J. William Callison and Maureen Sullivan, Partnership Law & Practice § 24:4 (2006) (citing *Northwestern Nat. Bank of Minneapolis v. Swenson*, 414 N.W.2d 543 (Minn. Ct. App. 1987) (holding that evidence supported trial court's finding that limited partner had no knowledge that his notes, which were given for his investment in limited partnership, would be used as collateral for loans to general partner, which were then used by general partner for non-partnership purposes, and, therefore, limited partner was not estopped from asserting defence that proceeds of loans were used for non-partnership purposes)).
41. *See* UCC § 9-102(a)(3) (AM. LAW INST. & UNIF. LAW COMM'N 2010) ("account debtor" means a person obligated on an account, chattel paper, or general intangible).
42. Because the notice must recite that payment is to be made to the assignee, it is prudent to provide notice upon an event of default, which is the time after which a lender has the right to receive payment of the capital contributions, even if prior notice has been delivered or if Investors Letters are in the transaction.
43. *See, e.g., IIG Capital LLC v. Archipelago, L.L.C.*, 36 A.D.3d 401, 404-05 (N.Y. Sup. Ct. 2007) (holding assignee properly asserted a breach of contract cause of action against account debtors under New York's version of UCC§ 9-406).
44. This requirement normally can be satisfied by the lender sending notification on its letterhead or on a form on which its name appears. *See also* UCC § 9-102(a)(7) (AM. LAW INST. & UNIF. LAW COMM'N 2010) (defining "authenticate" to mean "with present intent to adopt or accept a record, to attach to or logically associate with the record an electronic sound, symbol, or process").
45. *See e.g., Banque Arabe et Internationale D'Investissement v. Bulk Oil (USA) Inc.*, 726 F. Supp. 1411 (S.D.N.Y. 1989) (holding notice of an assignment is effective when the debtor receives notice that the funds have been assigned and that payment is to be made to the assignee); *General Motors Acceptance Corp. v. Albany Water Bd.*, 187 A.D.2d 894 (N.Y. 1992) (no particular form of notice is necessary in order to require payment to the assignee; it is sufficient if information known to the debtor either apprises it of the assignment or serves to put it on inquiry).
46. *See* UCC. § 9-406(b)(1) (AM. LAW INST. & UNIF. LAW COMM'N 2010); *Warrington v. Dawson*, 798 F.2d 1533, 1536 (5th Cir. 1986).
47. *See 29 Williston on Contracts* § 74:56 at n.43 (4th ed. 2008). In this scenario, the lender would likely have alternative cause of action against the fund for unjust enrichment and/or *quantum meruit*. The existence of a valid and enforceable contract typically precludes recovery in quasi-contract for events arising out of the same subject matter,

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but if there is a *bona fide* dispute as to the existence of a contract or if the contract does not cover the dispute in issue, then the plaintiff may be able to proceed on an alternative theory such as unjust enrichment or *quantum meruit*. *See IIG Capital*, 36 A.D.3d at 404-05 (citations omitted).

48. *See IIG Capital*, 36 A.D.3d at 402-03.
49. It is important to note that "[n]otification is for the benefit of the assignee, who would otherwise have no recourse against the account debtor if the assignor failed to forward payment that the account debtor made directly to the assignor." *Novartis Animal Health US, Inc. v. Earle Palmer Brown, LLC*, 424 F. Supp. 2d 1358, 1364 (N.D. Ga. 2006).
50. *GMAC Commercial Credit LLC v. Springs Industries, Inc.*, 171 F. Supp. 2d 209, 213-14 (S.D.N.Y. 2001) (quoting *Septembertide Publishing, B.V. v. Stein and Day, Inc.*, 884 F.2d 675, 682 (2d Cir. 1989)).
51. *See, e.g., C.H.I. Inc. v. Marcus Bros. Textile, Inc.*, 930 F.2d 762, 763 (9th Cir. 1991) (enforcing terms of contract confirmation form that was sufficiently specific and provided for mutuality of remedy).
52. (*Iridium I*), 307 F. Supp. 2d 608, 612 (D. Del. 2004); *see also Blair v. Anderson*, 325 A.2d 94, 96-97 (Del. 1974) (holding that a federal prisoner could enforce a contract between the United States and Delaware involving care for prisoners, and stating: "It is established Delaware law that a third-party beneficiary of a contract may sue on it."); *John Julian Constr. Co. v. Monarch Builders*, 306 A.2d 29 (Del. Super. Ct. 1973) (creditor of liquidated corporation could enforce the assumption of liabilities contract against the defendants as a third-party beneficiary). Note that the analysis provided in these cases should apply equally to the investors in a limited partnership.
53. *Iridium I* at 612.
54. "Accordingly, the Court will grant Chase summary judgment on its first claim for relief, breach of contract." *Id*. "It is undisputed that Iridium LLC defaulted on the Chase Loan and that Chase called the Members' RCC obligations pursuant to Section 4.02 of the amended LLC Agreement. The Members refused to comply with Chase's demand for payment in contravention of the amended LLC Agreement, thus compelling the Court to grant Chase summary judgment on its breach of contract claim." *Id.* at 612 n.1. *See also Chase Manhattan Bank v. Iridium Africa* (*Iridium II*), 474 F. Supp.2d 613 (D. Del. 2007).

    "Based on the Court's conclusion that the Members may not deny the validity of the Certificate's representation that the amended LLC Agreement is "true and correct," the Court will not discuss the Magistrate Judge's Report and Recommendation on the issues of … 2) whether Chase is entitled to summary judgment on its first claim for relief due to the Security Agreement." *Iridium I* at 612 n.2.
55. For a highly publicised example, *see Wibbert Investment Co. v. New Silk Route PE Asia Fund LP*, case number 650437/2013, in the Supreme Court of the State of New York. Wibbert Investment Co., the investor, declined to fund a capital call after allegations of the general partner's gross negligence and/or willful malfeasance and the conviction of a related person for insider trading. Wibbert alleges that the Fund has threatened to implement default remedies, and he was granted a preliminary injunction preventing the fund from declaring default. The case is still active.
56. When the partnership agreement and subscription agreements do not contain waiver of defenses, the Partner Confirmations usually contain such language.
57. *See Iridium I* at 612-13 (where the LLC Agreement provided that each Member agreed that its duty to perform under the Reserve Capital Call (RCC) obligation was "absolute and unconditional" and each Member waived "any defense it may have or acquire with respect to its obligations under the [RCC]").
58. *See* 17B C.J.S. Contracts § 637 Waiver of Defenses (2008).

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59. *See Wells Fargo Bank Minnesota Nat. Ass'n v. Nassau Broadcasting Partners, L.P.*, No. 01 Civ 11255(HB) 2002 WL 31050850, at *2 (S.D.N.Y. Sept. 13, 2002) ("The hell or highwater provisions at issue, especially in light of the degree in which they explicitly waive [defendant's] right to assert setoffs, defenses or counterclaims, are generally enforceable.") (citations omitted).
60. No. Civ. A. 01-821-SLR, 2003 WL 360255, at *2-3 (D. Del. Feb. 14, 2003).
61. *Id*. at *3, n.1.
62. It appears by "anti-reliance language", the court refers to broad waiver of defense language that is clearly inconsistent with reasonable reliance on extracontractual representations (and therefore the defence of fraud in the inducement). In particular, the court refers as "anti-reliance language" the following language (emphasis added):

    "The right of the beneficiary to receive payment for losses under this policy shall be absolute, continuing, irrevocable and unconditional irrespective of … (c) *any other rights or defenses that may be available to the insurer to avoid payment of its obligation under this policy (all of which rights and defenses are hereby expressly waived by the insurer)....*"

    MBIA Ins. Corp. v. Royal Indemnity Co., 426 F.3d 204, 210 (3d Cir. 2005) (emphasis added) (Wells Fargo (and others) as beneficiaries under credit risk insurance policies insuring payment of principal and interest in the event of defaults on underlying student loans brought action against Royal Indemnity Company ("***Royal***"), as insurer, to recover under the policies. Royal defended on the ground that the lender of the underlying student loans fraudulently induced it to issue the policies and that this fraud in the inducement entitled it to rescission. The court held that Royal's policies unambiguously and effectively waived defences to its obligations even if induced by fraud.)

    The court pointed out that, to establish fraudulent inducement, the defendant insurer must show *reasonable and detrimental reliance* on a misrepresentation intentionally or recklessly made to induce action or inaction. *Id*. at 212. The court thought it was unfathomable that an insurer that intended to rely on extracontractual representations would agree that its obligations are "absolute, continuing, irrevocable and unconditional irrespective of ... any other rights or defenses that may be available to the insurer ... (all of which rights and defences are hereby expressly waived by the insurer)." *Id*. Thus, according to the court, the defendant insurer could not possibly claim that its reliance on those representations was reasonable when it waived all defences based on reasonable reliance. *Id*. Thus, an agreement may foreclose a fraud defence not only by waiving "fraud" but also by setting forth terms clearly inconsistent with reasonable reliance on extracontractual representations. *Id*. at 213.
63. *Id*. at 218 (emphasis added). The court acknowledged that some cases, in particular a line of New York cases, had referred to "*specificity*" (of the waiver language) as a test for the enforceability of waiver of defense language. However, the court then rejected such test and predicted that the Delaware Supreme Court would adopt the "*clarity*" (of the waiver language) test.
64. *Id*. at 217. Fraud in the factum is "the sort of fraud that procures a party's signature to an instrument without knowledge of its true nature or contents", and the party does not even know the "true nature" of what it is signing. *Id.*; *see also supra* note 62 and accompanying text.
65. *Commercial Money Ctr., Inc. v. Illinois Union Ins. Co.*, 508 F.3d 327 (6th Cir. 2007).
66. *Id.* Commercial Money Center, Inc. (CMC) was an equipment leasing business allegedly engaged in a Ponzi-type scheme. When CMC collapsed, numerous creditors and insurance companies filed claims and counterclaims related to credit transactions to which CMC was a party. One such transaction was a surety agreement between

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CMC (principal), Illinois Union (surety) and JPMorgan Chase (creditor, as trustee of Citibank). Under the surety agreement, Illinois Union was obligated to "answer for the debt, default, or miscarriage" of CMC notes purchased by Citibank. When CMC filed for bankruptcy, Illinois Union sought rescission of the surety agreement, arguing, *inter alia*, that CMC fraudulently induced Illinois Union to provide surety coverage through various material misrepresentations. In discussing Illinois Union's waiver of the right to assert fraud as a defence under the surety agreement, the court explicitly followed the *MBIA* opinion, ultimately finding that the allegations against CMC did not rise to the level of fraud in the factum (which is discussed below).

67. *Id.* at 344.
68. *See Eureka Broadband Corp. v. Wentworth Leasing Corp.*, 400 F.3d 62, 69-70 (1st Cir. 2005); *Computer Sales Intern., Inc. v. Lycos, Inc.*, No. Civ. A. 05-10017 RWZ, 2005 WL 3307507 at *5 (D. Mass. Dec. 6, 2005) ("[U]nder Massachusetts law, it is well settled that clauses 'attempting to protect a party against the consequences of his own fraud are against public policy and void where fraud inducing the contract is shown'." (citations omitted)); *see also F.D.I.C. v. Borne*, 599 F. Supp. 891, 894 (E.D.N.Y. 1984) ("A waiver of the right to assert a setoff or counterclaim is not against public policy and has been enforced by this court. However, such a waiver will not be enforced so as to bar a viable setoff or counterclaim sounding in fraud." (internal citations omitted)).
69. *See MBIA Ins. Corp. v. Royal Indemnity Co.*, 426 F.3d 204, 210 (3d Cir. 2005). Wells Fargo (and others) as beneficiaries under credit risk insurance policies insuring payment of principal and interest in the event of defaults on underlying student loans brought action against Royal Indemnity Company ("*Royal*"), as insurer, to recover under the policies. Royal defended on the ground that the lender of the underlying student loans fraudulently induced it to issue the policies and that this fraud in the inducement entitled it to rescission. The court held that Royal's policies unambiguously and effectively waived defenses to its obligations even if induced by fraud. The court pointed out that, to establish fraudulent inducement, the defendant insurer must show *reasonable and detrimental reliance* on a misrepresentation intentionally or recklessly made to induce action or inaction. *Id*. at 212. The court thought it was unfathomable that an insurer that intended to rely on extracontractual representations would agree that its obligations are "absolute, continuing, irrevocable and unconditional irrespective of ... any other rights or defenses that may be available to the insurer ... (all of which rights and defenses are hereby expressly waived by the insurer)." *Id*. Thus, according to the court, the defendant insurer could not possibly claim that its reliance on those representations was reasonable when it waived all defenses based on reasonable reliance. *Id*. Therefore, an agreement may foreclose a fraud defense not only by waiving "fraud" but also by setting forth terms clearly inconsistent with reasonable reliance on extracontractual representations. *Id*. at 213. *See also Manufacturers Hanover Trust Co. v. Yanakas*, 7 F.3d 310, 316-17 (2d Cir. 1993) (comparing New York state law waiver cases and concluding that "[w]here the fraud claim has been dismissed, the disclaimer has been sufficiently specific to match the alleged fraud [,]" but that "the mere general recitation that a guarantee is 'absolute and unconditional' is insufficient . . . to bar a defense of fraudulent inducement, and that the touchstone is specificity.").
70. For further analysis of the distinction between fraud in the factum and fraud in the inducement, *see infra JPMorgan Chase Bank v. Liberty Mutual Insurance Co.*, in which the surety was asked to insure the delivery of a commodity when, in fact, it was guaranteeing a loan. 189 F. Supp. 2d 24, 28 (S.D.N.Y. 2002); *see also MBIA Ins. Corp.*, 426 F.3d at 217 (describing *JPMorgan Chase Bank* as an "unusual and extreme case" and questioning whether waiver would even be possible when a contract is procured through fraud in the factum).

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71. In a capital commitment facility, the collateral granted by a limited partnership borrower to the lender falls under "general intangible" as defined in Article 9 of the UCC and the security agreement is governed by Article 9.
72. "Except as otherwise provided in this section, *an agreement between an account debtor and an assignor* not to assert against an assignee any *claim or defense that the account debtor may have against the assignor* is enforceable by an assignee that takes an assignment:
    (1) for value;
    (2) in good faith;
    (3) without notice of a claim of a property or possessory right to the property assigned; and
    (4) without notice of a defence or claim in recoupment of the type that may be asserted against a person entitled to enforce a negotiable instrument under UCC § 3-305(a)."
    UCC § 9-403(AM. LAW INST. & UNIF. LAW COMM'N 2010) (emphasis added)); *see also Id.* at Comment 2 ("However, this section expands former Section 9-206 to apply to all account debtors; it is not limited to account debtors that have bought or leased goods.").
73. *See* 68A Am. Jur. 2d Secured Transactions § 485 (2017).
74. Since UCC § 9-403's scope is not limited to waiver of defenses in negotiable instruments, it appears that when applying UCC § 9-403, one should read the word "instrument" in UCC § 3-305 as referring to whatever agreement or document which contains the waiver of defenses language in question. And presumably, it is regarding the same agreement or document the account debtor is raising a fraud in the factum defence. *See generally Chase Manhattan Bank, N. A. v. Finger Lakes Motors, Inc.*, 423 N.Y.S.2d 128 (N.Y. Sup. Ct. 1979); *MBIA Ins. Corp. v. Royal Indemnity Co.*, 426 F.3d at 217 ("Royal does not seriously question the nature of the transactions covered by its policies").
75. This defence is most frequently referred to by the courts as fraud in the factum, but is also sometimes denominated fraud in the essence or fraud in *esse contractus*, among other terms. *See* Milton Roberts, Annotation, Fraud in the Inducement and Fraud in the Factum as Defenses under UCC § 3-305 Against Holder in Due Course, 78 A.L.R.3d 1020 § 2 (1977); *see also supra* at notes 69-70 and accompanying text.
76. *See* UCC §§ 9-403, 3-305(AM. LAW INST. & UNIF. LAW COMM'N 2010).
77. *Supra* note 73 (citing *Equico Lessors, Inc. v. Mines*, 148 Cal. Rptr. 554 (Cal. Ct. App. 1978) (lessees refused to pay rent to lessor's assignee; court rejected as a valid defence against the assignee lessees' defense of failure of consideration – that the equipment had not been delivered); *Stenger Industries, Inc. v. Eaton Corp.*, 298 S.E.2d 628 (Ga. Ct. App. 1983) (lessee refused to pay rent to lessor's assignee; court rejected as a valid defence against the assignee lessee's defence – that machinery was defective); *Washington Bank & Trust Co. v. Landis Corp.*, 445 N.E.2d 430 (Ill. App. Ct. 1983) (lessee refused to pay rent to lessor's assignee; court rejected as a valid defence against the assignee lessee's defence – that the machine under the lease never worked and it was taken from lessee to make room for a replacement lessee never accepted)).
78. *See F.D.I.C. v. Kassel*, 421 N.Y.S.2d 609 (N.Y. App. Div. 1979) (lessee refused to pay rent to the successor in interest of the lessor's assignee; court rejected as a valid defence against the successor in interest of the lessor's assignee lessee's defence – that the lessee was fraudulently induced to enter into the lease arrangement); 68A Am. Jur. 2d Secured Transactions § 485 (citing *Chase Manhattan Bank, N. A. v. Finger Lakes Motors, Inc.*, 423 N.Y.S.2d 128 (N.Y. Sup. Ct. 1979) (lessees refused to pay rent to lessor's assignee; court rejected as a valid defence against the assignee lessees' defence

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– that the lessor entered into the contract for the express purpose of fleecing the lessees, assigning the paper to the assignee, taking the money and not performing)).

79. *Supra* note 73 (citing *Compton Co. v. Minolta Business Systems, Inc.*, 319 S.E.2d 107 (Ga. Ct. App.1984) (lessees refused to pay rent to lessor's assignee; court rejected as a valid defence against the assignee lessees' defence – that there had been no meeting of the minds with respect to certain terms of the contract and thus no contract was formed between the lessor and lessee).
80. *See Partnership Equities, Inc. v. Marten*, 443 N.E.2d 134, 136 (1982). However, one court has suggested a possible defense to a capital call contribution obligation where "a profound failure of consideration such as a repudiation of, or fraud incident to, the essentials of the venture to which subscription was made." *Id.* The example provided by the court of this possible defence was a general partner who absconded with all of the initial contributions and did nothing at all in furtherance of the partnership's goals. *Id.* Notably, a material breach of the partnership agreement, negligence, mismanagement, or disappointed expectations do not constitute defences to capital call obligations. *Id.* at 138.
81. *See British Int'l Ins. Co. Ltd. v. Seguros La Republica, S.A.*, No. 90 Civ.2370 (JFK) (FM), 2000 WL 713057, at *5 (S.D.N.Y. Jun. 2, 2000).
82. *See Greyhound Exhibit Group, Inc. v. E.L.U.L. Realty Corp.*, No. 88 Civ.3039 (ILG), 1993 WL 50528, at *1 (E.D.N.Y. Feb. 23, 1993).
83. *See Banco Central de Paraguay v. Paraguay Humanitarian Fund.*, No. 01 Civ.9649 (JFK), 2006 WL 3456521, at *9-10 (S.D.N.Y. Nov. 30, 2006).
84. *See, e.g.*, N.Y. C.P.L.R. § 5201 (2017).
85. *See, e.g.*, N.Y. C.P.L.R. § 5230 (2017).
86. 28 U.S.C. § 1963 (2017).
87. Uniform Law Commissioners, Uniform Enforcement of Foreign Judgments Act Legislative Fact Sheet, http://uniformlaws.org/LegislativeFactSheet.aspx?title=Enforcement%20of%20Foreign%20Judgments%20Act (last visited Nov. 29, 2017). California has a similar statute in place that accomplishes the same basic objective. Cal. Civ. Proc. Code §§ 1710.10-1710.65 (1974, 1977, 1982, 1983, 1984, 1985, 2003).
88. UEFJA § 2 (UNIF. LAW COMM'N 1964). Recall that domestic state pension plans with Eleventh Amendment immunity must be sued in the courts of their own state, and that there will be statutory requirements particular to each state that must be followed. *See supra* notes 23-24 and 26 and accompanying discussion.
89. U.S. Dep't of State, Enforcement of Judgments, http://travel.state.gov/content/travel/en/legal-considerations/ judicial/enforcement-of-judgments.html (last visited Nov. 29, 2017).
90. Philip R. Weems, *Guidelines for Enforcing Money Judgments Abroad*, https://www.adraonline.co.za/file/0ec97674ebb638f67ba20e9774d2761c/guidelines.pdf (last visited Nov. 29, 2017).
91. 307 F. Supp. 2d 608 (D. Del. 2004).

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The rise of private equity secondaries financings

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Summary

Whilst the use of leverage by secondary fund managers to finance secondary transactions is not a new phenomenon, the last few years have seen a significant growth in the number of secondaries transactions supported by debt finance and the number of secondary fund managers using debt as a liquidity and portfolio management tool. Like other types of fund finance products, these facilities are private and confidential in nature and therefore there is no publicly available data on the volume/size of the market. However, based on our experience, we estimate that the size of this market in 2017 exceeded $15bn globally and we believe that the majority of large private equity secondary acquisitions now invariably rely on some form of debt financing.

Whilst $15bn may seem small compared to the estimated size of the global fund finance market as a whole, this figure represents a significantly larger percentage of total capital raised by secondary funds (estimated at over $37bn in 2017) than global fund finance as a percentage of private capital raised globally, principally due to the fact that aggregate capital raised has consistently been dominated by secondary fund managers raising $1bn+ funds. In 2017, the average fund size reached almost $2bn as fewer larger managers continued to dominate this space, with echoes of the primary market. The size of secondary funds has increased by over 110% in the last decade. The largest deals in the market continue to involve sales of large portfolios of limited partner (LP) interests and buyers able to acquire a material portion of, or indeed all, of those stakes, enjoy stronger bargaining power. This drives larger transactions which, in turn, drives a greater need for debt financing.

However, the past few years have also seen a significant increase in general partners (GPs) raising smaller, more specialised funds focusing on particular regions, asset classes or strategies. Buy-out represents the majority of stakes sold in the secondary market but as these positions consistently trade near to or, in some cases, at par, secondary GPs are increasingly looking to strategies offering greater discounts, including real estate and venture. Many of the top secondary GPs are raising and managing ancillary vehicles alongside their general secondary funds to focus on niche strategies within secondaries. As a result, we have seen an increase in the financing of smaller secondary transactions, including the financing of direct interests and less diversified portfolios where, in some cases, the financing is of a single fund interest.

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In addition to the increase of acquisition finance debt in secondary transactions, we have also seen secondary GPs using senior debt later in the fund's life cycle to provide early liquidity for investors and, increasingly, as part of GP restructurings – all of this being driven by the high pressure on secondary GPs to continue achieving high levels of returns. Coupled with this is the fact that, as the secondary market has matured, so has the lender community's confidence in its ability to provide robust and "liquid" collateral to support debt finance in its various guises.

Yet the pool of lenders with credit appetite for this type of financing is considerably smaller than, say, the subscription credit facility market, and there are currently fewer than 15 specialised institutions globally in the market providing this type of financing on a standalone basis. Unlike the subscription credit facility market, this figure has only increased marginally year on year since the early 2000s, and we estimate that this slow growth in providers will continue. The core rationale for this is that the underlying assets are illiquid and, outside of direct secondary financings, lenders are unable to directly access or influence those underlying assets. The calculation of the net asset value (NAV) of the assets against which the lender is providing finance is neither necessarily scientific (as there is no marked to market (albeit the private equity industry has taken steps to improve this through its valuation methodologies)) nor necessarily a real representation of the potential for near-term cash generation. The only or primary source of repayment for a lender will be distribution proceeds resulting from realisations of the underlying assets, and there will be no clear visibility as to the timing of those realisations, which will be dependent on market factors at the relevant time.

In this article we examine:

- the factors behind the rapid emergence of the secondaries market and the financing opportunities this has given rise to;
- why secondary GPs and managers are increasingly looking to finance secondary transactions with debt finance and use debt as a liquidity and portfolio management tool;
- how specialised lenders are comfortable with the risk profile of these transactions;
- how secondary financing structures have evolved over the last 18 years; and
- how we expect the market to develop in the future.

What are the drivers behind the rapid growth of secondary financings?

The secondaries market has rapidly emerged over the years since the global financial crisis as a mainstream alternative asset class and significant component of the private capital landscape, with volume as at the end of Q3 2017 already reaching over $34bn, and many expecting 2017 to be a record year for deal volume. If, as expected, the aggregate capital raised globally by secondary funds by the end of 2016 reaches almost $40bn, this will represent an increase of over 40% from 2015. At the end of 2017, over 60 secondaries funds are in the market, targeting $25bn. Compare that to the approximately $10bn raised by secondary fund managers 11 years ago, and you have a market that has virtually quadrupled in size in that time. It is perhaps therefore not surprising that, as the secondaries market has grown, so has the popularity of financing to support the activities of secondary fund managers.

The secondaries market was historically stigmatised and regarded as a marketplace for distressed sellers forced to sell their interests out of necessity rather than as a product of active portfolio management, with the effect that sale prices achieved were at a significant

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discount to the reported NAV. As the market has matured and become a crucial portfolio management tool for private markets managers, higher pricing has followed suit – in 2017, average pricing was approximately 90% of NAV across all strategies – such that secondary funds now deliver in IRR terms higher median net multiples than all other private markets funds. So, what is behind this rapid growth?

- In the immediate aftermath of the global financial crisis, the seller market was dominated by distressed sellers such as banks and insurance companies forced by regulation to reduce their private equity positions. Now these sellers make up a significantly smaller percentage of sellers globally.
- Sellers are now not selling out of necessity but through active portfolio management, as they seek to rebalance their portfolios across asset classes, industries and vintages and refocus their investment strategies on a smaller group of GPs. The blind pool risk associated with primaries is substantially reduced in secondaries as the investments are mature, substantially invested assets.
- Buyers looking for access to the private markets to increase their private equity exposure are attracted to the level of diversification across all strategies, vintages, managers and geographies and near-term cash realisation prospects of secondary funds.
- Via stapled transactions, secondary fund managers are using the secondary market as an opportunity to create capital for future fundraises, as well as fresh capital for existing funds via co-investment rights.
- In the case of direct secondaries, portfolio companies are using the secondary market to breathe life back into the investment via a new investor.
- Importantly, the availability of leverage for secondary transactions is driving volume.

Why are secondary fund managers using debt both to finance secondary transactions and as a portfolio management tool?

- ***Enhancement of returns:*** leverage, if structured and priced correctly, can enhance returns significantly for secondary fund managers by reducing the weighted average cost of capital.
- ***Filling the funding gap:*** vendor financing on secondary acquisitions has historically been a large and, in some instances, necessary part of structuring secondary transactions. Leverage facilities can, however, be used to replace the need for deferred consideration and allow the purchaser to finance the sale consideration in full at the time of completion, thus allowing the purchaser to differentiate itself from other potential purchasers in a competitive situation.
- ***Accelerated liquidity:*** whilst one of the most attractive features of secondary funds for investors is the accelerated liquidity profile these funds afford, as sellers' pricing expectations remain high, leverage facilities can provide early liquidity for secondary fund managers to crystallise returns to investors without needing to exit underlying positions. Equally, the manager can use this liquidity to acquire other assets or portfolios without needing to call capital from investors.
- ***Increased firepower:*** debt financing can significantly enhance the firepower of a secondaries manager in a competitive bid situation, a tool which has become increasingly important as dry powder levels in the private equity secondaries industry continue to rise and prices remain on average at a slim discount to NAV.

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The lender's perspective …

Whilst on the face of it these transactions might not seem attractive from a credit perspective due to the illiquid nature of the underlying assets, the uncertainty around the accuracy of the NAV calculation, and a lack of visibility on the timing and level of distributions flowing to the secondaries fund to repay the facility, there are a number of features of these transactions which, for specialised institutions with capacity to carry out the requisite due diligence and a sophisticated understanding of this asset class, make these transactions compelling propositions:

- ***Diversification:*** whilst we are beginning to see many transactions which are more concentrated in a few or even one single LP position, a large number of transactions are highly diversified across a number of high-quality underlying fund managers, with excellent performance track record where positions are highly funded.
- ***The absence of over-leverage in the underlying portfolio:*** not every secondaries transaction will be suitable for leverage finance, and one of the key factors a lender will take into consideration in assessing whether or not leverage is appropriate is the level of leverage in the underlying portfolio.
- ***Near-term cashflow generation:*** whilst there is no absolute guarantee that market conditions will be conducive to a sale of the relevant underlying positions within the tenor of the facility, a sophisticated and experienced leverage provider to this asset class will be able to assess the likelihood of near-term cash generation and will typically look for assets which are likely to be realised within 18-24 months. These facilities typically include a mandatory cash sweep of all or a portion of distributions (depending on the LTV level and general risk profile of the transaction) and, in our experience, the operation of these sweeps generally results in these facilities being repaid within only a couple of years.
- ***Comparatively low-geared financing:*** current market conditions with high valuation multiples provide for low LTV and LTC (loan to cost) ratios which present an appealing risk profile, even when lenders apply the most vigorous stress-testing on performance models.
- ***Reduced risk of blind pool lending:*** whilst the secondaries market provides more visibility of underlying LP performance than in the fund of fund financing space (which tends to rely more on statistical lending and bottom-up analysis), lenders will often place value on the historic data that a fund manager who is also an investor in the underlying portfolio can provide.
- ***Experience of secondary fund management team:*** seasoned lenders will often take into account the track record and market know-how of individuals within a management team. Whilst there are a number of new funds that have come to market in recent years, longevity and expertise can often be found in the partners within the new fund manager, which can be a compelling argument for credit committees.
- ***Hybrid value-add***: to mitigate the concentration risk in transactions with few or a single LP position, some fund managers are able to offer additional credit enhancement in the form of a guarantee or equity commitment from the secondary fund itself in support of the SPV financing. This is a significant value-add which allows lenders to consider the creditworthiness of the secondary fund (and often the LPs behind it) when considering pricing and risk allocation.

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Secondary structures

<u>The past</u>

The shift from direct to indirect security over collateral…

Over the past decade, we have seen the structure of secondary financings continue to evolve as the market has matured. In the early 2000s when the product was nascent, the closest type of mainstream financing to secondary financing was leverage/acquisition finance and this understandably framed the mindset of lenders in structuring the terms of the financing and the collateral package. In practice, this meant that lenders expected to have direct security over each item of collateral, being each LP interest which was the subject of the acquisition financing. Invariably, this arrangement was prohibited by the terms of the underlying fund documents governing the LP interest being acquired, and required the consent of the underlying general partner or manager.

Moreover, not only was the granting of security over the interest prohibited by the terms of the underlying fund documents, but the ability of the lender to transfer the interest to a third party purchaser on an enforcement of such security required such consent. Lenders also expected to be involved in the negotiation of the form of the consent to be given by the underlying general partner or manager in order to ensure that it adequately addressed both the proposed security and any future transfer of the interest following an enforcement. The consequence of this for secondary managers contemplating using debt finance for their transaction was that if they had not factored this into their very early-stage discussions with the seller, attempting to put this type of financing in place at a later stage would prove challenging given the practical difficulties caused by the length of time it would take to negotiate the consents, as well as the commercial difficulties in attempting to reopen discussions with the seller on the terms of the sale and purchase.

As the market began to open up in the years leading up to the global financial crisis as more institutions began to show credit appetite for these types of financings, the balance of power visibly began to shift to the secondaries managers, who began to question the necessity and value of this financing and collateral structure. Often, these acquisitions involved multiple LP interests in various jurisdictions – in some cases exceeding 50 or more interests – which resulted in these transactions being costly and time-consuming to implement. Enforcing all of these security interests individually through multiple processes in multiple jurisdictions would also necessarily be more protracted and expensive. Further, even where discussions around the form of consent required by the lender took place at an early stage in the transaction, in most cases the underlying managers were unable to give more than an upfront consent to the creation of security. Providing an upfront consent to the transfer of the interest on an enforcement to an unidentified third party was virtually impossible for a fund manager to agree to, given the secondary fund manager's obligation to its investors to ensure that the admission of an LP would not give rise to any adverse legal, regulatory or tax consequences for the fund and its existing investors, as well as the manager's duty to independently assess the creditworthiness of the LP in respect of any unfunded commitments. Secondary fund managers were therefore left questioning the real value of this collateral structure and began a dialogue with lenders around other alternative structures.

What appeared to quickly emerge was an acceptance that, although direct security over individual interests (and obtaining the relevant consents) was the preferred collateral package for a lender, in certain situations where the secondaries manager was of a very high quality and well known to the lender, where the underlying assets were quality, highly

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diversified assets and, importantly, that the structure of the fund and the underlying fund documents allowed the lender to benefit from indirect security over those LP interests, the financing was still viable through an indirect collateral structure.

... ***Indirect collateral structures***

In basic terms, indirect collateral structures involve the secondaries manager setting up a wholly owned special purpose vehicle (the **SPV**) which, in turn, acts as the purchaser of the target LP interests. The financing is entered into with the secondaries fund backed by a guarantee from the SPV and secured by way of a pledge (or equivalent) over the secondary fund's interest in the SPV. Whilst this structure does not give the lender the same flexibility to directly enforce its security over individual LP interests (subject to the consent considerations outlined above), it does, if structured correctly and provided the underlying fund documents do not prohibit the same, allow the lender to sell the underlying portfolio as a whole to a third party purchaser without the need for consent from the underlying manager via one enforcement process. However, there are still a number of potential issues to navigate with this structure:

- ***The requirement for consent***: taking indirect, rather than direct, security does not necessarily obviate the need for consent from the underlying manager. Many provisions in private markets limited partnership agreements which seek to regulate the transfer of LP interests are not drafted with this type of arrangement in mind, yet in some instances the language could capture indirect security and an enforcement thereof. These provisions need to be reviewed carefully to establish whether consent is still required and, if it is, how this can be resolved. Even if the provisions could capture indirect security and/or indirect enforcement of such security, in many cases the stated consequences of a breach of these restrictions in the relevant underlying limited partnership agreement do not bite unless the transfer involves a change to the identity of the LP on the register of limited partners. If, however, it is clear that consent is required, then either:
  - (a) ***consent:*** consent will need to be obtained, noting that any such consent is likely to be limited as described above, with the result that consent may be needed for the enforcement of the indirect security interest over <u>all</u> of the LP interests making up the portfolio; or
  - (b) ***hive-out:*** the affected LP interest is hived out into another SPV and either remains unsecured, and therefore outside of the qualifying collateral for the purpose of the financing, or comes into the secured portfolio at a later stage if a clean consent can be obtained from the underlying fund manager.
- ***The nature of the indirect security:*** generally, as a result of tax considerations, the SPV cannot be formed as a limited company and must be formed as a limited partnership. Whilst taking security over the entire interest in a limited company is generally straightforward and quick to both implement and enforce in many jurisdictions that we routinely come across in these types of financings, it is significantly more challenging to achieve the same result in respect of a limited partnership. The reason for this is that, unlike with a corporate structure, the interests in a limited partnership are split between the limited partners and the general partner and, in order to be able to transfer the entirety of the interests in the partnership so as to be able to deliver both the control and economics of the limited partnership and its assets, both of the interests need to be transferred. The exact issues to be navigated will be dependent on the relevant jurisdiction in which the SPV and its general partner are formed, but are likely to include:

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a) ***regulation*****:** taking and/or enforcing security over the shares in the general partner may require regulatory consent and/or give rise to liability issues. In some cases, this can be avoided by the interposition of an SPV above the general partner and security taken over the interests in the SPV rather than the general partner itself, but this isn't always the case and alternatives will need to be found; and

b) ***nature of security over the limited partner interest*****:** when taking this type of security, a lender will be looking for the legal title of the interest to remain with the fund and to take the benefit of an equitable charge/assignment (or equivalent) over the interest, which will allow it to transfer the interest to a third party on an enforcement. However, some jurisdictions do not recognise the concept of an equitable charge and/or, in some jurisdictions, the taking of security over the entire interest requires certain public announcements to be made. If security over the whole of the interest cannot be taken due to these or other factors, it may still be possible to take security over the economic entitlement of the limited partner, which is principally where the value lies in this interest, although this may impact the marketability of the asset on an enforcement. This may be coupled with a power of attorney to facilitate the transfer of the interest in such circumstances, although the survival of the power of attorney in an insolvency scenario will need to be taken into consideration in determining its value.

The present and the future…

Whilst direct and/or indirect collateral structures are still the most common and preferred structures employed in secondary acquisition financings, we have seen an increase in the number of secondary fund managers looking for debt financing later on in the life cycle of the fund to bridge distributions to its investors where the value of the underlying portfolio supports this. With this type of financing, it is too late for the foundations of the indirect collateral structure to be put in place (if not there already) and the direct collateral structure is likely to be heavily resisted where there are a large number of LP stakes forming part of the portfolio. In these situations, depending on: (i) the quality of, and relationship with, the manager; and (ii) the quality/value/diversification of the underlying assets, we have seen lenders get comfortable with alternative structures, including:

a) ***distribution account security and winding-up protection:*** relying on a pledge over the distribution accounts held by the fund, alongside the ability of the lender to wind up the fund in a default scenario. Note that this structure has only been seen with very high-quality managers and where there is a close relationship across other product lines between the lender and the secondaries manager; or

b) ***custody arrangements:*** where the underlying assets are held through a custodian, an assignment of the secondary manager's interests in the custody agreement to give the lender the ability to direct the custodian in an enforcement scenario; or

c) ***trust arrangement:*** where the underlying documentation permits the same and where this structure is appropriate for the relevant transaction, the creation of a trust in respect of the manager's interest in the underlying assets.

The outlook for 2018

A combination of a continuing low interest rate and difficult macro environment, which is unlikely to change any time soon, is creating significant challenges for investors as these factors weigh on returns across many asset classes. These factors, coupled with the consistently high performance of the private equity secondaries market comparative to other

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asset classes, will continue to attract a wide range of sellers and buyers to the market and continue to drive the growth of the secondaries market, which will in turn drive the volume of debt finance used by secondary fund managers. As the levels of dry powder in the industry increase year on year, secondary fund managers are under considerable pressure to use their capital as efficiently as possible and leverage, both in respect of secondary transactions and portfolio management, will continue to be an invaluable tool.

* * *

Endnote

1. Latest data available at the time of writing this article.

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1940 Act issues in fund finance transactions

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Introduction

As discussed elsewhere in this publication, investment funds and other issuers use financing through loans and other credit instruments for a variety of reasons, including to provide liquidity for redemptions or capital calls, or as leverage in an attempt to magnify investment returns. Lenders and other counterparties, when arranging financing or engaging in similar transactions with an investment fund (or any issuer with fund-like characteristics), should remain conscious of a number of legal and regulatory issues, including those presented by the Investment Company Act of 1940, as amended (the **1940 Act** or the **Act**). Many in the finance industry are aware that the 1940 Act applies a broad and proscriptive regulatory framework to funds registered with the Securities and Exchange Commission (**SEC**) under the 1940 Act, such as open-end funds (mutual funds), closed-end funds, interval funds (such funds, **Registered Funds**) and business development companies (**BDCs**, which we include within the term Registered Funds unless otherwise noted). Lenders and counterparties, however, must also be aware that the 1940 Act applies to transactions with a private fund – and any other issuer with certain characteristics set out in the 1940 Act – and could prohibit a transaction with such an issuer and render the transaction documents void.

The manner in which the 1940 Act applies to fund financing and similar transactions depends on the type of fund involved – private funds and other issuers generally need to comply with an applicable 1940 Act exemption, while Registered Funds are subject to numerous 1940 Act prohibitions and restrictions on borrowing and embedded leverage. Further, the 1940 Act's leverage and related provisions apply differently depending on the type of Registered Fund involved in the transaction. We discuss these topics in more detail below.[1]

The 1940 Act

The 1940 Act is the principal federal regulatory regime applicable to investment funds, and is likely most familiar as the regulatory framework governing the structure and operation of mutual funds, closed-end funds, and BDCs. The 1940 Act, however, also broadly prohibits any entity that meets the definition of "investment company" from using means of United States commerce to engage in certain activities – including borrowing money and issuing securities – unless it qualifies for an exemption from registration with the SEC. As a result, fund counterparties need some level of understanding of what types of entities are or may be deemed investment companies.

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The definition of "investment company"

The 1940 Act, by its express terms, applies to an "investment company", which definition generally includes an issuer:

- that is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting or trading in securities; or
- that is engaged or proposes to engage in the business of investing, reinvesting, *owning, holding* or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40% of the value of the issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis.[2]

The first definition is intended to apply to an entity whose structure and operations are that of a *bona fide* investment fund, such as a hedge fund, a private equity fund, or a venture capital fund. The second definition, by design, captures "inadvertent" investment companies and entities that may intend to operate a non-investment business but whose activities and assets suggest otherwise (i.e., the second definition ignores an entity's intent). Lenders and counterparties should be careful not to assume that an entity that runs a non-investment business is not an investment company, as the "inadvertent" definition applies to any entity with a large proportion of securities on its balance sheet, including securities of minority-owned subsidiaries and joint ventures. As a result, a holding company with this type of structure may be an investment company, even if its subsidiaries or joint ventures engage in true operating company businesses.

Other potential inadvertent investment companies include an operating company that has sold (or may sell) a business line that represents a large majority of its assets and invests the proceeds temporarily in securities, certain securitisation vehicles, certain issuers engaged in a real estate securities business, start-up companies with significant cash on their balance sheets, and entities that carry large balances of securities for operational or regulatory purposes, such as banks and insurance companies.

Investment company prohibitions and consequences – Private funds and other entities

Meeting the definition of an investment company generally prohibits an entity from engaging in certain activities in the United States unless it has registered with the SEC. More specifically, Section 7(a) of the Investment Company Act prohibits a U.S.-domiciled entity that meets the definition of investment company from engaging in ***any*** business in interstate commerce and from offering or selling any security in the United States. Section 7(d) of the Act prohibits a non-U.S. entity that meets the definition of investment company from offering or selling its securities in the United States.[3]

These prohibitions present less of an issue for mutual funds, closed-end funds and BDCs that intend to register with the SEC, but are more complicated for an entity that intends to remain unregistered or a borrower whose business could not practically comply with the 1940 Act's restrictions on capital structure, governance, and affiliate transactions, such as a REIT, a CLO, or other similar entity. Moreover, given the 1940 Act's definition of "security", which is broader than the definition used in the Securities Act of 1933, many loan transactions – and guarantees of those loans – with private funds and other entities that meet the definition of investment company may be considered securities offerings under Section 7.

Not only could an entity's noncompliance with Section 7 result in a violation of the 1940 Act for which it could be subject to SEC enforcement, it also directly affects any lender or counterparty to that entity. Section 47 of the 1940 Act deems any contract made in violation

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of the Act, or whose performance involves a violation of the Act, unenforceable by either party, unless a court finds that enforcement of the contract would be more equitable than non-enforcement. As a result, a lender or other counterparty to any entity in a financing transaction will, in all but the most obvious instances, typically seek representations and covenants from the entity, and a legal opinion from the entity's counsel, that provide comfort that no 1940 Act issue exists.

Investment company exemptions

Fortunately, however, the 1940 Act contains a number of exemptions from the definition of investment company so as to allow an entity that does not intend to be an investment company to potentially avoid having to register with the SEC (and, thus, avoid having to attempt to fit its business into the comprehensive regulatory requirements of the 1940 Act) or, in the case of a non-U.S. entity, allow it to raise capital in the United States. We discuss below some of the more common exemptions.

For entities structured as funds, Section 3(c)(1) and Section 3(c)(7) of the 1940 Act provide the most applicable exemptions.[4] These exemptions apply somewhat differently to U.S. and non-U.S. funds. An entity formed or otherwise organised in the United States that seeks to rely on Section 3(c)(1) must meet two conditions: (1) the entity cannot make or presently propose to make a public offering of its securities; and (2) the entity cannot have more than 100 beneficial owners of its securities.

An entity formed or otherwise organised in the United States that seeks to rely on Section 3(c)(7) needs to meet two conditions: (1) the entity cannot make or presently propose to make a public offering of its securities (this is the same condition as in Section 3(c)(1)); and (2) all of the Section 3(c)(7) entity's beneficial owners must be "qualified purchasers" or "knowledgeable employees".

Section 2(a)(51) of the 1940 Act and certain rules under the 1940 Act define "qualified purchaser" to include:

- natural persons who own at least $5 million in investments;
- closely held family companies that own at least $5 million in investments;
- trusts that have not been formed for the specific purpose of acquiring the securities of the private fund and as to which the trustee and each settlor or other person contributing assets to the trust are qualified purchasers; and
- persons (including entities) acting for their own account or the accounts of other qualified purchasers, that in the aggregate own and invest on a discretionary basis at least $25 million in investments.

Further, an entity will be a "qualified purchaser" if all of its owners are qualified purchasers.

Section 3(c)(1) and Section 3(c)(7) apply similarly to non-U.S. entities, although pursuant to interpretive positions of the SEC and its staff, an entity formed outside of the United States neither needs to count its non-U.S. investors towards the 100-investor limit in Section 3(c)(1) nor ensure that its non-U.S. investors are qualified purchasers.

Other exemptions from the definition of investment company exist. Securitisation vehicles (including some CLOs) may be able to meet the exemptions provided by Section 3(c)(5)(A) or (B) of the 1940 Act and Rule 3a-7 under the Act, while REITs and other real estate issuers typically qualify for the exemption in Section 3(c)(5)(C) of the Act. Rule 3a-2 under the 1940 Act exempts temporary or "transient" investment companies that have a *bona fide* intent to return to operating company status, and a more qualitative exemption provided by Section 3(b)(1) of the Act may be available to certain holding company structures and

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entities with a demonstrable history of non-investment company operations, although this exemption generally has been interpreted narrowly by the SEC and its staff and presents somewhat less comfort to counterparties due to its qualitative nature.

Potential Volcker Rule issues

Notwithstanding an entity's ability to rely on Section 3(c)(1) or Section 3(c)(7) to avoid 1940 Act issues, relying solely on one of such exemptions would result in the entity being a "covered fund" for purposes of Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, commonly referred to as the "Volcker Rule". As a result, any counterparty that is subject to the Volcker Rule as a "banking entity" needs to consider whether it holds any equity or other interest in the covered fund that could be deemed to be an "ownership interest" for purposes of the Volcker Rule.

As a general matter, loan transactions are not considered ownership interests, although certain derivatives may be. Similarly, a banking entity lender that acquires covered fund ownership interests as a result of a default scenario (as may be the case in a financing to a fund-of-funds that collateralises its loan with the equity interest of the underlying funds into which it invests) can generally rely on an exemption that allows it to hold such interests for a period of time. The exemption allows for a bank to hold fund interests acquired in the ordinary course of a "debt previously contracted" (or **DPC**) so long as the bank lender "divests the financial instrument as soon as practicable, and in no event may the banking entity retain such instrument for longer than such period permitted by [its primary regulator]", typically within approximately two years.

Any borrower that can rely on a 1940 Act exemption other than Section 3(c)(1) or Section 3(c)(7) (or that can otherwise rely on one or more specific exemptions provided by the Volcker Rule itself) generally would not be a covered fund.

Investment company prohibitions and consequences – Registered Funds

The 1940 Act is the principal federal regulatory regime applicable to Registered Funds such as mutual funds, closed-end funds, and BDCs. The 1940 Act imposes comprehensive and substantive regulatory and compliance obligations on virtually every aspect of a Registered Fund's business, including organisational matters and registration with the SEC, governance, investment strategy, transactions with insiders and affiliates, selling and distribution of shares, internal compliance and review, custody of assets, liquidity of assets and, most relevant to the topic of fund finance, leverage and capital structure.

1940 Act capital structure/leverage restrictions

The 1940 Act does not expressly prohibit a Registered Fund from borrowing or obtaining leverage. Strict limits on a Registered Fund's capital structure, however, are imposed through restrictions on a Registered Fund's ability to issue "senior securities", defined generally by the 1940 Act to mean "any bond, debenture, note or similar obligation or instruments constituting a security and evidencing indebtedness, and any stock of a class having priority over any other class as to distribution of assets or payment of dividends". The 1940 Act, in the context of leverage, states specifically that:

> *the national public and the interest of investors are adversely affected …when investment companies by excessive borrowing and the issuance of excessive amounts of senior securities increase unduly the speculative character of their junior securities… or… when investment companies operate without adequate assets or reserves.*

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Different limitations and prohibitions exist depending generally on the type of Registered Fund (mutual fund, closed-end fund, BDC) and the liquidity it offers, although any Registered Fund can enter into temporary borrowings of short-term duration of up to 5% of the fund's total assets. A loan is presumed to be temporary if it is repaid within 60 days and is not extended or renewed.

Mutual funds – Registered Funds that offer daily liquidity through redeemable shares – can borrow from a bank (on a secured or unsecured basis) so long as the fund maintains a 300% asset coverage ratio (including the amount borrowed) at all times that the borrowing is outstanding (e.g., a mutual fund with $100 in assets and no existing debt could borrow only $50). An open-end fund may not have any class of debt securities.

Closed-end funds (including interval funds)[5] – which do not issue redeemable securities – can borrow from a bank or from private sources (on a secured or unsecured basis), subject to the same 300% asset coverage requirement. A closed-end fund, however, also can have a capital structure that includes one class of stock, one class of preferred securities, and one class of debt. A closed-end fund must have asset coverage of 200% for its class of preferred stock and 300% for its class of debt; both the preferred stock class and the debt class must include certain restrictions and protections for the senior security holders, such as dividend stopper provisions and board election rights.

BDCs elect to be regulated under the 1940 Act and thus are not, as a literal matter, registered under the 1940 Act. A BDC election, however, subjects a BDC to regulation under the 1940 Act in much the same way as a closed-end fund, including with respect to its capital structure, although the 1940 Act requires a BDC to have only 200% asset coverage of its debt and borrowings. A BDC can also issue multiple classes of debt.

As a commercial and legal matter, any counterparty lender to a Registered Fund should conduct extensive diligence on the fund, its investment objective and portfolio holdings (particularly with respect to BDCs, which are required to hold at least 70% of their assets in specific investments), liquidity ratios (particularly with respect to closed-end funds and BDCs), presence of subsidiaries, maintenance of registration with the SEC, and on any potential affiliated relationships with the fund, as the 1940 Act generally prohibits affiliates of a Registered Fund from transacting with the fund on a principal or joint basis.

Wholly owned subsidiaries

At times, a Registered Fund may form wholly owned subsidiaries as extensions of the fund's operations and to facilitate its investment strategy. Such subsidiaries can, among other things, borrow for investment leverage; such structures are common for Registered Funds that operate a futures or commodities strategy, and BDCs that form and hold small a business investment company (**SBIC**) and other subsidiaries to access the credit markets. The staff of the SEC generally requires a Registered Fund to consolidate such subsidiaries and to treat any debt subsidiary debt (and assets) as its own. Some BDCs may be eligible for SEC exemptive relief that does not require consolidation of any SBIC subsidiaries; a BDC would need to apply to the SEC for such an exemption, which the SEC may determine not to provide.

Securities lending issues

Apart from traditional credit lines and revolving facilities, many Registered Funds use securities lending programs as a form of leverage designed to enhance returns on their portfolios. The SEC and its staff generally consider a securities lending transaction where a Registered Fund loans its portfolio securities to be a form of borrowing subject to the 1940

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Act's asset coverage and other requirements. In general, a Registered Fund that engages in securities lending is subject to the following requirements:

- securities loans are subject to a 300% asset coverage requirement;
- the Registered Fund's board of directors must formally approve the program and the fund's registration statement must expressly provide that the fund's fundamental policies do not prohibit securities lending;
- the Registered Fund must earn a "reasonable" return on the securities it lends (which can be a combination of fees and interest and returns on the loaned securities);
- each loan must be 100% collateralised (collateral typically ranges from 102% to 105% of the market value of the loaned securities) with cash, US government securities or irrevocable bank letters of credit;
- collateral must be marked-to-market daily and adjusted accordingly to cover increases in the market value of loaned securities and decreases in the value of the collateral;
- the Registered Fund must be permitted to terminate any securities loan at any time and recall the loaned securities; and
- the Registered Fund must be able to exercise voting rights with respect to the loaned securities.

<u>1940 Act restrictions on derivatives transactions</u>

A Registered Fund may also seek to increase returns by engaging in derivatives transactions with embedded leverage, such as short sales, writing options, futures transactions, swaps, forwards, reverse repurchase agreements, and when-issued commitments. The SEC and its staff interpret Section 18 of the 1940 Act and the definition of "senior securities" broadly, and consider any transaction that creates a potential future payment or delivery obligation on the part of the fund to be a senior security.

Based on SEC and staff interpretive positions over time, a Registered Fund, however, generally avoids consideration of a derivative instrument as a "senior security" – *and thus avoids having to apply the 1940 Act's 300% asset cover requirements to the derivative* – so long as the Registered Fund "covers" its obligations that can arise as a result of the derivative by setting aside liquid assets in an amount (marked-to-market daily) equal to those obligations.[6] In some cases, including with respect to many cash-settled transactions such as swaps, a Registered Fund can set aside the net amount of its potential exposure rather than the full notional amount of the transaction. The SEC staff also permits a Registered Fund to "offset" its exposure to a derivative counterparty rather than set aside liquid assets. A Registered Fund can "offset" its exposure created by one derivative transaction by entering into another position that fully offsets its exposure to the first.[7]

The SEC, in a departure from its and its staff's decades-old approach to derivatives that focuses on asset segregation/offset, proposed in 2015 new Rule 18f-4 under the 1940 Act. Rule 18f-4 would, if adopted, require a Registered Fund to adhere to one of two specific portfolio limits on derivatives in addition to complying with asset segregation. The portfolio limits include: (1) an aggregated exposure based-limit where the fund would be required to cap its notional exposure created by derivatives to 150% of its net assets; and (2) a risk-based limit that permits aggregate notional exposure up to 300% of its net assets but would be available only if the fund satisfied a "value at risk" test that demonstrates that the use of derivatives has reduced the fund's overall portfolio risk. The asset segregation element of proposed Rule 18f-4 would require a Registered Fund to segregate/cover its derivatives positions at mark-to-market plus an additional risk-based amount that represents what the

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fund would have to pay to close out the position in stressed market conditions. The SEC proposed Rule 18f-4 in December 2015 and received comments from the public and the fund industry. The comment period closed in March 2016.

Other 1940 Act considerations

Derivatives transactions raise a number of other issues under the 1940 Act Fund. Certain Registered Funds are subject to portfolio diversification and industry concentration requirements that require careful analysis in connection with the use of derivatives, as counterparties/industries can often be difficult to identify consistently. All Registered Funds are subject to specific portfolio valuation requirements, asset custody requirements (which raise particular issues for swaps counterparties that are accustomed to receiving counterparty assets as pledges of security, potentially raising 1940 Act custody issues), and limits on investing in the equity or debt of issuers in a "securities-related business", which captures fund counterparties such as banks and dealers.

* * *

Endnotes

1. We do not discuss situations where a fund provides financing by way of originating loans as lender or acquiring the existing credit instruments of a borrower.
2. A third definition applies to "face amount certificate" companies, although it is uncommon for issues to arise under this definition.
3. Broadly speaking, a non-U.S. lender or counterparty to a non-U.S. entity does not trigger Section 7(d) of the 1940 Act as a literal matter. Section 7 applies, however, to the extent the counterparty is a U.S. person or the fund or entity is a U.S. person.
4. Section 3(c)(1) and Section 3(c)(7) are most commonly used by hedge funds, private equity funds, and venture capital funds due to those exemptions' limited conditions. Section 3(c)(1) and Section 3(c)(7) are not, however, limited to entities organised as funds; any entity that meets the terms of the applicable exemption is exempt from the definition of investment company.
5. An interval fund is a type of closed-end Registered Fund that offers periodic liquidity through scheduled redemptions or tender offers.
6. Specific liquidity rules apply to certain Registered Funds, and setting aside liquid assets to cover a derivatives position generally results in the covering assets being "illiquid". A Registered Fund entering into a short sale may, for example, hold the stock that it is selling short or purchase an option to acquire that stock.
7. A Registered Fund writing a call option on a security may, for example, hold the security or purchase a call on the same security at the same price.

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Recent developments in fund financing:
Hybrid facilities, insider leverage and overcall limitations

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Background – Subscription Facilities and NAV Facilities

In recent years, credit facilities provided to private equity funds have been dominated by two forms: the "Subscription Facility" and the "NAV Facility".

The Subscription Facility – sometimes referred to as a "capital call" credit facility – has become increasingly common for newer funds with significant unfunded capital commitments, with the loans secured by the fund's right to call such capital commitments from its investors. Availability under a Subscription Facility is subject to a "borrowing base" determined as a percentage of the unfunded commitments of certain "included" investors in the fund (with the inclusion and advance rates on such unfunded commitments dependent on the creditworthiness of each such investor). Subscription Facilities are generally intended to serve a fund borrower's short-term capital needs by bridging the time between the issuance of capital calls to investors and the time such capital is actually contributed.

But for many funds, Subscription Facilities are not a viable option, either because the fund's organisational documents do not permit such facilities (or do not permit certain essential features – e.g., the pledge of capital commitments to a third-party lender) or, in the case of a mature fund, the fund has already called upon – and thereby reduced – a significant portion of its commitments. These private equity funds have sought instead to raise capital through an "asset backed" or net asset value facility: a "NAV Facility". NAV Facilities are credit facilities backed by the assets included in the fund's investment portfolio. For a "fund-of-funds", these assets will typically be the limited partnership and other equity interests in hedge funds and private equity funds, often purchased by the fund-of-funds borrower in the secondary market.

Availability under a NAV Facility is also subject to a borrowing base, in this case determined by reference to the net asset value of "eligible" portfolio investments satisfying specific investment criteria (e.g., the absence of certain adverse investment events) and often adjusted for manager, industry and other concentration limits. In the event that, at any time, the ratio of loans outstanding under the NAV Facility to the borrowing base as adjusted from time to time (the "LTV Ratio") exceeds a specified threshold, the NAV Facility will

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require the borrower to prepay loans in order to bring the facility into compliance with such maximum LTV Ratio.

In this article, we examine and contrast the typical structures of and collateral securing Subscription Facilities and NAV Facilities, as well as focus on recent developments with respect to such facilities, including the increasing use of hybrid facilities, with features of each type.

Structure and collateral: Subscription Facilities

Subscription Facilities typically include a "main/onshore" fund borrower as well as an "offshore" fund co-borrower or guarantor, with the ability to add additional fund borrowers that are liable for the loan obligations on a joint and several basis. This structure allows the fund borrower to include a broader range of investors in the borrowing base, since the lender will only give borrowing base "credit" to investors in a fund that is itself a guarantor or joint and several co-borrower of the facility. In a typical Subscription Facility, the main/onshore fund, the offshore fund (together with the main/onshore fund, the "Pledging Funds") and the general partner(s) of the Pledging Funds grant a security interest in favour of the lender in: (i) the unfunded capital commitments of the investors in such funds; (ii) the right to make capital calls on such investors; and (iii) the deposit accounts into which the resulting capital contributions are funded. To perfect the lenders' security interest in such collateral granted by the Pledging Funds, UCC financing statements are filed against each Pledging Fund and its general partner and the deposit accounts of the Pledging Funds are made subject to control agreements, with the lenders' right to block most often springing upon an event of default or borrowing base deficiency.

Structure and collateral: NAV Facilities

Unlike Subscription Facilities, which "look up" to the capital commitments of investors in the fund borrower for collateral, NAV Facilities "look down" to the underlying portfolio investments of the fund borrower for credit support. In a typical NAV Facility for a fund of private equity funds, the fund establishes two special purpose vehicles ("SPVs"). The first SPV, the borrower (the "NAV Facility Borrower"), is created for the sole purpose of obtaining the financing under the NAV Facility and holding the equity interests of the second SPV ("Holdco"), which directly (or, less frequently, indirectly) owns the portfolio investments included in the borrowing base. The NAV Facility Borrower generally provides an "all assets" pledge to the lender to secure its obligations under the facility, including a pledge of 100% of the equity interests of Holdco (the "Equity Interest Collateral").

If the NAV Facility Borrower is a limited partnership, lenders will generally require that its general partner (the "General Partner") provide a pledge of the general partner interests in the NAV Facility Borrower (the "GP Interest"). Holdco most typically guarantees the NAV Facility Borrower's obligations under the NAV Facility and secures such guarantee with a pledge of the deposit and securities accounts into which distributions on and proceeds of the portfolio investments are paid.[1] This double-SPV structure and pledge of Holdco equity and, where applicable, the GP Interest, provides lenders upon a default with the right to foreclose upon (or exercise other secured creditor remedies with respect to) the Equity Interest Collateral, thereby obtaining the ability to manage an orderly disposition of the underlying portfolio investments. To perfect the collateral granted by the NAV Facility Borrower and Holdco, UCC financing statements are filed against both entities and any such deposit or securities accounts are required to be subject to control agreements in favour of the lender.

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In contrast, if the NAV Facility is for a fund of hedge funds rather than private equity funds, the lender will typically require the NAV Facility Borrower to credit its underlying hedge fund investments to a securities account under Article 8 of the UCC, which account is held at a securities intermediary. The securities intermediary becomes the legal owner of the underlying hedge fund investments (with beneficial ownership remaining with the fund borrower), thereby creating a "securities entitlement" in favour of the borrower. The borrower then pledges this securities entitlement, as well as the securities account (but not the underlying hedge fund investments) to the lender to secure its obligations under the NAV Facility. To ensure perfection of the lender's security interest in the securities entitlement, the securities account is subject to a control agreement in favour of the lender – here most often with day-one control – and a UCC financing statement is often filed against the fund borrower. The pledge of the securities entitlement, and protections under the control agreement, provide the lender, upon an event of default, with the right to instruct the securities intermediary to redeem the underlying hedge fund interests pursuant to the terms of the underlying fund documentation.

Recent developments in NAV Facilities

Historically, NAV Facilities have been used by fund-of-funds to borrow against the value of limited partnership and other equity interests in private equity and hedge funds. Recently, however, some private equity funds have been using the NAV Facility technology to borrow against the equity value of their investments in operating/portfolio companies.[2] Given the illiquidity of these assets, these facilities will likely take the form of "Hybrid Facilities", secured not only by interests in the underlying portfolio investments but also by fund investors' capital commitments. Typical features of Hybrid Facilities – consistent with other forms of fund financings – include: (i) posting additional collateral or pre-paying in the event the LTV Ratio (calculated on the basis of the value of the underlying portfolio investments) exceeds a certain threshold; and (ii) a mandatory prepayment upon the loan amount exceeding a certain percentage of unfunded capital commitments. Hybrid Facilities are particularly useful for a fund looking for long-term financing that is available from the fund's inception (when it has significant uncalled capital commitments, but few (if any) investments) until the time the fund is fully invested (when all such commitments have been utilised to finance such investments).

In another recent devolvement, funds have used the NAV Facility technology to permit fund management and other insiders to leverage their existing investments in the funds they manage. Given that, in these cases, the collateral consists of internally controlled underlying funds, lenders are permitted to take a direct pledge of the underlying fund interests and, thus, lend on a greater percentage of the value of the underlying fund interests.

Recent developments in Subscription Facilities

Limited partnership agreements and other organisational documents of Pledging Funds for Subscription Facilities (especially investor "side-letters") often contain various types of "overcall" limitations. These limitations ("Overcall Limitations") take a number of forms, but all limit the obligation of the applicable investors to fund more than a specified percentage of any capital call or capital calls in the aggregate. Overcall Limitations most typically arise in connection with a defaulting (or excused) investor's failure to fund a capital contribution, in which case, absent such limitation, the other investors would effectively be required to make up the resulting shortfall. An Overcall Limitation limits the performing investor's obligation to fund that shortfall.

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Recently, there has been a particular focus by lenders on the terms of side letters to identify any Overcall Limitation applicable to an individual investor (an "Individual Overcall Limitation"). For example, assume a fund borrower has agreed to an Individual Overcall Limitation capping an investor (the "Capped Investor") at not more than 19.99% of aggregate funded capital of the fund. Assuming that such Capped Investor represents 17.5% of the fund's commitments, on a $100 million capital call, the Capped Investor should be required to fund $17.5 million. However, if one or more investors constituting 25% of the fund's commitments default, the actual amount funded will be only $75 million. This would mean that the Capped Investor will have funded $17.5 million of $75 million, or 23.3% of the aggregate call, in excess of its 19.99% limitation (requiring the fund to return approximately $2.5 million to such Capped Investor).

Where the capital commitment of the Capped Investor relative to the fund size makes the likelihood of breaching the Individual Overcall Limitation reasonably likely, lenders may insist that Individual Overcall Limitation not apply to capital contributions utilised to repay the Subscription Facility. Another solution, where the remedy of the Capped Investor for a breach of the Individual Overcall Limitation is limited to transferring its capital commitment (as opposed to the more customary withdrawal right by the Capped Investor), is for the lender to prohibit in the Subscription Facility documentation the general partner of the fund from consenting to any such transfer that would result in a borrowing base shortfall by virtue of a transfer to a less credit-worthy investor, unless the borrower repays any outstanding loans in the amount of such shortfall. Finally, depending on the mix of "included" investors, lenders have taken comfort that, as a practical matter, the Overcall Limitation would only be breached in the exceedingly remote circumstance in which a significant number of high-grade investor defaults occur.

Conclusion

As funds continue to realise the benefits of using NAV Facilities, we expect to see the types of funds using such facilities, as well as the purposes for which such facilities are used, continue to broaden. Further, as the use of Subscription Facilities continues to rise and lenders continue to focus on the organisational documents of funds seeking Subscription Facilities, we expect to see further developments in the approach to Overcall Limitations, as well as a rise in other, even more technical issues implicated by such documents.

* * *

Endnotes

1. We note that in certain NAV Facilities, the Holdco entity acts as borrower, with the top-level SPV providing a downstream guarantee of the borrower's obligations secured by a pledge of the Equity Interest Collateral. While for purposes of this article, there is no difference between the two structures, we have referred to the more typical approach throughout.
2. We note that lenders providing these facilities to private equity funds are almost always structurally subordinated to lenders providing financing secured directly by the assets of the underlying portfolio companies.

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Fund finance: An 'offshore' perspective

Alex Last, Danielle Roman & Robert Duggan
Mourant Ozannes

Introduction

The private equity funds market, like many aspects of the financial services industry, has become increasingly globalised and complex over recent years. Whether it is General Partners in China looking to raise capital from investors based in the United States, or Europe-based banks lending to Asia-based funds, this global trend looks set to continue as existing players search for new opportunities and new market entrants look to break into the industry.

One thing that is certain is that this growth in cross-border activity and complexity has coincided with an ever-increasing use of fund vehicles established in well-regulated and sophisticated "offshore" finance centres such as the Cayman Islands, Guernsey and Jersey. For example, based on statistics released from the Registrar of Exempted Limited Partnerships in the Cayman Islands, there are over 20,000 exempted limited partnerships registered in the Cayman Islands, more than double the number registered at the end of 2009.

This chapter will explore the role of the leading offshore jurisdictions in the private equity funds market. As part of this, we will discuss the key reasons why offshore vehicles are popular from a sponsor, investor and lender perspective and review findings from a research project commissioned by Mourant Ozannes (in which market participants, including many of the leading global private equity sponsors, were interviewed by independent researchers). We will then examine the key offshore aspects of a typical subscription finance transaction, using a Cayman Islands structure as an example. Finally, we will look at some of the trends we have observed from an offshore perspective in each of the United States, Asia and Europe from our Cayman Islands, Hong Kong and London offices.

Why offshore?

Fund perspective

It is a truism that market participants have a natural tendency to use vehicles in their home jurisdiction where they are familiar with the legal, regulatory and tax regimes. Accordingly, there has to be a tangible benefit to establishing a fund in a third country.

In our experience, there are a number of factors which drive the choice of fund domicile. From a General Partner's (**GP's**) perspective, probably the most important consideration is fundraising. It is crucial that the GP is able to present a fund to market that is established in a jurisdiction which works for, and is familiar to, the target investor audience. This is

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particularly acute for first-time or smaller GPs. The fundraising process can be challenging and highly competitive. GPs do not want to spend time in investor meetings discussing choice of domicile, they want to focus discussions on the investment opportunity. As a result of this, momentum plays a huge part in jurisdictional selection. In order to move away from the tried and tested model, there has to be an incentive to change.

The world's leading fund sponsors have been using jurisdictions such as the Cayman Islands, Guernsey and Jersey as part of their structures for many years. Equally, and probably more importantly, institutional investors have been investing in them. They understand the regulatory and tax treatment of these vehicles in their home jurisdictions, and that their rights as investors will be maintained and protected. The key commercial parties in the industry have developed a clear understanding and confidence in these jurisdictions.

One thing that all of the key jurisdictions mentioned have in common is a sophisticated and stable legal regime based on English common law principles. Equally, each has a highly regarded and well established judicial system. The court of final appeal for the UK overseas territories and Crown dependencies (including the Cayman Islands, Guernsey and Jersey) is the Judicial Committee of the Privy Council in London. This provides a huge amount of legal certainty to market participants.

The importance of the finance industry to the economies of the offshore finance centres means that they are very focused on ensuring that their product offering is at the cutting edge of developments in the market and can respond quickly to change. To this end, the legislation applicable to fund structures in each of these jurisdictions is constantly being adapted and modified to cater to the demands of the end user. For example, the Exempted Limited Partnership Law in the Cayman Islands was overhauled in 2014 to bring it closer into line with the corresponding Delaware legislation and to deal with a number of specific points related to the private funds market.

One of the biggest advantages of an offshore jurisdiction is that it provides neutrality for all parties to the transaction. No-one has home field advantage. This is particularly acute in transactions involving multiple counterparties in multiple jurisdictions with often conflicting legal systems. Investors may be willing to take investment risk in relation to a particular opportunity or in a particular jurisdiction but, in most cases, they are reluctant to take structural risk. Channelling an investment through a vehicle established in a neutral and well-regulated jurisdiction such as the Cayman Islands helps to mitigate this. It provides a platform which is understood and acceptable to all parties to a transaction and, most importantly, enables a huge amount of certainty of outcome.

<u>Lender perspective</u>

It is important to note that private equity funds do not operate in a vacuum. As such, it is not just the GP and limited partner (**LP**) community that has to be comfortable with the domicile of the fund. All commercial counterparties need to be familiar with and understand the consequences of using a particular domicile. In the context of fund finance, establishing a fund in an unfamiliar jurisdiction may, at the extreme end, affect a fund's ability to borrow and, in all cases, is very likely to affect pricing.

In our experience as offshore counsel, from a bank's perspective, the key concerns are the identity and perceived creditworthiness of the LPs, the maintenance of the value of the secured assets (i.e. ensuring that there is no leakage, e.g. through excuse provisions or the use of blocker or feeder vehicles) and, ultimately, its ability to enforce its security upon default. These concerns are significantly mitigated if the transaction is structured through a neutral, creditor-friendly, jurisdiction such as the Cayman Islands.

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Mourant Ozannes' private equity survey

In order to critically assess market trends and opportunities in the private equity industry, we commissioned independent researchers to interview 200 GPs and 60 institutional LPs spread equally across Asia, Europe, North America and the rest of the world. The results were extremely interesting.

Unsurprisingly, the survey revealed that one of the biggest concerns for both GPs and LPs was the ever-changing and complex regulatory landscape. In particular, the EU's Alternative Investment Fund Managers Directive (**AIFMD**) has clearly made it more challenging for GPs to raise funds from EU-based investors.

However, notwithstanding this regulatory headwind, market sentiment was still extremely strong when it came to allocations to funds domiciled offshore. Well over half of the LPs surveyed globally (60%), and 70% of those in North America, in particular, plan to increase or maintain the amount of capital they have invested in private equity funds in offshore locations in the next five years.

The survey also highlighted the increasingly cross-border nature of the industry, with Asia- and Europe-based investors looking to increase allocations to North America over the coming years, and vice versa. In particular, sentiment towards opportunities and the outlook for private equity in Europe (and the UK especially) was very strong.

When asked what the most important factors were when it comes to deciding to make an allocation to a private equity fund, the LPs surveyed highlighted investment strategy as the most important. However, our research indicated that the location of a fund is also firmly on the list of factors that influence LPs investment decisions, with 25% of respondents indicating that this factor sits in their 'Top Three' decision-influencing criteria. Interestingly, when GPs were asked what they thought LPs valued most, a returning investor base came out on top, followed by the reputation of the GP.

One of the frustrations felt by many of the offshore jurisdictions was the tendency by the popular media to try to paint a negative picture of all offshore centres, failing to differentiate between those that have taken a global lead in transparency and regulatory initiatives and those that have clung to an outmoded secrecy model.

The research very clearly supported the analysis above as to why the private equity market uses offshore fund vehicles. From a GP perspective, the top reasons given for using offshore structures were based on the sophistication and robustness of the legal regimes of jurisdictions like the Cayman Islands, Guernsey and Jersey. Respondents focused on the sophistication and quality of the applicable legislation in the relevant offshore jurisdictions. The key factors that the GPs surveyed highlighted were: predictability of law enforcement; speed to market; fund structuring flexibility; a mature dispute resolution environment (including the number and quality of professional services firms operating in the relevant jurisdictions); and tax neutrality.

From an LP perspective, the key drivers were: fund structuring flexibility; clarity of regulation; tax neutrality; a mature dispute resolution environment; and cost.

Leaving aside fundraising, the survey also very clearly highlighted the concerns of both GPs and LPs over rising asset prices and the competition in the market to acquire assets. This was particularly true in North America, where 79% of the GPs surveyed highlighted this as an acute challenge. Just over half of the GPs believed that this was having a negative effect on their relationship with LPs. On the other side of the coin, two thirds of LPs believed this was negatively impacting their view of GPs.

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How does this impact fund finance?

The survey results were interesting from a fund financing perspective for a number of reasons.

Firstly, from a structural perspective, it seems clear that funds will continue to be domiciled in jurisdictions like the Cayman Islands, Guernsey and Jersey (and so lenders will continue to provide finance to vehicles formed in these jurisdictions).

Secondly, given the increasingly globalised fundraising environment, we anticipate that fund structures will only become more complex with the continued use of multiple feeder and alternative investment vehicles (**AIVs**) to cater for the particular tax, legal and regulatory demands of investors in multiple jurisdictions. In our experience, many of the largest fund sponsors are particularly heavy users of AIVs in their fund structures.

Thirdly, a clear theme which came through from the survey was the importance of speed of execution. This is particularly important given high asset prices and competition for deals. With this in mind, it is highly likely that GPs will continue to utilise fund-level financing facilities to execute deals in an expedited manner. Furthermore, we expect that LPs will expect this as they look to their GPs to find and execute the best deals.

Finally, and related to this, we expect the use of net asset value (**NAV**) facilities to increase as GPs look for deals in the secondary market. Over three quarters of the GPs surveyed confirmed that they are looking for deals outside of their normal primary markets to find opportunities to add value as a result of high asset valuations.

Fund level credit facilities: an offshore view

Based on the above analysis, it is clear that offshore structures will continue to play a key role in the private equity market and, as a result, fund finance. With this in mind, it is helpful to look practically at the role offshore legal advisers play when looking at a typical fund finance deal. We note that a separate jurisdiction-by-jurisdiction analysis is set out elsewhere in this book and so we have assumed that a Cayman Islands structure is used for the purposes of the discussion in this section.

The involvement of offshore advisers in a fund finance transaction is derived entirely from the fact that one of the entities involved in the transaction (e.g. the fund vehicle or an AIV) is formed in an offshore jurisdiction. Accordingly, the focus of local counsel is on the law as it affects the relevant vehicle. For example, does the relevant entity have the authority and legal capacity to enter into and perform its obligations under the relevant finance documents as a matter of local law and under its constitutional documents and do the relevant documents create valid, binding and enforceable security in the relevant jurisdiction? Invariably, a lender will look to obtain a "clean" legal opinion from local counsel to confirm this is the case before lending.

As such, the role of offshore counsel differs somewhat from that undertaken by the principal counsel to the parties. While the latter will concern themselves with negotiating the main deal documentation to protect their respective clients' positions and with ensuring that the terms of the documents reflect the commercial understanding between the parties, the role of offshore counsel is essentially twofold: firstly, focusing on the fund borrower itself, its ability to enter into the deal and ensuring it follows the correct procedures in doing so; and secondly, ensuring that legal considerations arising out of the law of the fund's jurisdiction of formation are adequately addressed.

<u>Fund documentation and due diligence</u>

Given that the primary focus of local counsel is on the borrower entity formed in the

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relevant offshore jurisdiction, it follows that a key part of the role is to carefully review the constitutional documents of the relevant entity. In the context of a private equity fund constituted as a limited partnership, this will be the limited partnership agreement (**LPA**).

In particular, counsel will review the LPA to ensure that it permits the fund to avail itself of the relevant credit facility, and for the fund and the GP to grant security over the unfunded capital commitments of the LPs. In addition, counsel will look for, amongst other things, language giving the GP the power to make capital calls to fund bank financing obligations (including after expiration of the investment period), the ability to grant a power of attorney to support the security package, and any provisions which may impose restrictions on borrowing (e.g. relating to duration or purpose). As noted above, counsel will ultimately be expected to issue a "clean" opinion to the effect that the transactions contemplated by the deal documents do not breach the LPA, and so will look for anything which may affect the ability to provide this.

It is now common for LPAs to include provisions expressly permitting the fund to enter into subscription facilities and to grant security over those unfunded capital commitments, but there may be other restrictions or conditions which must be met. For example, advisory committee consent may be required, or there may be restrictions on the maturity or amount (typically expressed as a percentage of aggregate capital commitments) of any permitted indebtedness. In these situations, offshore counsel will raise the restrictions with their instructing counsel or client in order to ensure that appropriate steps are taken or protections built into the documents.

The terms of investor side letters can also impact the deal in a number of ways. Although it is unlikely that the terms of a given side letter will operate to prevent a fund ever entering into a subscription facility, they can dilute the value of the investor's commitment as part of the security package. The ways in which they can do so are almost unlimited. We have seen examples of side letters providing: that an investor is only obliged to fund capital calls made by the GP, rather than by any delegate or attorney; that default remedies under the LPA may only be exercised by the GP; that investors be given extended grace periods to cure funding defaults or before the fund; or that the GP may exercise default remedies, or grant investors additional excuse provisions in certain circumstances. We have also seen side letter terms to the effect that investors need not provide any financial information for the benefit of a financing lender unless such information is already publicly available. In these circumstances, the usual course of action for the lender is to exclude the relevant investor from the facility's borrowing base.

When reviewing the structure, a lender's counsel should also be alive to the potential for leakage if the LPA permits the GP to set up AIVs, blockers or parallel funds. Such provisions can allow the GP to divert investor commitments to these other vehicles. As noted above, in our experience the biggest PE sponsors tend to be very "AIV heavy" in their fund structures.

If the LPA contains such provisions, lenders will want to ensure it also permits the GP to grant security over the undrawn investor commitments to any such vehicles, and the facility documentation should include covenants obliging the fund and the GP to ensure that any investor commitments to these vehicles are added to the security package. The lender will typically expect any legal opinion to also be extended to these AIVs (which are usually also established in offshore jurisdictions).

Finance documents: issues to note

Rather than focusing on the commercial aspects of the transaction documents (which, as noted above, is more the purview of principal counsel), offshore counsel will instead

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concern themselves primarily with aspects of the documentation which may be impacted by local law.

The key offshore jurisdictions are sensitive to the demands of their principal users, including the private equity industry, and aim to meet those demands with user-friendly and practical legislation: as noted above, the Cayman Islands, for example, overhauled its Exempted Limited Partnership Law in 2014 in response to industry feedback.

Because of this, offshore fund vehicles tend to be flexible and their governing legislation accommodating of common industry practice, and it should rarely be necessary for offshore counsel to make substantial comments on a draft loan agreement or security document. The review will mainly concentrate on ensuring that appropriate representations and events of default are included and that customary conditions precedent documents are included and correctly described.

Notification of assignment of call rights: "perfection" and priority

The typical security package will include rights under the fund's LPA, which will be governed by the law of the jurisdiction where the fund is formed and registered. Accordingly, offshore counsel will need to satisfy themselves that any relevant legal requirements for the creation and perfection of this security are satisfied.

For example, lenders and fund sponsors who use Cayman Islands fund structures will know that, in order to secure the priority of the lender's security interest over capital call rights under the LPA, it is necessary to notify investors that those rights have been assigned as part of the security package.

The timing for the dispatch of such notices can frequently be a point of negotiation between lenders eager to safeguard the priority of their security and GPs who are reluctant to disturb investors unnecessarily. Lenders will generally want GPs to send notices upon closing, and to provide lenders with evidence of delivery (since the notice is only effective when received by an investor, rather than upon dispatch), whereas GPs may be unwilling to do this and only to send notices on the next financial reporting date or upon default. Ultimately, this will be determined by the relative negotiation position of the parties.

A lender faced with a GP adopting such a negotiating position might derive some comfort from remembering two things. First, although the sending of notices is frequently described as a "perfection" requirement, from a Cayman Islands law perspective it is not technically so, in the sense that a valid security interest will still have been created at signing even if no notices are sent. Secondly, from a Cayman Islands law perspective, the "priority" of the lender's security interest is its priority only as against *competing* interests in the secured assets. A validly created security interest over capital call rights will still have priority over the claims of a liquidator or unsecured creditor of the fund even if no notices have been sent, and covenants in the main credit agreement prohibiting additional indebtedness and negative pledges in the security documents should ensure that, as a matter of contract, the risk of a competing creditor claiming a security interest over the call rights is minimal.

Offshore legal opinions

An offshore legal opinion should address both the capacity of the fund to enter into the transaction documents and the enforceability of those transaction documents against it.

It has long been market standard in any kind of lending transaction for a borrower's offshore counsel to give opinions to the effect that the borrower is duly formed and registered and in good standing, that it has taken all necessary action under its constitutional documents to authorise its entry into, and to perform its obligations under, the transaction documents,

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and that the obligations of the fund under those transaction documents are legal, valid, binding and enforceable.

In addition to these "standard" opinions, there are a number of additional aspects deriving from the particular features of subscription credit facilities which lenders are increasingly requiring to be addressed in any offshore legal opinion.

Given the importance of the capital call rights to the quality of the credit, lenders will want the offshore opinion to confirm not only that a valid security interest has been created over those rights and that the secured party will have recourse to those assets in priority to any third party (including a liquidator or unsecured creditor of the fund), but also that priority as against competing interests is secured by sending notice of the assignment to the limited partners, and specifically that the form of notice prepared for this purpose (typically included as an exhibit to the credit agreement or security document) will be sufficient to achieve this.

In addition, lenders are now frequently requesting the borrower's offshore counsel (who, in most cases, will have acted on the formation of the borrower vehicle and so will have had input into the drafting of the LPA) to confirm in their opinions that the obligations of the limited partners under the LPA to contribute capital when called are legal, valid, binding and enforceable.

It is also becoming increasingly prevalent for a borrower's offshore counsel to be asked to confirm that the fund's obligations under the transaction documents do not conflict with or breach the terms of any side letter. As noted above, this may not be possible in all circumstances.

Jurisdictional focus

As discussed, the private equity market and, as a result, the fund finance market have become increasingly globalised. Given the role offshore jurisdictions play in this market, we are often well placed to spot trends. In essence, what happens offshore is a mirror of the onshore market.

We have set out briefly below some observations on the market in North America, Asia and Europe from our private equity and fund finance practices in the Cayman Islands, Hong Kong and London.

USA

The offshore jurisdiction we see most used by fund sponsors in North America is the Cayman Islands. In most cases, the offshore Cayman Islands fund complements the corresponding onshore fund of the relevant sponsor which, from our experience, is typically established in Delaware. The Exempted Limited Partnership Law in the Cayman Islands very closely tracks the equivalent Delaware statute.

In addition, the Cayman Islands recently introduced a new LLC regime which, again, largely mirrors the corresponding Delaware legislation. The Cayman LLC will enable US sponsors to easily replicate their onshore LLC vehicles offshore. Aside from fund-level financing, and beyond the scope of this chapter, we also expect the LLC to feature in GP financing transactions, as it lends itself well for GP, carry and management company structuring.

In terms of deal trends, the number of fund financing transactions we have been working on has grown enormously over the last few years. This has covered both typical bridge financing but also increasingly longer-duration deal financing and NAV facilities,

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particularly in a secondary deal context. We expect this to continue. We have a number of large sponsor clients who are increasingly utilising capital call facilities to finance deals and, correspondingly, looking to reduce the number of LP capital calls they make each year.

From a fundraising perspective, the key trend we have seen from an offshore perspective is a flight to quality, with larger sponsors being able to close new funds extremely quickly. The survey confirmed this and also demonstrated that, notwithstanding the challenges of high asset valuations, both the GP and LP community remain positive about the outlook for the private equity market in the United States over the coming years.

Asia

The private equity fund structure we see most commonly used in Asia is the Cayman Islands exempted limited partnership. In fact, in Asia, it is rare to come across an offshore fund domiciled in a jurisdiction other than the Cayman Islands.

There have been a number of large funds raised in Asia over the last couple of years. However, fundraising has been more challenging given the strong performance of funds in mature markets like the United States. The points noted above about the "flight to quality" and competition for deals are equally applicable in Asia.

One trend that we have observed is the launch of various "entrepreneur" funds by GPs spinning out of technology companies rather than traditional investment firms. These have gained traction with global investors, including institutional LPs in the United States. These funds have performed well and so we expect this trend to continue.

In a fund finance context, the subscription facility market is at an earlier stage of development in Asia but we have seen a significant increase in the number of transactions over the last few years. While most of these have tended to be fairly "plain vanilla" subscription lines, the market is growing in sophistication and we have seen a rise over the last 12 months in higher-value syndicated and bespoke capital call facilities. There have also been a number of GP financings. We have observed the trend of GPs "rolling up" and making fewer capital calls. This is particularly noticeable with some of the larger sponsors.

The lender profile in Asia has been evolving as awareness and understanding of capital call facilities has grown. Historically, there were a few US banks offering such facilities to the more established Asia sponsors. However, a shift in strategic focus from local banks in Asia has led to an increased interest from them in this market. Broadly, the lenders we now see in Asia can be split into three categories.

- First, US banks who are actively seeking subscription line opportunities in the Asian market.
- Secondly, UK, Australian and European banks offering such facilities from time to time to key relationship clients or to bring in new target clients as part of their private equity focus.
- Finally, Chinese and other Asian banks, who are newer entrants to the market and are eager to compete by offering cheaper lending with lower interest rates and margins.

We expect the influence of this third category to grow as investment in private equity by Asian-based institutional and sovereign wealth investors also grows. Ultimately, the credit risk on a fund-level financing is the LP base and, inevitably, Asia-based lenders are likely to be more comfortable with Asia-based LPs (with whom they may have a long-standing relationship) than overseas lenders.

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Europe

In the European market, the offshore jurisdictions we see most frequently used for private equity structures are Guernsey and Jersey. This is particularly the case for London-based GPs. Again, the typical fund vehicle for private equity structures in both jurisdictions is the limited partnership.

The fundraising environment in Europe has been dominated by the introduction of the AIFMD. Almost all of the GPs surveyed confirmed that they have found it more challenging to raise funds from investors based in the European Union since the introduction of AIFMD. That said, there have been some very significant fund-raisings over the last few years utilising both Guernsey and Jersey fund vehicles.

From a fund finance perspective, we have seen an increasing use of subscription facilities. Interestingly, as with Asia, the number and influence of US banks in the European market has increased. From an offshore perspective, as the European fund finance market has matured, a key trend has been greater focus from fund formation counsel on the borrowing provisions in LPAs. Typically, LPAs will now contain very clear provisions dealing with subscription facilities and the related security package.

Again, the points noted above in relation to flight to quality, competition for deals and fewer capital calls, are also prevalent in the European market. However, as noted above, our survey demonstrated clearly that both GPs and LPs are very optimistic about the European private equity market and, in particular, the opportunities in the UK over the next five years.

Conclusions

In our view, the above analysis demonstrates that finance centres like the Cayman Islands, Guernsey and Jersey have a key role to play in the private equity funds market and, as a corollary to that, the fund finance market. This is particularly true to the extent that the industry continues to grow and expand across geographical borders.

Ultimately, these offshore jurisdictions are familiar to investors in multiple countries and provide neutrality, political stability and legal certainty to market participants from diverse regions. They are a vital part of the private equity eco-system.

Given the continued growth in the global private equity market, we fully expect that banks and other lenders will find themselves increasingly providing financing to, and taking security over the assets of, borrowers formed in one of these offshore jurisdictions. Equally, we are confident that the jurisdictions themselves will continue to adapt and develop their product offering to remain at the cutting edge of the industry and to ensure that they continue to be attractive to each of the GP, LP and lender communities.

* * *

Endnote

1. Minimum fund size surveyed US$200m.

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Equity commitment facilities: A primer

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Introduction

Equity commitment facilities ("***ECFs***") are loans to a portfolio company ("***Portfolio Company***") of a private equity fund ("***Fund***") where the lender's ("***Lender***") primary and intended source of repayment is a contractual commitment from the Fund to contribute capital to the Portfolio Company. Somewhat akin to both a contractually committed "equity cure" in the leverage finance market and a subordinated, unsecured subscription credit facility ("***Subscription Facility***") in the fund finance market, ECFs have increased in popularity in recent years. When properly structured and documented, ECFs are fundamentally sound transactions that provide the Lender with a clear and viable path to full repayment from creditworthy sources in the ordinary course. However, there are material nuances and complexities in both the transaction structure and enforceability analysis that the Lender should fully understand to properly underwrite an ECF. This chapter summarizes the key structural features of an ECF and outlines the essential considerations for Lenders.

Transaction structure

Basic structure

While the ECF structure could in theory be applied to any Portfolio Company, the structure offers the most utility where the Portfolio Company is either an early-stage vehicle formed to undertake a development-type project or where the Portfolio Company faces some level of short-term illiquidity and requires a bridge cash infusion. In both circumstances, the Portfolio Company is likely without sufficient cash flow or tangible assets to obtain the needed credit on preferred terms. Historically, these circumstances compelled the Fund to contribute equity capital into the Portfolio Company immediately to enable the Portfolio Company to execute its business plan. However, with an ECF, the Fund only contractually commits (the "***Equity Commitment***") to fund equity into the Portfolio Company immediately, but is not obligated to actually fund the capital ("***Equity Contributions***") until receipt of a demand notice from the Portfolio Company or the Lender. The Lender, in reliance on the Equity Commitment, in turn makes the loan immediately, enabling the Portfolio Company to use the loan proceeds to execute its business plan. Ultimately, if not repaid by other means, the ECF is repaid by a capital call on the Equity Commitment. ECFs are often structured in connection with a "follow on" investment of the Fund in the Portfolio Company and not in connection with the initial acquisition or investment. We have typically seen ECFs in the infrastructure and energy areas, although they seem well-suited to other, similar contexts.

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Benefits of ECFs

ECFs have multiple benefits for Portfolio Companies, Funds and Lenders. For the Portfolio Company, ECFs offer debt capital that would otherwise be unavailable on comparable terms. ECFs are typically structured with no financial covenants tied to the performance of the Portfolio Company, thus enabling operational flexibility. The cost of an ECF is typically meaningfully lower than what the Portfolio Company could secure based on its own credit wherewithal, thus reducing cash drag and increasing EBITDA. For the Fund, in addition to improving the performance of its Portfolio Company, an ECF defers the need to contribute additional equity capital into the Portfolio Company. In fact, if the Portfolio Company is successful in executing its business plan with the loan proceeds from an ECF, it may be able to eventually refinance the ECF with new credit facilities recourse only to the Portfolio Company, thereby completely eliminating the need for the Fund to contribute the follow-on Equity Contribution. In addition, an ECF may provide a Fund a structural solution when an outright guaranty or use of the "Qualified Borrower" feature under the Fund's Subscription Facility are unavailable due to capacity limitations. For the Lender, an ECF provides an attractive, risk-adjusted return from familiar repayment sources and deepens its relationships with both the Fund sponsor and the Portfolio Company.

Collateral package

The Portfolio Company secures an ECF with a pledge of its rights in the Equity Commitment, including its right to call and enforce the funding of Equity Contributions by the Fund. The Portfolio Company also establishes a deposit account (the "***Collateral Account***") into which all Equity Contributions are required to be deposited. The Collateral Account is pledged to the Lender and the Lender has authority to take exclusive control of the Collateral Account upon the occurrence of certain triggering events, including any event of default under the ECF. This collateral package is quite familiar to Lenders. It is identical to that in a Subscription Facility, just one step removed. The Fund itself provides no collateral to secure an ECF.

Fund involvement and disclosure

ECFs are typically fully disclosed and transparent to the applicable Fund, often arranged directly by the Fund sponsor itself and not by the Portfolio Company. The Fund executes an acknowledgment letter (the "***Consent***"), acknowledging and consenting to the ECF, waiving certain defenses that may be available with respect to the funding of Equity Contributions and addressing certain funding risks and contingencies related to the Equity Commitment itself. The Consent gives the Lender comfort that the Fund is fully committed, establishes privity of contract, and gives contractual assurances that the Fund will not take actions contrary to the intent of the transaction. The Consent also includes certain reporting obligations on the Fund to enable the Lender to monitor the transaction. The actual Equity Commitment is documented in either the limited partnership agreement or other applicable constituent documents of the Portfolio Company (a "***Partnership Agreement***") or in a separate letter agreement between the two parties (an "***Equity Commitment Letter***"). The Partnership Agreement or Equity Commitment Letter, as applicable, is heavily diligenced by the Lender to ensure the funding obligation of the Fund is absolute and unconditional.

Underwriting approach

While the Portfolio Company is fully obligated to repay an ECF, most Lenders put little to no value on the financial wherewithal of the Portfolio Company. Rather, underwriting is entirely focused on the ability of the Fund to make Equity Contributions pursuant to the Equity Commitment to enable the Portfolio Company to satisfy its obligations under

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the ECF. The Fund has two sources of liquidity: the remaining capital commitments ("***Remaining Investor Commitments***") from its limited partner investors ("***Ultimate Investors***"); and the disposition proceeds (and in certain cases, cash flow) from its investments ("***Investments***"). Because the Investments are typically illiquid, most banks primarily underwrite the Remaining Investor Commitments as their primary source of repayment, with the net asset value ("***NAV***") of the Investments considered as valuable credit enhancement and a mitigant in a loss-given-default analysis. Historically, Ultimate Investor funding of Remaining Investor Commitments has been pristine; one of the lowest rates of delinquencies in unrated exposures in the credit markets. Thus, most Lenders will simply require Remaining Investor Commitment coverage sufficient to ensure the Fund will be able to honor the Equity Commitment when called. A typical ECF would require a coverage ratio (a "***Coverage Ratio***") along the lines of:

> Remaining Investor Commitments must exceed the sum of (i) the principal obligations outstanding under any Subscription Facility of the Fund, plus (ii) the Equity Commitment, plus (iii) any other indebtedness, guarantees, liabilities and other equity commitments of the Fund (which will likely be *pari passu* with the Equity Commitment), plus (iv) a buffer to over-collateralize for Ultimate Investor delinquencies and springing liabilities.

Some ECFs, particularly in the case of flagship Funds for experienced sponsors, may supplement the Remaining Investor Commitments in the Coverage Ratio with a small percentage of the Fund's NAV (or, alternatively, advance to 100% of Remaining Investor Commitments but require the Fund to maintain a minimum NAV floor at all times).

Structural observations and considerations

Like most transactions, ECFs are never perfect from the creditor's perspective. Below is a list of structural issues and nuances in ECFs the Lender should be aware of.

1. The Fund's Subscription Facility. As is standard course in the Subscription Facility market, the Subscription Facility lender to the Fund will have a first priority security interest in the Remaining Investor Commitments, any related capital contributions and the related collateral account into which such contributions are deposited. Thus, in an insolvency proceeding of the Fund, the Remaining Investor Commitments, when funded, would first be applied to the repayment of all outstandings under the Subscription Facility prior to being available to honor the Equity Commitment. Thus, to the extent the Lender is underwriting the ECF primarily on the Ultimate Investors funding their Remaining Investor Commitments to enable the Lender's ultimate repayment, the ECF is structurally subordinated to the Subscription Facility. The position is in many ways analogous to being an unsecured lender to the Fund, subordinated to a Subscription Facility as to the Remaining Investor Commitments (a not uncommon lending construct in the market for private equity funds of higher tier profile). Additionally, should an event of default occur under the Subscription Facility, the agent under the Subscription Facility could be expected to take exclusive control of the related collateral account and direct all payments funded by the Ultimate Investors to the repayment of the Subscription Facility. Such an event could create a meaningful impediment to the timely payment or collection of the Equity Commitment. To get comfortable with this subordination, Lenders often look for some additional credit enhancement from the Fund's NAV. As the NAV is often significantly greater than the Equity Commitment, a truly significant asset value deterioration event would have to occur before the Investments become so distressed that their values are insufficient to

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ultimately enable the funding of the Equity Commitment. For this reason, ECFs often include an NAV floor or related protective covenant.

2. Multiple Funds and AIVs. In most ECFs, the "Fund" will never be a simple, single entity. There may be multiple distinct Funds involved, likely the sponsor's comingled Fund along with one or more separate accounts. And even within a Fund, there will be parallel vehicles. Alternative Investment Vehicles ("***AIVs***") are often utilized as well, and the Investments of the Fund will likely be held in multiple AIVs. To the extent the Lender values NAV as an additional source of repayment, it should only value the NAV of the AIVs party to the Equity Commitment, not the NAV of the Fund in its entirety. In an insolvency scenario, we cannot confirm whether all of the AIVs and the main Fund would be consolidated into a single bankruptcy estate. Similarly, the various Fund entities and vehicles may not commit to the Equity Commitment on a joint and several basis. Thus, the analysis may have additional underwriting complexities. In theory, this risk could be solved by all of the Fund entities guaranteeing the Equity Commitment. However, in our experience, such a request can be commercially challenging.
3. Fund level due diligence. To properly underwrite an ECF based on the Fund's Ultimate Investors, the Lender has to do a certain level of due diligence on the Ultimate Investors and their Remaining Investor Commitments. Often, the ECF Lender is a lender in the Fund's Subscription Facility, enabling it to piggyback somewhat off the diligence done for that transaction. Regardless, many Lenders still conduct Ultimate Investor due diligence by review of the Ultimate Investor list, the Fund structure chart and its partnership agreement. Subscription agreement and side letter review are required in certain, but not all, circumstances.
4. Fund covenants. Fund covenants, typically included in the Consent, are often negotiated at length. Of course, the Lender wants the continued existence of its initial lending expectations, and the Fund wants to be able to conduct its ongoing business in the ordinary course without undue burden. Thus, matters such as the consent standard for amendments to the partnership agreement of the Fund, and the implication of wholesale Ultimate Investor transfers, can be challenging.
5. Default triggers. The events of default in an ECF include, of course, all of the standard credit triggers customary in corporate credit transactions. But, because the underwriting focuses on the Fund's ability to honor the Equity Commitment, there are typically additional triggers tailored toward the Fund's liquidity and compliance with the terms of the Consent. For example, ECFs typically include a cross default to the Fund's Subscription Facility, a tight trigger based on Ultimate Investor funding defaults (depending on the actual advance rate in the Fund's Subscription Facility) and, in certain cases, an event of default based on NAV declining below a certain percentage of Investment acquisition costs.

Conclusion

ECFs can provide a compelling financing solution to Funds and Portfolio Companies while providing Lenders increased yield from a repayment source they have significant familiarity with. While there are a variety of nuances and complexities, ECFs are sound transaction structures, and a financing tool we anticipate seeing utilized more frequently in the coming years.

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Mike Mascia is Co-Chair of the firm's Finance Group and a member of the firm's Management Committee. He has a globally recognized fund finance practice, having represented lenders in subscription credit facilities to real estate and private equity funds sponsored by many of the world's pre-eminent fund sponsors. He has been lead counsel on numerous hybrid facilities, and is one of the few attorneys in the United States with experience in both subscription credit facilities and CLOs. Mike represents lenders on leverage facilities to secondary funds and other credits looking primarily to fund assets or NAV for repayment. Mike is the founder of the annual Global Fund Finance Symposium, now in its 8th year, and he is a founding member and the Secretary of the Funds Finance Association.

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Tim's practice focuses on fund finance, and he has significant experience negotiating and documenting subscription credit facilities made to multijurisdictional fund vehicles, including private equity, real estate, REIT, infrastructure and debt funds. He routinely serves as counsel to lenders and lead agents on bilateral and syndicated credit facilities with complex fund collateral structures, including subscription-secured credit facilities, net asset value secured credit facilities and management fee secured credit facilities. Tim's experience also encompasses working with fund-related borrowers on the negotiation of third-party investor documents with institutional, high-net-worth and sovereign wealth investors.

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Credit facilities secured by private equity interests and assets held by debt funds

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Introduction

In recent years, investment funds have raised substantial amounts of capital for investments into private equity limited partnership ("LP") interests. Similarly, credit funds have increased in both size and number, as they look to invest in bank loans and other private debt assets. These funds are increasingly obtaining structural leverage on their investment portfolios. The use of leverage can significantly enhance returns and can also provide funds with additional liquidity and the ability to monetise a portion of an otherwise illiquid investment portfolio. This chapter sets out some of the salient issues borrowers and lenders should be mindful of in structuring credit facilities secured by private equity LP interests ("fund-of-funds facilities") and assets held by private and public debt funds ("asset-based facilities").

Eligible investments in collateral package

In a fund-of-funds facility, lenders will limit the types of LP interests that will qualify as "eligible investments" and be included in the collateral package. If certain adverse events have occurred or are likely to occur in respect of any LP interests, those interests would no longer qualify as an eligible investment. For example, an LP interest for which the borrower is in default on a related capital call will typically not qualify as an eligible investment. Other common reasons for disqualifying LP interests include the existence of conflicting liens and material write-downs or write-offs of portfolio investments of the underlying private equity fund.

Comparatively, asset-based facilities include a combination of eligibility criteria and concentration limits that the collateral assets must satisfy in order to be included in the borrowing base. These criteria may include the following categories:

- senior secured and first/second lien loans;
- minimum EBITDA thresholds;
- maximum leverage limitations;
- valuations by independent third party appraisers;
- minimum credit rating (which in some cases, may be a rating determined through specified risk calculations, credit estimates or similar programs);

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- minimum outstanding tranche size;
- broadly syndicated (as opposed to a bilateral loan) and/or "middle market" loan criteria;
- at least two bids available from nationally recognized pricing services;
- maximum original term to maturity (e.g., not greater than seven years for first lien loans);
- maximum industry classification limitations;
- maximum geographic limitations (with respect to obligor domicile); and
- lender approval rights (typical in SPV financings).

The borrower and lender in both fund-of-fund and asset-based facilities will negotiate a set of criteria that allow the borrower to add and remove assets in the borrowing base during a defined "reinvestment" period (asset-based financings that are directly at the fund level (as opposed to bankruptcy remote "special purpose vehicles" wholly owned by debt funds ("SPV financings")) often allow all eligible portfolio investments (subject to certain concentration limits) to automatically be included in the borrowing base.

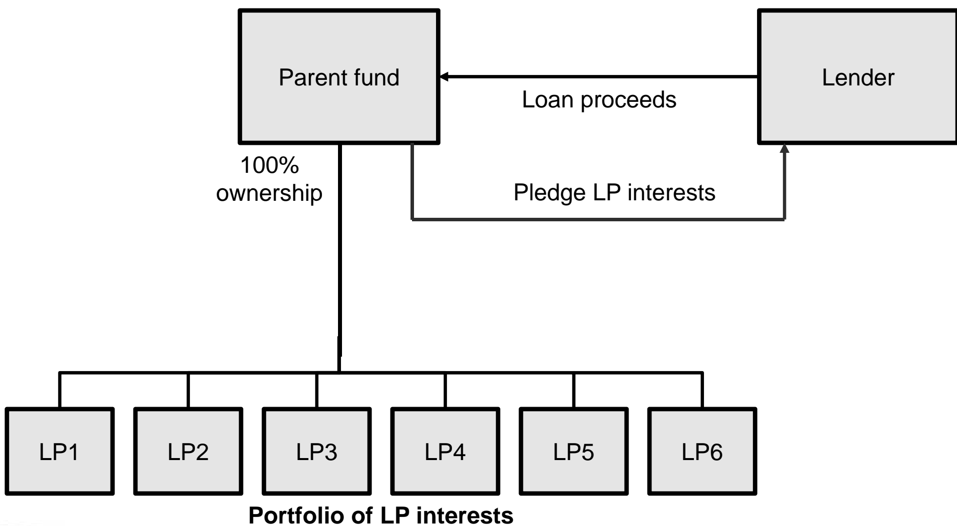

Fig.1: Common financing structure for credit facilities secured by limited partnership interests in private equity funds. This structure is also commonly used for credit portfolios.

Advance rates

The amount of financing a borrower can obtain will vary depending on the different types of collateral that will comprise the borrower's portfolio. Certain key considerations for any lender in an asset-based facility will be the expected recovery value of a particular asset in a distressed scenario (*e.g.*, the anticipated defaulted recovery value of a senior secured loan will be higher than a second lien loan) and the priority of security interest attached to such asset (first lien *vs* second lien, etc.). In addition, asset-based lenders will generally prefer to lend against portfolios with greater liquidity, with an eye on liquidating the portfolio if the financing defaults. By way of example, a broadly syndicated senior secured loan to an obligor with a public corporate rating will generally have greater liquidity than a senior secured middle market loan to an obligor with no corporate rating. With the foregoing in

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mind, borrowers can generally expect the advance rate on a senior secured loan to be higher than the advance rates offered on mezzanine loans or whose priority of payment and/or security interest is structurally subordinated with respect to other debt of the related obligor.

A lender will assign a certain amount of collateral value for each type of eligible investment. For example, in a fund-of-funds facility a lender may assign LP interests in the private equity funds with a particular strategy a value of 60% of their value. The lender will then "advance" funds only in an amount equal to 60% of the value of such LP interests. The 60% assigned to these interests is the "advance rate", while the 40% reduction in collateral value of these interests is known as a "haircut" (the haircut formulas in a fund-of-funds facility can often be lengthy and are customised to each borrower's investment strategy).

Borrowing base

The borrowing base is the aggregate amount of the collateral value of each eligible investment portfolio and is calculated by summing the product of the advance rate for each eligible investment multiplied by the assigned value of such eligible investment (as such value is determined pursuant to the terms of the credit facility).

Borrowers should test the borrowing base in advance of closing by applying the proposed advanced rates and concentration limits to hypothetical investment portfolios to assess how they will affect the borrowing availability under the credit facility.

The borrowing base will typically be subject to reductions if the collateral portfolio exceeds certain concentration limits on an aggregate basis. Lenders typically require these reductions to mitigate concentration risk associated with a particular type of asset or assets with certain characteristics. Because these financings are typically multi-year facilities, lenders are concerned that the borrower may concentrate its investment portfolio during the term of the credit facility in a particular asset or cluster of similar assets. Concentration limits on the collateral may have the effect of reducing the borrowing base but will still allow the borrower to have some degree of flexibility in managing its investments. At the same time, concentration limits also preserve the overall diversified quality of the collateral pool for the lender.

For example, in a fund-of-funds facility a lender may include a concentration limit that prohibits LP interests of the funds focused on certain strategies (*e.g.*, special situations funds) from exceeding 25% of the aggregate amount of the loan outstanding under the credit facility. If $100 million is outstanding under the fund-of-funds facility to a fund with an interest in a special situations fund valued at $100 million, the borrowing base would be reduced by the excess above $25 million, or $5 million.

Common concentration limits for fund-of-funds facilities include: limitations on underlying private equity funds with particular strategies; limitations on industry sectors; and limitations on sponsors of the underlying private equity funds (*e.g.*, limitations on sponsors outside the United States or Europe).

An example of a concentration limit in an asset-based financing would be limiting the percentage of assets in the portfolio related to the same obligor to 2.0% of the aggregate outstanding balance of the portfolio (with limited exceptions for a certain number of obligors in the portfolio). Concentration limits typical in asset-based facilities include: limitations on non-first lien loans (including mezzanine, second lien and last-out loans); covenant lite loans; loans that have ratings below certain levels; loans to borrowers in certain industries; loans that do not pay interest with certain frequencies (e.g., quarterly); loans that have "paid-in-kind" interest; investments to foreign entities; and loan size limitations.

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Collateral valuation

Fund-of-funds facilities may include quarterly or other periodic valuations of the collateral depending on when the related sponsors provide valuations to their investors. Asset-based facilities can vary widely in terms of when collateral valuations occur, and may include daily valuation when the collateral consists of quoted investments, weekly internal valuations of unquoted investments, quarterly valuations of unquoted investments through independent third party appraisers and, in some cases, no valuation until certain adverse events occur with respect to the issuer of an unquoted investment. In many cases, the lender will also have the right to periodically value the collateral (either using its own marks and/or an independent third party appraiser). The borrower will often have the right to dispute the lender's valuations but the specifics of such dispute mechanism is a negotiated point between the borrower and the lender. The dispute mechanics will likely be of a greater importance in any credit downturn so borrowers will want to carefully evaluate their rights in this context prior to closing any facility. One common approach is obtaining valuations from one or more independent third party appraisers and using such values or averaging such values.

Financial ratios

The periodic valuation of the collateral has an impact on several key aspects of the credit facilities discussed in this chapter. Most credit facilities have a basic collateralization ratio (also called a loan-to-value ratio) that compares the aggregate outstanding balance of loans under the credit facility (and if permitted under the facility, other debt of the fund) on any date of determination against the aggregate value of the collateral portfolio on such date. A mark-down of the borrower's assets could jeopardise compliance with this covenant. A breach of this covenant could require the borrower to take some type of a remedial action, such as the investment of additional equity and/or paydown of the loan under the credit facility, to prevent the occurrence of an event of default. During an event of default, the borrower will be required to begin amortising the facility and further advances will not be permitted. Some facilities also have requirements to comply with a certain asset-to-debt ratio (which may or may not be similar to any applicable and similar regulatory requirements), minimum liquidity requirement, interest coverage ratio and a minimum partner or shareholder's equity requirement.

Even in the case where an asset-to-debt ratio covenant is not breached, a devaluation of the collateral would result in the erosion of the amount of the borrower's equity, which may give rise to a breach of the covenant that requires the maintenance of minimum equity. The lender relies on this equity cushion as the first-loss piece and often considers it critical to the deal. The borrower will then need to obtain the injection of additional equity or pay down the loan under the credit facility with available cash or by liquidation of the collateral.

In addition to the foregoing, SPV financings may include "collateral quality tests" based on weighted average spread, weighted average recovery rate, weighted average rating factor, diversity score and weighted average life to maturity of the investment portfolio. Although a breach of such tests may limit the borrower's ability to acquire new assets and/or sell assets, such breaches do not typically require the borrower to immediately amortise the advances outstanding under the credit facility.

Creation and perfection of security interests in collateral

A borrower usually secures a credit facility by granting a security interest in the collateral through the execution and delivery of a security agreement. Under the Uniform Commercial

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Code ("UCC"), a security agreement must include the following: value must be given by the secured party to the debtor; the debtor must have rights in the collateral or the power to transfer rights in the collateral to a secured party; and the debtor must "authenticate" a security agreement that provides a description of the collateral.

Perfection of a lender's security interests in LP interests may be accomplished through the filing of a UCC financing statement. Under Article 9 of the UCC, an interest in a limited partnership may be a security or a general intangible. Section 8-103 of the UCC further provides that the interest will be a general intangible, "unless it is dealt in or traded on securities exchanges or in securities markets, its terms expressly provide that it is a security governed by this Article, or it is an investment company security." Therefore, the typical LP interest in a private equity fund will be a general intangible, and the method to perfect a security interest in such interest is the filing of a UCC financing statement.

Perfection of a lender's security interests in assets held by a debt fund under an asset-based facility (or with respect to any SPV financing) may be accomplished by filing a UCC financing statement in the applicable jurisdiction or for possessory collateral (e.g., cash, promissory notes, certificates of equity) by possession of such collateral. In most cases, by operation of law or pursuant to the terms of the relevant asset-based facility, all collateral is held in one or more deposit and security accounts with a third party custodian and the lender and the borrower enters into an account control agreement with such custodian with respect to such accounts.

Consent requirements for pledges of LP interests

General partners ("GPs") of underlying private equity funds typically place restrictions on the ability of limited partners to pledge or transfer their LP interests without the GP's consent. Therefore, there is a risk to the lender in connection with the disposition of the LP interest following a default because the lender would need to obtain the GP's consent to such transfer. Borrowers will generally address this limitation and risk in one of three ways: by obtaining GP's consent; through use of an SPV subsidiary; or through use of a securities account.

GP's consent

The borrower may simply obtain the consent of the GP of each of the funds whose LP interests are being pledged to the lender. Such consent would achieve two goals: (1) to waive the restriction in the limited partnership agreement that prohibits the grant of a security interest in the LP interests; and (2) to obtain the GP's consent to the transfer of the LP interest to the lender in connection with its exercise of remedies following a default under the credit facility. Any further transfer of the LP interests by the lender to a third party as a result of its exercise of remedies would be subject to transfer restrictions in the limited partnership agreement and generally require an additional consent from the GP. However, some funds of funds may own LP interests in a large number of underlying funds, and the time and expense of obtaining consents from the GPs may be prohibitive, especially because there is no standardised form of such consent. More recently, however, GPs have become increasingly willing to engage in discussions to grant consents due to the expanded secondaries market for LP interests and their comfort with secondaries funds. Some GPs understand firsthand the need to obtain consents in connection with pledging LP interests as collateral for the credit facilities for their own secondaries funds, and are willing to grant consents as they themselves would need to obtain consents from GPs of other funds.

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Special Purpose Vehicle ("SPV") subsidiary structure

In certain cases, a parent debt fund may establish an SPV to hold the LP interests for the purpose of eliminating the need for the GP's consent to the pledge. LP interests held by the parent fund may be transferred to the SPV so long as the related limited partnership agreement allows transfers to affiliates of the parent fund. Following the transfer of the LP interests to the SPV, the parent fund will then pledge to the lender its holding of the equity in the SPV. Upon a default under the fund-of-funds facility, the lender may foreclose on the equity of the SPV and then control the management or disposition of the LP interests owned by the SPV as the equityholder of the SPV. However, any transfer of LP interests from the SPV to the lender or a third party in connection with the lender's exercise of remedies would still require the GP's consent. Moreover, from the lender's perspective, having a security interest in the equity of the SPV is not as desirable as having a security interest in the LP interests themselves as the loan will be structurally subordinated to any debt of the SPV. This issue is commonly addressed by preventing the SPV from incurring any additional debt, other than debt incurred in the ordinary course of its business operations.

Securities account structure

More recently, lawyers have developed another structure to address pledge and transfer restrictions by requiring the borrower to open a securities account with a third-party custodian. The borrower credits the LP interests to the securities account, and the custodian functions as a securities intermediary. Under Article 8 of the UCC, the lender obtains a perfected security interest in the securities account and the securities entitlements (that is, the LP interests in the account) by way of a tri-party account control agreement executed by the borrower, the lender and the securities intermediary. The LP interests are typically held in the name of the lender for the benefit of the borrower, obviating the need to obtain the GP's consent to the pledge of the LP interests and thereby shortening the time period needed for closing the credit facility. However, upon a default under the credit facility, if the lender wishes to dispose of the LP interests to a third party, it would require the GP's consent. While this structure has not been historically widely used in the private equity industry, it is becoming increasingly common as more lenders are now requiring family offices and individual investors to implement this structure to address potential operational risks when lending to non-institutional borrowers.

Consent requirement relating to lender's realization on corporate loans in asset-based facilities

Underlying loan documents for investment portfolios consisting of loans included in the collateral package of asset-based facilities typically allow lenders to pledge their rights under those loan documents to their own lenders without the consent of the underlying borrower (in fact, the ability to do so is often one of the eligibility criteria in any asset-based facility). However, if a lender under a warehouse facility wants to transfer or assign any such loan to itself or a third party as a new lender under the underlying loan documents in connection with the realization on the collateral following a default under the asset-based facility, the lender will need to comply with the transfer restrictions set forth in the agreement governing such loan, and may need to obtain the consent of the underlying borrower or agent to such transfer or assignment. Lenders in SPV financings will often incorporate springing power of attorney concepts into credit facilities such that the borrower will grant the lender a broad power of attorney that is activated upon on

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event of default. These provisions allow lenders broad discretionary rights with respect to interaction with underlying obligors to help facilitate the lender's ability to collect on the loans and/or otherwise liquidate the portfolio.

Use of Special Purpose Vehicle subsidiary

As discussed above, SPVs can be utilised in both fund-of-funds and asset-based facilities. A borrower may utilise an SPV structure to address difficulties in obtaining GP consent for a pledge of LP interests. In addition, lenders will often require that a fund form a new bankruptcy remote SPV subsidiary to mitigate the risk of the fund filing for bankruptcy protection, and to provide the lender with greater control over the collateral. For this purpose, the fund will sell and/or contribute collateral assets to the SPV at closing of the financing, and from time to time during the term of the credit facility, in return for a combination of cash and equity interests in the SPV. This structure is designed to isolate – or "ring-fence" – the collateral from the bankruptcy estate of the parent fund by insulating the lender from any other debt or liabilities incurred at the parent fund level.

The parent fund also benefits from the use of an SPV because this structure provides the parent with more flexibility in its business operations, including the ability to set up additional SPVs and have such SPVs obtain financings from other lenders. Only rarely would the collateral held by one SPV ever be cross-collateralized with the collateral of another SPV, so funds can build portfolios with different risk profiles and strategies. However, note that the leverage obtained by such SPVs will be included on the balance sheet of its parent.

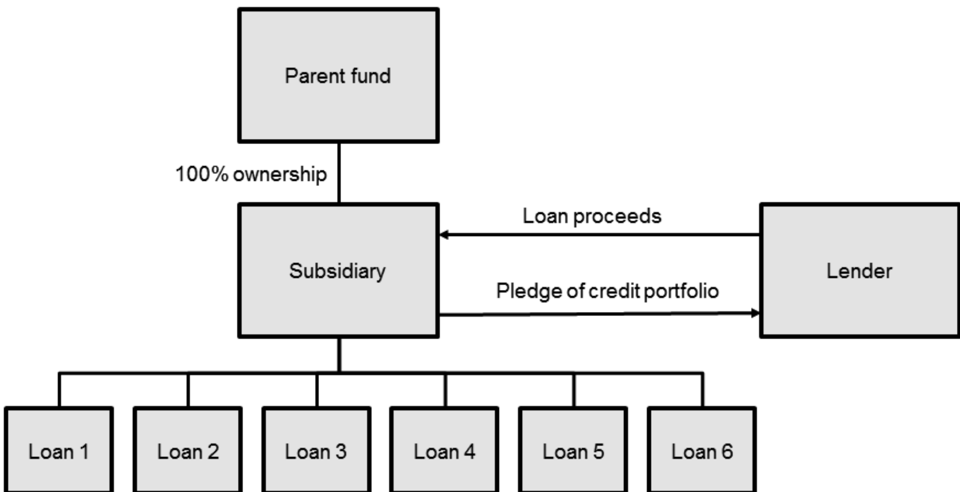

Fig.2: Common financing structure involving the use of an SPV subsidiary

<u>True sale of assets</u>

In order to ensure the bankruptcy remote structure of an asset-based facility to an SPV, the parent fund's transfer of the collateral assets to the SPV must be accomplished through a "true sale" or a "true contribution" of the assets. After a transfer, the parent fund should not have any residual claim or interest in the assets transferred to the SPV. This is intended to prohibit the creditors of the parent in the bankruptcy case of the parent fund from seeking to include the assets transferred to SPV in the estate of the parent for the benefit of such creditors.

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Factors considered by bankruptcy courts in determining whether a transfer of assets is a "true sale" or a "true contribution" include: whether fair consideration for the assets has been paid by the SPV to the parent fund; whether the parent fund or the SPV bears the risk of loss on the assets; whether the SPV has any recourse to the parent fund for loss on the assets; the intent of the parties (whether the transferor and the transferee explicitly intended for the transfer to be a sale); the accounting treatment of the transfer as a sale on balance sheets of the parent fund and the SPV; whether the parent fund has the obligation to repurchase the assets; and whether the parent fund continues to collect payments on the assets. Counsel to the borrower is generally required to provide a true sale opinion at closing regarding the initial transfer of assets to the SPV.

Non-consolidation of entities

Lenders will also require some assurance that, upon a bankruptcy of the parent fund, the SPV will not be consolidated with the parent fund. Under the doctrine of "substantive consolidation", a bankruptcy court may treat two legally distinct entities as a single debtor with a common pool of assets and liabilities. Consequently, the bankruptcy of the parent fund of an SPV borrower could result in the bankruptcy court having jurisdiction over the borrower and combining the borrower's assets and liabilities with those of the parent fund.

Several steps are required to be taken to prevent the substantive consolidation of the SPV with the parent fund. First, the permissible activities of the SPV under its organisational documents and the financing documents are limited to activities incidental to the ownership of the collateral and the financing in order to limit the scope of creditors. Second, "separateness covenants" are included in the SPV's organisational documents and the financing documents, requiring the SPV to comply with all necessary corporate formalities to maintain its separate existence as a matter of law and to maintain proper accounting books and records so that its separate assets and liabilities can be identified. The SPV should also have independent directors whose consent is required for a bankruptcy petition or other fundamental changes of the SPV. Compliance with these provisions on a continuing basis should be sufficient to maintain the separateness of the SPV and avoid the consolidation of the SPV with an affiliate of the SPV in the event of a bankruptcy of such affiliate. The financing documents should include customary limited recourse language and the parties' agreement not to file a bankruptcy petition against the SPV.

Issues particular to asset-based facilities

1. Application of payments ("waterfall")

   In asset-based facilities, payments received by the borrower in respect of the underlying investments are usually divided into interest proceeds and principal proceeds and then applied pursuant to a payment priority "waterfall". Some common features of a waterfall include: (1) expenses are paid near the top of the waterfall subject to a negotiated cap; (2) expenses in excess of a cap are paid near the bottom of the waterfall but ahead of equity distributions; (3) if interest proceeds are insufficient to make the interest payment under the credit facility, principal proceeds will be used to make the payment; (4) interest proceeds will be diverted to reduce the outstanding principal amount under the credit facility if any overcollateralization or similar tests are not met; and (5) distributions to equity holders of the fund may be permitted near the bottom of the waterfall so long as certain conditions are met (e.g., overcollateralization ratio in excess of a prescribed level).

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2. Asset sales

Borrowers in asset-based financings do not have an unfettered right to sale assets out of the portfolio. During an event of default, or if any collateral quality tests or coverage tests are not met (unless in some instances the then-current level is maintained or improved), the borrower will not be permitted to acquire new assets or sell assets under a warehouse facility. In some warehouse financings (particularly SPV financings), an annual dollar or percentage cap on discretionary asset sales may also be imposed. There may be a prohibition on selling assets below par unless the asset is a defaulted loan. If a sale is to an affiliate, obtaining a third-party appraisal or bids from recognized dealers may be required (lenders will typically want assurance that the sale is done at arm's length and on terms no more favourable than those that the borrower would have obtained if selling to an unaffiliated entity).

It should be noted that an asset-based facility at the parent level does not contain many of these restrictions and often provides the parent with much more flexibility (including a broader array of assets permitted to be included in the borrowing base (mezzanine, last-out, second lien and, in some cases, equity), assets meeting eligibility criteria automatically included in the borrowing base (as opposed to requiring lender consent), generally no restrictions on making investments (or pre-defined selling investments), ability to make distributors equity holders, ability to redeem equity of shareholders, ability to incur other debt, etc.).

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Comparing the European, U.S. and Asian fund finance markets

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Introduction

This chapter considers the differences between the European, U.S. and Asian approach to fund finance, both from a high-level market perspective and the contrasting nuances of transactions.

Market differences

Historically in Europe, the fund finance market originated with a few banks offering products on a bilateral basis to existing customers who required more liquidity, and the market was very much relationship-driven. Because of the existing relationship between bank and borrower, the banks would make an effort to structure the deals without the need for investor consents or amendments to the limited partnership agreements ("**LPAs**"), and often offered these facilities on an unsecured and/or uncommitted basis. The European banks carried out limited due diligence on the creditworthiness of, and potential enforceability against, investors.

Recently, however, the European lender landscape has become saturated by the emergence of U.S., Australian, Asian and new fund finance market entrant European banks competing with the long-standing European bank players already in this space, and it is estimated that there are now approximately 40 lenders offering this product in the European market. This competition has led to pricing pressure for banks operating in the European market and familiarity with fund finance products as well as cheaper financing. This has resulted in larger facility sizes, necessitating more club deals and syndicated financings, given bank balance sheet restrictions and borrower appetite for a diverse lender base. Although more recent, the Asian markets have also now begun to see increased competition, resulting in similar effects.

A similar trend of growth in the market and corresponding pressure to push down pricing was seen in the U.S. approximately a decade ago. In the U.S. the current market is more lender-friendly (as further explained in this chapter) and is mainly dominated by a few U.S. banks, although recently a number of European and Asian banks have started to build up their presence in the U.S. The majority of deals in the U.S. tend to be syndicated, as opposed to bilateral. For this reason, U.S. deals tend to be structured in a way that makes them easier to be rated by agencies.

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Over the last few years there has been a shift by certain banks in Europe to an approach more akin to that taken in the U.S. By comparison, the Asian market is still primarily driven by lender relationships, both with fund sponsors and, in many instances, investors. This results in more bespoke covenant structures and deal terms. However, indicators such as increased Asian participation in the Fund Finance Association, and other cross-border contact between the markets, would suggest that the future of the Asian markets will be more heterogeneous. Furthermore, the component parts of the market are quite distinct: firstly, there are the large European and U.S. managers looking to raise funds in Asia; secondly, there are the Asian-based sponsors raising funds in Asia with Asian investors; and thirdly, there is what some would describe as the Australian sub-market.

Traditionally, fund sizes in Asia were smaller than some of the funds being raised in Europe and the U.S., and relationship facilities were provided by lenders on a bilateral basis. Like Europe, the Asian market is changing, in part in response to the increase in fund sizes and a corresponding increase in facility sizes, which pushes the need for these facilities to be syndicated. In general, the use of fund finance facilities, whilst not as prevalent as in the U.S. and Europe, is on the increase in Asia. The governing law for Asian deals varies in reflection of the market, often depending on the identity of lenders, funds and investors. In recent times Asian facilities have been governed by U.S., English or Japanese law.

It is fair to say that the size of the fund finance market is largest in the U.S., with the expected fund finance market size for 2017 being approximately $200bn. The English fund finance market for 2017 was estimated to be circa £65bn. The Asian market is now estimated to be worth approximately $30-$50bn. All figures are based on lender commitments. Although the European market is smaller and younger than that seen in the U.S., there is a higher percentage of more innovative products in Europe, for example, NAV facilities, hybrids, general partner ("**GP**") lines and secondary structures. The expectation is that the market for such products will develop in the U.S. and Asia over the next few years.

Due diligence

As the U.S. and European markets have developed in different ways, the due diligence process similarly differs between U.S. and European lenders. In Asia, although deals are much more relationship-driven influencing covenant structures and deal terms, the level of due diligence is mainly driven by the governing law. The choice of governing law not only affects the issues necessary to address in the due diligence phase, it also tends to dictate either a U.S. or European cultural approach.

Since the fund finance market emerged in Europe and Asia originally as a relationship-driven product, the level of due diligence conducted by European and Asian lenders has historically been less extensive than that required by U.S. lenders.

Traditionally, U.S. lenders will require significant diligence on all of a fund's constituent documents, including its LPA, subscription agreements and any side letters entered into between the fund or its GP and any investor. Additionally, U.S. lenders will closely analyse the creditworthiness of borrowing base-eligible investors, including by receiving financial information in respect of investors, as well as guarantees or other credit linkage documents demonstrating the connection between any SPV investor and its credit provider.

In recent years, European and Asian lenders have likewise started to focus more energy on investor diligence; now lenders in all three markets will review LPAs and typically side letters and subscription agreements too (along with any other relevant fund documentation). In performing this diligence, lenders will look for comfort on a variety of issues. In addition

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to the obvious borrowing, guaranteeing and security checks, of particular concern to a lender will be any provisions that could potentially limit the amount that may be called from investors. In Asia, however, side letters containing sovereign immunity provisions are commonplace; this is due to the fact that often, cornerstone investors in Asian funds are sovereign wealth funds. Some lenders in Asia are comfortable lending to such sovereign investors if they have a track record of advancing capital commitments, whilst other Asian lenders may require such investors to waive their immunity, as per the European and U.S. approach, if such investors are to be counted towards the borrowing base.

As investors increasingly look for geographic diversity and opportunity, lenders increasingly leverage internal institutional market intelligence from their branches around the globe in making credit decisions with respect to investors. Having a branch with useful credit information in a jurisdiction where a particular investor is located can provide a competitive edge in other jurisdictions where the lender is structuring a loan, where the market is seeing the said investor for the first time.

In order to facilitate this due diligence review, U.S. lenders will often require completion of diligence checklists on all relevant fund documentation as part of their credit underwriting, which identifies the various issues of concern for the lender and addresses how such concerns are dealt with in the LPA and the credit facility documentation. In recent years, European and Asian lenders have also begun developing their own form of diligence checklists, though the level of granularity on issues that could affect enforcement and interpretation of the LPA and investor documentation differs between U.S., European and Asian jurisdictions.

Further to the foregoing, U.S. and European banks typically have different expectations as to what provisions are included in LPAs or other constituent documents. Customarily, U.S. banks expect the borrower's LPA to include explicit language made for the benefit of the lender, including: (a) provisions authorising the credit facility and the pledge to the lender of the fund's and GP's rights to call for and receive capital contributions; and (b) language whereby the investors agree to fund capital calls made by the lender without defence, setoff or counterclaim.

To the extent that an LPA does not contain these lender-focused provisions, the lender will often require the investors to deliver investor letters including the desired language. Conversely, European lenders tend to get comfortable if the LPA permits security to be granted over the GP's/manager's right to issue call-down notices, without specific reference to the lender. A lender would then be able to rely on the contractual relationship created under any security document which, amongst other things, assigns the right to issue call-down notices to the lender (and the power of attorney included in the related security agreement to execute any notices on behalf of the GP/manager). Often, English law-governed LPAs do not include the "without defence, set off or counterclaim" language, and typically they explicitly state that there is nothing in the LPA that confers any right on any person not a party to the LPA, and furthermore that any person not party has no right under the Contracts (Rights of Third Parties) Act 1999 to enforce any provision of the LPA. In contrast, many U.S. law-governed LPAs state that the lenders will be third party beneficiaries under the LPA.

Anti-terrorism and sanctions due diligence is an ever-more prevalent part of all financial transactions, and the fund finance space is not immune. Asia, and Hong Kong in particular, have some of the most onerous regulatory requirements, which can and do delay closings. The problem is more acute for U.S.-based funds that are not only unfamiliar with Asian procedures but are often put in difficult positions by conflicting laws across jurisdictions. For instance, the Hong Kong requirement that copies of passports for responsible officers be

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certified as true and correct by a certified public accountant or lawyer is at odds with liability-mitigating rules applicable to U.S.-based certified public accountants or lawyers.

Reconciling these, and many other similar issues, can be time-consuming and costly. The relatively small nature of the Asian markets, coupled with the more recent emergence of both the Asian markets and Asian anti-terrorism and sanctions regulations, means that mechanisms for addressing these issues are just now evolving; however, lenders and lawyers alike are diligently working to develop cost-effective and efficient solutions.

Security

As the European fund finance market developed out of existing relationships between banks and customers, European banks have previously been willing to provide these facilities on an unsecured basis. However, as this product became more popular in Europe, European banks adopted the same approach as their U.S. counterparts in terms of security packages, and the majority of European deals now require the fund and its GP to pledge collateral to support the fund's obligations. In Asia, these transactions were often unsecured; however, owing to the trend towards a more syndicated market requiring multiple lenders, the majority of deals are now being done on a secured basis. In general, the terms for Asian fund financings are beginning to converge with the terms in the U.S. and Europe; in particular, requiring robust security packages.

Whilst the actual assets a lender will look to secure are essentially the same in all three markets (i.e. the rights to call down from investors and any collateral account into which investor calls are paid), the methods around granting security, perfection and enforcement vary across jurisdictions. A few of the dissimilarities to be aware of are as follows:

1. *Deposit account control agreements* ("**DACAs**") – Under the Uniform Commercial Code (the "**UCC**"), the statutory authority governing secured transactions in U.S., in order for a lender to perfect its security interest in a deposit account, it is required to maintain "control" (as defined in the UCC) over the deposit account. The most common method of maintaining control is by the execution and delivery of a DACA, which is an agreement between the account bank, the fund and the lender, whereby the account bank will agree to honour instructions issued by the lender with respect to the account without the further consent of the fund. The DACA is usually in a form generated by the account bank, and account banks will typically not accept many changes to their preferred form. Though not required for control under the UCC, an account bank may insist on a DACA being in place in the U.S., even where the account bank and the secured party are the same entity, in order to set forth the relative rights and obligations of separate branches or divisions of the bank. This is most important in syndicated deals where the lender syndicate has a vested interest in the agent bank clearly delineating its roles as agent and account bank. In England and Wales, and generally in Asia, it is usual for the terms of how any secured monies will be dealt with to be contained in the facility agreement and/or the account security agreement itself. In terms of account security in England and Wales, perfection is achieved by the receipt of a notice by the account bank, putting the account bank on notice that the monies they hold in that account are subject to a security interest and to make the account bank aware of the secured party's signing rights. It is market standard for account banks to request that their own form of notice and acknowledgment be used, or to counter-sign the notice by way of acknowledgment.
2. *Notices* – In England and Wales any security over the right to call down from investors will be perfected by notice being duly served on, and received by, the investors.

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Depending on the method of delivery of notice, a secured party may accept read receipts if notices are delivered to investors via e-mail, or evidence of notices being sent by recorded delivery if notices are delivered by post.

In the U.S., notices are not required in order to perfect security over call-down rights, and are rarely, if ever, delivered. Rather, under the UCC, the right to call capital on the investors is classified as a "general intangible" (as defined in the UCC). Therefore, in order to perfect the lender's security interest in the right to call capital, the lender is required to file a UCC-1 financing statement naming the fund and the GP as debtors and the lender as the secured party. The UCC-1 financing statement must be filed in the "location" of the debtor (as set forth in the UCC), and serves to put third party creditors on notice of the lender's security interest.

3. *Collateral waterfalls* – Funds and investors that participate in U.S. law governed fund finance facilities must also be mindful of certain regulatory and statutory regimes that could govern the relationship between the lender and the fund or the investors. For example, if an investor is a pension or retirement fund (an "**ERISA Investor**") that is subject to the Employee Retirement Income Security Act 1974, as amended ("**ERISA**") and if the credit facility is determined to create contractual privity between the lender and the investor, then this could result in a "prohibited transaction" under ERISA. Failure to comply with ERISA could expose the investor and the fund to significant liability or trigger excuse rights that would permit the ERISA Investor to avoid funding capital contributions. As further protection for ERISA Investors, funds will often require ERISA Investors to be limited partners in a feeder fund that will then feed into the main fund. In this instance a 'cascading collateral structure' is put in place whereby the feeder fund will pledge to the main fund its and its GP's rights to call capital on its investors, and the main fund will then on-pledge to the lender its rights under the security documents between the main fund and the feeder fund. This type of cascading collateral structure may also be utilised by funds that are sensitive to the tax implications or other legal or structural considerations that could be triggered by creating privity between the investors and the lender, or else by virtue of the loans provided under the credit facility. There are no similar instances where this type of security structuring is required in respect of English funds, as generally there is no issue with English entities contracting directly with a lender, however, given that many European financings involving other jurisdictions are project-managed out of England, alternative financing structures such as equity commitment letters and put and call options may be adopted as opposed to typical financing and security structures to accommodate any jurisdictional tax or regulatory concerns.

Additionally, choice of governing law remains an important consideration for investors and lenders for the credit facility and the LPA and other investor documents. Typically transactions governed by the laws of a U.S. jurisdiction tend to see more Cayman-, Delaware- or Bermuda-organised borrowers, as such jurisdictions offer preferable tax and corporate governance laws for a fund and its investors. Likewise, U.S. lenders are comfortable that the laws of such jurisdictions will enable enforcement by the fund or GP (or the lender, under the security documents) of the investor's obligations to fund their capital contributions. For similar reasons, in European deals, it is more common to see Luxembourg, Channel Island, Scottish, English, Nordic, Netherlands or Cayman structures, whereas in Asia investors have historically favoured Cayman, BVI and Australian vehicles. Traditionally, Asian fund sponsors have used Cayman Island fund vehicles, typically formed as limited partnerships. Some sponsors have introduced Singapore and Hong Kong vehicles for local investors. The

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Asian fund finance market also sees Luxembourg, Delaware and Australian vehicles for larger funds.

In certain jurisdictions (particularly those in Europe that are subject to the Rome Convention), the governing law of where the borrower's assets are situs will dictate how security is taken in that jurisdiction; for example, if an LPA is governed by the laws of England and Wales, then the call-right security will be taken under the laws of England and Wales as the investors' obligation to meet a call-down notice is governed under an English law contract. Conversely, this is not strictly the case in non-EU jurisdictions, including New York and Delaware, where the governing law of a security agreement might not necessarily be the same jurisdiction as where that asset is based. The majority of U.S.-based fund finance facilities are governed by New York law, as lenders are comfortable that the laws of New York contain favourable provisions for the interpretation of the credit documents and enforcement of remedies against the fund. Therefore, the law governing the security agreement and the creation and attachment of a security interest in the collateral would be New York law. However, under the UCC, security filings are required under the law of the debtor's location (as defined in the UCC) to perfect the security interest in the collateral. Consequently, if a fund is organised under the laws of Delaware, the UCC would specify that Delaware is the "location" of the debtor and perfection of the collateral would be made by the filing of a UCC-1 financing statement in Delaware. This would be the case regardless of what governing law is included under the LPA and investor documents (though such governing law typically corresponds to the fund's jurisdiction of organisation).

Covenants

Whilst U.S. deals have historically sought comfort from lending against a borrowing base (looking at each investor on an individual basis by applying individual advance rates, haircuts and concentration limits before aggregating results) and granular due diligence of fund documentation including any side letters entered into by the fund or GP for the benefit of investors, European deals have taken a more holistic view on the financial covenants (looking at the investor base as a whole and applying one advance rate) and sought comfort through covenants in the facilities agreement, for example, through a repeating representation that no side letter or other agreement between an investor and the fund or GP contain terms that are materially adverse to the rights of a finance party under the finance documents or, if taken one step further, which would affect the ability of the fund or GP to require investors to make capital contributions to the fund. Historically, in Asia deals were structured with a coverage ratio. Nowadays facilities may be sized on a borrowing base calculation or coverage test. Negative pledges are also more likely to apply to all assets of the borrower in an English law-governed facility agreement, whereas in a U.S. credit agreement a negative pledge may only apply to those assets of the borrower that are the subject of the transaction security.

The reporting obligations of the borrower tend to be more frequent, onerous and administratively burdensome in U.S. deals. U.S. lenders usually require more visibility regarding the amount and frequency of any distributions made to investors, financial information on the investor base and more frequent monitoring of the borrowing base threshold.

Conditions precedent

As mentioned above, one of the key differences when it comes to security CPs will be delivery and receipt of perfection notices (in England and Wales) and UCC-1 financing statements (in the U.S.).

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Completion searches differ between jurisdictions, with lien searches under the applicable UCC and tax laws being carried out where a borrower is located under the UCC in the U.S., and in some cases in the U.S. jurisdiction where its chief executive office is located. The purpose of a UCC lien search is to determine whether any other creditors hold existing liens against the collateral that would take priority over the liens to be created by the credit documents. Likewise, under U.S. law, any tax lien filed against the fund by a governmental authority would hold higher priority than the liens created by the security agreement. Whilst similar security searches are carried out at the relevant Companies House in the UK for corporate entities and limited liability partnerships, there is no security searches register for limited partnerships, which is the typical private equity fund structure in the UK. Therefore any security granted by a fund, in the form of a limited partnership, over its assets will not be noted at the registry and so priority liens in respect of such a fund cannot be searched for. Depending on the type of security being granted, different filing obligations will also apply in the UK. Again, security filings can only be made in respect of security interests granted by corporate vehicles or limited liability partnerships over their assets, not limited partnerships.

Legal opinions are a requirement for lenders in all three markets. However, although the content and substance will be largely the same, the market expectation as to who provides which opinions differs greatly. In Europe, it is expected that lender's counsel will provide the enforceability of security opinion and that borrower's counsel will provide the capacity and authority opinions and any ranking opinion (if required). In the U.S., it is expected that borrower's counsel provide all legal opinions, though the fund's main counsel might provide only the enforceability opinions and rely on local counsel that is licensed in the jurisdiction of the fund's organisation to deliver corporate opinions on capacity and authority. Many U.S. lenders will also accept an opinion of a borrower's in-house counsel as to capacity and authority to enter into the finance documents. With regard to cross-border transactions, it should be agreed between all parties as soon as possible as to who is providing which opinions, so as to have an accurate indicator of costs and to avoid last-minute delays.

Execution of documents/completion mechanics

The signing process in England and Wales is very strict in the wake of *R (on the application of Mercury Tax Group and another) v HMRC [2008] EWHC 2721* (the "Mercury Case"). Following the findings in the Mercury Case, English counsel follow best practice guidance when it comes to virtual signings and closings. Hong Kong practice is in large part following the same path. The method of signing will depend on whether or not the document in question is a deed, but in summary the best practice for execution of a deed virtually is as follows (and it is worth noting that often, the English market follows this same approach for documents which are not deeds, albeit not strictly necessary):

1. the final version of the deed to be circulated to all parties;
2. the signatories to print the entire deed (or the signature page);
3. a scanned copy of the entire deed (or the signature page) to be sent back to the lawyer who circulated the deed, together with the final form deed; and
4. the signatories to confirm whether the deed is deemed to be delivered and/or when it is deemed delivered.

In respect of executing documents in England and Wales that are not deeds, the guidance following the Mercury Case is as follows:

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1. the final version of the document to be circulated to all parties;
2. the signatories to print and sign the signature page; and
3. a scanned copy of the signature page to be sent back to the lawyer who circulated the document, together with written authority of the relevant signatory to attach that signature page to the final form document.

Where the document in question is not a real estate contract, the signature page may be circulated and signed whilst the document is still being negotiated. The signature page would then be held to order and released once the relevant signatories have confirmed that their signature page can be attached to the final form document.

Conversely, in the U.S. there is no requirement to circulate a final form of the document prior to execution of signature pages. Signature pages to documents that are still subject to negotiation can be circulated, signed and returned separately to the complete agreement. The parties will then each agree that their pre-signed signature pages can be attached to the final version of the document once it is in agreed form.

Summary

Whilst there remain many differences between the U.S., European and Asian markets, it is expected that lenders in Europe will continue to be influenced by their U.S. counterparts while lenders in Asia will continue to be influenced by their counterparts in the U.S. and Europe. However, there will always be inconsistencies at the transactional level that borrowers, lenders and their counsels should be aware of and appreciate. The Asian market continues its strong growth and development and will rely heavily on both the U.S. and European markets.

Although lenders tend to have a very strong bargaining position in the U.S., investors are also starting to put pressure on GPs to be more transparent about the use of subscription line facilities through the published principles of the International Limited Partners Association ("**ILPA**"). ILPA is less well known in the European and Asian markets but no doubt will become more widely recognised as the trend of the European and Asian markets following the U.S. continues.

* * *

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Umbrella facilities: Pros and cons for a sponsor

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Overview

In this chapter we will discuss what constitutes "umbrella facilities" (including how they compare and contrast with a standard fund finance facility) and explore the pros and cons of using these products from the perspective of a sponsor. We will also cover which types of funds tend to use umbrella facilities, and the outlook for the future of umbrella facilities in the market.

Description of umbrella facilities

A standard fund finance facility will involve a single fund (or several parallel funds, still referred to in this chapter as "a fund") as borrower, with the lender or lenders providing a single revolving facility, or sometimes both a revolving facility and a term facility, on a committed basis under a single facility agreement. The facilities can be utilised by the fund for any permitted purpose in the usual way, with multiple drawdowns, repayments and redrawings (in the case of a revolving facility) as the needs of the fund require. The usual security package for a standard fund finance facility includes security over the uncalled commitments of the fund's investors, and security over the bank account into which the proceeds from drawdowns of those commitments are paid.

In contrast, umbrella facilities can have multiple funds or a single fund and one or more of its subsidiary special purposes vehicles ("**SPVs**") as borrowers. Umbrella facilities can take several different forms, the most popular models of which generally split into the two main types as described below.

One type of umbrella facility ("**Model A**") involves documenting the various facilities using an uncommitted "master facilities agreement". This provides a framework under which a fund can request facilities from time to time from the lenders, subject to a pre-agreed overarching facilities limit. The facilities which may be requested typically include term, revolving and letter of credit facilities. Typically, SPVs can also accede as borrowers for specific facilities, or just a single facility, with their obligations being guaranteed by the fund (or by the fund entering into a binding commitment to provide funds to its subsidiary which is capable of being enforced by a lender). Each time the borrower (whether the fund as original borrower or a new SPV borrower) requires a new facility it submits a new facility request to the lenders detailing the type of facility it requires, the new facility amount and any other commercial terms relevant to that new facility (such as interest rates, currency and

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fees). The lenders will then approve (or not) that requested facility. Recourse for the lenders, for both borrowings by the fund and guarantees by the fund of borrowings of the SPVs, is to the fund's investors and the bank account into which proceeds of investor commitments are paid, as for a standard fund finance facility.

Under Model A, each new facility remains outstanding until its specific maturity, subject to an overall master facilities agreement long-stop maturity date, and the aggregate committed amount of all facilities cannot exceed the agreed master facilities limit. The purpose for borrowing each new facility may be for general fund purposes (such as working capital or payment of fees and expenses) or a particular purpose often related to the needs of a specific investment.

Another difference between Model A umbrella facilities and a standard fund finance facility is the different levels of events of default. Events of default which are relevant only to a single facility ("**Facility Level EoDs**") will usually only trigger an early repayment of that facility. Events of default which are relevant to the fund as borrower and guarantor (such as insolvency at fund level, or significant levels of investor default or non-payment) ("**Fund Level EoDs**") usually trigger early repayment of all facilities. Of course, a Facility Level EoD at a borrower SPV level which results in that facility being accelerated may lead to a call on the fund guarantee, and if the fund guarantee is not paid when due, that will trigger a Fund Level EoD, thereby potentially accelerating all the facilities.

A further key difference between Model A facilities and a standard fund finance facility is that the Model A facilities are provided on an uncommitted basis, one consequence of which is that commitment fees are not charged until an individual facility is committed, and then are charged for that facility only to the extent undrawn. This lowers the cost of Model A facilities compared to a standard fund finance facility, which we will discuss later in this chapter.

A second type of umbrella facility ("**Model B**") also involves a master facilities agreement but typically sees a different fund acceding as borrower for each new facility. The funds are managed by the same manager, and so are within the same fund group, but will usually have different, or slightly different, investors. Whilst the recourse position superficially appears the same as for a standard fund finance facility or for a Model A facility, with recourse to the uncalled commitments of the investors and the bank accounts into which proceeds of such commitments are paid, it is actually different. The lenders will only have recourse to the specific investors of the fund which is the borrower of a particular facility, and not to all investors of all the funds of that manager. There is no cross-guaranteeing by the borrower (or fund) of one facility by the borrower (or fund) of another facility. Model B is relevant when investors are providing their commitments for a specific investment purpose which will also be the purpose for that facility.

Tied to the preceding point, Model B facilities are frequently used by managers with multiple investment strategies. For example, a manager which invests in credit for leveraged buyouts might also invest in real estate debt. Those two asset classes would ordinarily be part of separate investment strategies and hence separate funds. On the basis that there is a common manager to each of the funds, banks frequently accept including those separate funds within the same umbrella (or Model B) facility. However, the ability of a manager to utilise a Model B facility structure is largely dependent on it having an established track record and, of course, on the strength of its investor base(s). Accordingly, Model B is suited to managers of funds with larger, institutional investors with a correspondingly strong borrowing covenant. In a typical Model B financing, the lenders will already know all of the investors of that fund group and there will be no question regarding the solvency of these "top class" investors.

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Whilst the overarching framework of Model B is similar to that of Model A (i.e. a master facilities agreement), due to the existing familiarity of the relationship between the manager and the lender, the strength of the manager's investor base and the frequency of transacting between the parties, the lenders and the manager of the fund group will have an agreed framework in place which will be replicated again and again (for each new borrower).

A variant of Model B uses a common terms agreement (in conjunction with a short form loan agreement for each borrower) rather than a master facilities agreement. As for a Model B facilities agreement, the individual borrower funds are only able to borrow up to their individual facility limit. The common terms agreement sets out the main body of borrowing terms which apply to each facility, whilst the short form loan agreement entered into by individual fund borrowers incorporates the common terms by reference and documents the agreed commercial terms and any other terms which are bespoke to that particular borrower and facility.

Recourse and security

The basic security package for an umbrella facility operates on the same basis as any other fund finance transaction. As mentioned above, the lender's key recourse is to the uncalled commitments of the fund's investors and therefore the lender will require security over uncalled commitments and security over the bank account into which the proceeds of such commitments are paid when drawn down. If there are feeder funds between a borrower/guarantor fund and the investors to which the lenders are to have recourse, typically those feeder funds will give guarantees and security over the uncalled commitments of their investors. In this way, the lenders always have direct security over the commitments of each investor, whether that investor is a direct investor in the fund or an indirect investor through a feeder. Furthermore, whilst the primary recourse of the lenders is to the uncalled commitments of the investors in that fund and the bank account(s) into which investor drawdown proceeds are paid, those same fund bank accounts frequently receive distributions and proceeds from the underlying investments of the fund. Where the latter is the case, the lenders will also, in practice, have security over distribution proceeds.

In certain circumstances, lenders may also require security over certain fund assets for a specific facility or facilities. For example, if a facility is borrowed by an SPV, the lenders might require security over the bank accounts of that SPV in addition to the bank accounts of the fund. Lenders might also require share security be granted over the fund's shareholding in the SPV and, if the SPV owns shares in another company, potentially from the SPV over that other company. The latter will clearly need to accommodate any security granted to third party lenders in respect of any financing for a fund's portfolio company, and is therefore not always obtainable.

This practice of taking additional security over the fund's or SPV's underlying assets is frequently required for a more mature fund where there are fewer uncalled investor commitments remaining. The positive benefit to the fund is therefore to extend the life of its financing, which might otherwise be unavailable due to that reduced level of investor commitments. That additional security can be combined with guarantees being provided by each of the fund's SPVs in respect of each other SPV and the fund's own obligations. When taken together with security granted by each SPV over its bank accounts and, potentially, subsidiary/ies, lenders obtain recourse to both any remaining uncalled investor commitments and the net asset value of the fund as a whole. The additional security and asset-recourse structure can be simply documented by a new facility request and security

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documents covering each of the relevant assets. It will, however, be necessary to confirm that each SPV can cross-guarantee each other in the manner described in this paragraph, although issues of that sort are beyond the scope of this chapter.

History of umbrella facilities

The concept of an umbrella/master facilities for fund financing first developed in the early 2010s. The idea for this type of facility was born out of a desire by fund borrowers to enter into new facilities speedily and in a cost-effective manner. The costs savings arise from both the lack of commitment fee (as above, on the basis umbrella facilities are provided on an uncommitted basis) and due to reduced legal fees being incurred for a succession of new facilities under the umbrella facility compared to legal fees for a succession of standalone facilities.

It is worth noting that a solid relationship between borrower and lender is key to a successful umbrella facility. We have experience of umbrella facilities working very well when the borrower is familiar with the lender's internal credit process and there is a strong relationship between the parties. Where the umbrella facility is uncommitted, lenders usually need to obtain credit approval quickly in order to meet a specific deal timetable set by the borrower. This process is expedited when the borrower knows exactly what to provide to the lender in terms of information or documentary evidence, and the lender's credit committee is familiar with the borrower's investors (in particular, their creditworthiness) and the borrower's investment activities. The flexibility which is built into umbrella facility finance documents also helps lenders to meet a borrower's needs in a timely fashion because there is (usually) no need to amend the existing facilities agreement to accommodate a specific deal structure. The latter being said, any additional security would require negotiation at the time (as discussed above).

Pros and cons

Viewed from a high level, the pros of using umbrella facilities compared to standard fund finance facilities can be summarised as flexibility. That flexibility encompasses: (i) a facility that develops over the life of a fund, starting off as a capital call facility then potentially becoming a partially asset-based facility towards the end of the life of the fund; and (ii) multiple borrowers and funds within one facilities agreement structure. Added to that flexibility, they are generally considered to be less expensive from both a fees and costs perspective, as explained in more detail below.

Again, from a high level, the cons are that umbrella facilities can be unwieldy and more time-consuming to negotiate and may not suit all conceivable types of potential fund finance transaction. While the parties can make every effort to pre-empt what they consider will be required throughout the term of the agreement, they are unlikely to be able to predict every eventuality. The umbrella facility may therefore need to be amended if the needs or activities of the fund change materially.

The pros and cons of using umbrella facilities can, accordingly, be broadly categorised by reference to flexibility and convenience and fees and costs.

<u>Flexibility and convenience</u>

Compared to a standard fund finance facility, umbrella facilities can be hugely flexible. They can offer the convenience of an uncalled capital commitment together with an underlying assets (or NAV-based) facility within one agreement. They can provide for either single or

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multiple borrowers as well as different forms of borrower vehicle (e.g. both fund entities as well as corporate vehicles). They can also be adapted over the life of a fund as its needs change, without having to put multiple standalone facility agreements in place or make extensive amendments to existing standard fund finance facilities.

Umbrella facilities can provide borrowers with greater speed of execution than a standalone facility because they don't have to go through an extensive CP process or enter into a new extensive suite of finance documents every time they require a new facility. That is particularly true in relation to new security (although see above in relation to asset-specific security). In particular, under a Model A type facility borrowers submit a new facility request each time they want to borrow a new facility. The new facility requests are short-form documents based on an agreed template. For straightforward transactions, the borrower can prepare the new facility request themselves without needing legal input. This enables the borrower to act quickly and efficiently without needing to instruct lawyers and because they are (usually) the same on each occasion, the borrower will become well-versed in preparing the new facility requests over time and even more efficiently.

Umbrella facilities also provide funds with the ability to match their funding requirements to a club of lenders who can provide all of the necessary facilities. The facility should have the discretion to allow lenders to be selected according to their ability to provide certain facilities. Where revolving or ancillary facilities are required, lenders with the ability to provide those facilities (and the requisite rating, if required) will participate. Lenders who can only provide term debt can be selected to provide a proportion of the term debt facilities. The latter point also enhances the ability to syndicate these sorts of facility to non-bank (or alternative) lenders, providing greater liquidity for the lenders and, potentially, greater pricing competition for the borrower.

While we have highlighted ways in which an umbrella facility can make life easier for borrowers and lenders alike, trying to create an all-purpose master facilities agreement may not always end up being as convenient as it seems. The parties (and their legal counsel) might spend a significant amount of time negotiating provisions into the master facilities agreement which do not end up being utilised (for example, the facilities agreement might provide for a letter of credit facility which is then never used). The fund might also negotiate the initial facilities agreement on the basis that it will last for the full life of that fund but realise over time that market terms have moved on and/or that it doesn't require a later life/asset-based facility.

Finally, whilst an umbrella facility being uncommitted might be convenient from a costs perspective, as each new facility will require credit approval, this could potentially delay the borrower's plans to draw down on a particular date. As discussed above, a well-developed relationship between borrower and lender can help to avoid those sorts of pitfall.

Fees and costs

As mentioned earlier in this chapter, one of main features which distinguishes an umbrella facility from a standard fund finance facility is that this type of facility is often partially or wholly uncommitted. The resulting absence of a commitment fee can be a significant cost saving for the borrower. The facility structure can therefore remain in place (albeit uncommitted) without ongoing costs accruing. This saves the borrower negotiating a new facility agreement at the point in time where it intends to draw down funds (again, subject to the points discussed above about the uncommitted nature of the structure) without paying a commitment fee for a facility which they are not using.

From a lender's perspective, umbrella facilities can be operationally easier to administer

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than multiple standalone facilities. For example, there is a single relationship between the lender and the fund (on a Model A type financing) or between the lender and the manager (on a Model B type financing), so lenders are able to pass on their cost savings to the borrower by charging lower fees. On the other hand, and in particular in relation to Model A facilities, if a borrower requires a complex, bespoke financing arrangement, then the lender may charge more for providing a specialist product.

Another financial advantage of using an umbrella facility is that legal fees will usually be lower overall because the fund is not entering into multiple facility agreements during its life. This reduces the time spent on negotiating finance documents, providing conditions precedent and incurring local counsel fees. However, a complex master facilities agreement or common terms agreement will require more extensive up-front discussion and negotiation than for a standard fund finance facility, so the up-front legal fees are likely to end up being higher than for a standard fund finance facility.

Putting an umbrella facility in place should also save the borrower's key personnel time in the long run. A significant amount of time will be needed from these key personnel to negotiate the initial umbrella facility. However, once the facility is in place, each new facility request should require much less time from both lawyers and key personnel than a standard fund finance facility. This will therefore allow the borrower's treasury personnel to spend more time on other day-to-day fund activities as well as reducing legal costs. Where a manager operates multiple different funds, there are potentially even greater cost and time savings where those funds can all benefit from a single umbrella facility (as discussed further below).

Despite the pros listed above, borrowers need to carefully compare the potential costs savings of an umbrella facility against the potential running costs of a standard fund finance facility. Whilst, as highlighted above, one of the most significant savings of an umbrella facility is the absence of commitment, if a fund is very active and is likely to draw a large portion of its available facilities, then the actual level of commitment fees paid for a fully committed facility (i.e. a standard fund finance facility) will be low. For this kind of fund, fee savings will be unlikely to be determinative of whether to use a standard fund finance facility or an umbrella facility.

In addition to the above, it is clearly worth testing whether the flexibility provided by an umbrella facility is actually required by a fund. On the basis that a substantial amount of time and cost will be spent in the negotiation of an umbrella facility, care must be taken to ensure that its use will be frequent enough to justify that initial outlay. There is a danger of flexibility being an end in itself rather than the facility having genuine application to the fund's needs. Having said that, many borrowers will only use an umbrella facility for bridging capital calls and be perfectly happy that that limited purpose is sufficient to justify the upfront costs.

While the complexity (and as a result, flexibility) of an umbrella facility can be seen as a pro for some sponsors, such complexity is also a potential con. Providing sufficient flexibility in the master facilities agreement (especially if it is the first time a borrower and lender are entering into an umbrella facilities agreement together) takes a significant amount of time. The facilities agreement will need to include more options than a standard fund finance facilities agreement and therefore there will be extensive commercial discussions between lenders and borrowers, and the lawyers will have to spend more time on drafting. Furthermore, in light of this additional complexity, a manager might require additional advice from their legal counsel in order to understand the terms of the facilities agreement (and this has time and cost implications).

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Who and where?

The diversity of the types of funds which use umbrella facilities reflects the multi-use nature of such facilities.

Even a single fund with a simple structure (i.e. the absence of a multiplicity of feeder vehicles and SPVs) might take advantage of the umbrella facility's flexibility. This flexibility might be required to ensure that it only has to enter into one facilities agreement during its life. As mentioned above, at the beginning of a fund's life its value for lenders is in the undrawn commitments of its investors, and thereafter in the value of the investments it has made or assets it has purchased with those commitments, and therefore a fund's facility may need to change from a pure capital call facility towards an asset-backed facility. Alternatively, a fund may be planning on doing bespoke activities which require something more complex than a standard fund finance facility.

A multi-asset, multi-strategy fund manager (i.e. a fund manager that raises multiple pools of capital across more than one sector (e.g. credit and private equity)) is one of the most obvious beneficiaries of the umbrella facility structure. In addition to its flagship comingled funds, the manager might need the facility to be available for single managed accounts ("**SMAs**") and also require flexibility for parallel funds or feeder vehicles to accede to the facilities. An umbrella facility provides this flexibility from day one as, whatever form the relevant vehicle requiring finance takes, the finance documents already include the framework to allow those different types of vehicle into the facility. However, for some SMAs a bespoke individual committed facility instead of an umbrella facility may be better if the reality is that their investment activity will be limited. A Model B facility would be best suited to this kind of situation, especially where a manager is looking to keep its comingled investments separate to those of SMAs. As above, however, a manager would need to assess which facility structure is most likely to be used by its managed funds, and whether the flexibility of having all entities in one structure is of genuine benefit.

The jurisdictions in which a fund can be based to take advantage of an umbrella facility are potentially unlimited. We have advised both borrowers and lenders in relation to facilities agreements governed by English law and with borrowers in onshore (for example, the UK or Luxembourg), near-offshore (for example, the Channel Islands) and far-offshore (for example, the Cayman Islands or Mauritius) jurisdictions.

Conclusion and outlook

We have considered what constitutes umbrella facilities and some of the pros and cons of using them, together with a look at which types of funds are using these types of facilities and in what jurisdictions. Looking ahead, what does the future hold for these types of facilities? Due to the potential cost-saving of not paying a commitment fee upfront and the flexibility of umbrella facilities, some lenders have noticed a trend for more borrowers requesting umbrella facilities, so we might start to see even more of them in the market.

Another driver for an increase in the number of umbrella facilities is the increasing tendency of managers to establish SMAs (due to the amount of cash investors are looking to invest) which, in turn, drives investors to seek bespoke investment strategies. If a manager can add those SMAs into an existing umbrella structure rather than have to go through the process of establishing a new structure (or indeed, put a single fund finance facility in place for each fund), then this is likely to appeal to investors and set the relationship between the manager and the investors off on a good start. Other positives for a manager are that investors will be attracted by the scope for cost saving (this is a direct benefit for investors as well as

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managers, because it means the return on their investment will be higher, as fewer fees and costs will be deducted when calculating their profit), and managers will save themselves a significant amount of time and energy by not having to manage multiple single facilities.

Whilst we have focused on the pros and cons of umbrella facilities in this chapter, on balance it appears there are more pros than cons for certain types of funds looking to enter into umbrella facilities. In particular, the in-built flexibility and the lack of commitment fee are largely what makes an umbrella facility attractive to a fund which: (i) requires such flexibility due to the nature of its activities; or (ii) is part of a structure which is more suited to an umbrella rather than standard fund finance facility (i.e. the structure described when discussing Model B). These two key pros are also the main distinctions between an umbrella facility and a standard fund finance facility. However, despite the potential advantages of using umbrella facilities, there are plenty of funds looking to borrow for whom a standard fund finance facility can be more beneficial because it is less complicated (and therefore quicker to put in place and cheaper from a legal costs perspective) and better suited to their business needs.

* * *

Acknowledgment – John Donnelly

The authors wish to acknowledge the contribution of John Donnelly to this chapter. John is a Scottish qualified lawyer who acts for lenders, borrowers and private equity sponsors, on a range of commercial lending, including fund financing, leveraged finance transactions and derivatives.

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Side letters: Pitfalls and perils for a financing

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Overview

Subscription-line (or capital call) facilities (referred to in this chapter as "sub-lines") are, generally speaking, loan agreements provided at fund level, with recourse given to the lender over the right to call uncalled capital of investors in the applicable fund (and related rights). The type of fund-level financing products offered by lenders is continually evolving. One constant that remains is the need to ensure a fund's governing documents do not prohibit or restrict the financing that the fund wishes to raise.

The terms of an investor's investment in a fund are usually governed by three main types of documents. First, a limited partnership agreement ("LPA") containing the primary terms applicable to all investors in the fund. Second, a subscription document through which an investor subscribes for an interest in the fund, makes certain representations and agrees to adhere to the terms of the LPA. Third, each investor may negotiate a side letter (on a bilateral basis) with the fund's general partner ("GP") or manager. A side letter supplements the terms of the LPA applicable to the specific investor (without modifying the application of the LPA to other investors in the fund). The provisions of a side letter may take into account specific regulatory or tax considerations of an investor or supplement the commercial terms applicable to the investor's investment.

It is critical that the terms of the fund documents accommodate any contemplated fund-level financing. For sub-lines, investors constitute the ultimate source of repayment for lenders if the fund defaults such debt. Lenders will therefore diligence the fund documents to check (among other things) restrictions on borrowing and enforceability of investor obligations to the fund. Issues in the fund documents may preclude the uncalled capital commitment of one or more investors counting towards the amount that a fund can borrow under a sub-line (the "borrowing base"). Worse still, restrictions in the fund documents may even preclude a fund from raising finance at all.

This chapter focuses on the final element of the fund terms framework − side letters. Investors increasingly negotiate side letters in connection with their investment in a fund and the scope of side letter provisions requested by investors is continually developing. As a result, a fund with a large number of investors will almost certainly have a wide array of side letter requirements to navigate. The terms of those side letters may individually, or collectively, affect a sub-line. Consideration of the terms of side letters is critical to sponsors, lenders and their counsel when contemplating fund-level financing.

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We consider in this chapter some of the key issues arising in side letters that may impact sub-lines, and suggest practical solutions to specific issues.

Background to side letter considerations

Disclosure

Lenders generally request copies of all side letters so that they can diligence whether the terms of the side letters impact the proposed financing. There are certain (limited) exceptions to this approach.

First, some sponsors are unwilling to provide side letters to a fund's lenders given the sensitive nature of side letter terms and the sponsor's relationship with the fund's investors. In some cases, lenders may be prepared to allow disclosure of side letters to their counsel only, or be comfortable with a summary of the terms of the side letters prepared by borrower counsel. In limited cases, lenders may accept non-disclosure of side letters and instead rely on a repeating representation from the borrower that there are no side letter terms that are materially adverse to the lenders' interests under the finance documents (other than terms disclosed). The borrower must therefore disclose any such materially adverse terms (but only those terms) to ensure no misrepresentation.

Second, one or more side letters may be subject to investor-specific confidentiality restrictions on disclosure (see below for an analysis of the consequences of such confidentiality restrictions for the financing).

Impact of investor requirements

There is a third perspective to consider in a fund financing in addition to that of lender and borrower – the perspective of investors. Investors' views will impact side letter terms and, consequently, the ability of the fund and lender to put financing in place.

Investor views are evolving. Throughout 2017, funds, investors and other interested parties have been vocal in discussing the role and use of sub-lines. As a consequence, the Institutional Limited Partners Association (a trade association for institutional LP fund investors) released guidance in June 2017 ("ILPA Guidelines") recommending (among other things) increased disclosure to investors with respect to the terms and impact of sub-lines. A fulsome discussion of the ILPA Guidelines is beyond the scope of this chapter. However, the views of investors and investor trade bodies are continuing to develop, and will continue to shape the scope of side letter provisions requested by investors and their related impact on fund financings.

Focus on side letter provisions

Lenders place great importance on detailed review of the fund organisational documents, including side letters. That due diligence review focuses primarily on the terms that could impact the lender's right to call capital from the fund's investors and enforce its security. Any restrictions on an investor's funding obligations will be a material lender concern.

1. Timing

   The key to ensuring the terms of side letters do not adversely impact a financing is to keep the sub-line in mind at the time of side letter negotiation. Sub-lines are generally entered into after a fund has had at least one closing (i.e., after the initial subscription for interests by investors). Side letters are therefore not always negotiated at the same time as the sub-line. Best practice is to involve finance counsel from the outset of a fundraising process to ensure that side letter provisions take into account future financing needs and avoid issues down the line.

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2. <u>Limitations on debt incurrence</u>

The fund must be able to incur the debt contemplated by its proposed fund-level financing. This is an LPA (rather than side letter) point, but is sufficiently fundamental to warrant comment! The LPA should expressly permit the incurrence of debt and the giving of any related guarantees and security. The LPA may contain limitations negotiated with investors in respect of size of the sub-line (for example, up to a percentage of fund size), purposes for which the sub-line can be used and the duration for which borrowings may remain outstanding.

Practical considerations

These are key limitations around the use and structuring of the sub-line. With greater investor focus on LPA debt limitations, the scope of permitted debt incurrence is an increasingly important negotiation point.

In that context, the ILPA Guidelines recommend that investors request reasonable thresholds around the use of sub-lines (indicating, as an example, a limit on the size of a sub-line to around 15-25% of uncalled capital). From a fund perspective, the recommended thresholds may not be appropriate. Funds do not all have the same structure, investment focus or commercial strategy. There cannot be a "one size fits all" approach to debt incurrence. For example, funds that may need to complete multiple deals in quick succession should ensure flexibility to draw sufficient amounts under the sub-line. Inclusion of a cap on debt incurrence that is too low could impair the fund's ability to complete one or more investments in the desired timeframe, potentially placing it at a competitive disadvantage.

This developing dialogue with investors emphasises the need to consider financing from the outset of the fund's life. This will avoid inadvertently restricting the viability of a sub-line.

3. <u>Prohibition of direct obligations to lenders</u>

The sub-line security package typically consists of security over the right to call capital of investors and security over bank accounts into which capital calls are paid. Capital call security allows a lender, on acceleration of the sub-line, to step into the GP or manager's shoes and issue drawdown notices to investors (and often have the right to issue drawdown notices either in the name of the GP or manager or in the lender's own name). Any side letter provisions stating that an investor has direct obligations only to fund parties, or otherwise expressly excluding any direct obligations to a lender, could (but does not necessarily) undermine the lender's ability to enforce its security.

Practical considerations

The drafting of the specific side letter provision matters hugely. The devil is in the detail. There are also supplemental regulatory matters to consider (see below).

First, the GP or manager can assign to a lender as part of the capital call security only those rights given to the GP or manager under the fund documents. The capital call security will not otherwise generally purport to give the lender direct rights against the investors. Some investors are concerned about grants to a third party of broad rights generally against the investor (rather than specific assignment of capital call rights). If this is the investor concern, the side letter restriction should be worded to make clear that it does not prohibit the lender calling capital on enforcement, while accommodating the investor's broader concern.

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Second, as a regulatory matter, in certain jurisdictions capital commitments (either of all investors or only of certain investors that are subject to specific regulatory requirements) may only be paid into bank accounts of the fund. If so, the side letter restriction should be worded to accommodate both investor concerns and regulatory requirements, while still allowing the lender to call capital (albeit into a bank account of the fund).

4. Administrative requirements of investors

As an administrative matter, certain investors may request that the fund agree to a formal drawdown process. Investors are normally only concerned with practicalities. For example, investors may ask the fund to use headed notepaper for drawdown notices or provide a certified list of authorised signatories. On their face, these requirements seem unobjectionable. However, although unintended, such procedural mechanics may prevent a lender calling capital on acceleration of a sub-line.

Practical considerations

If the fund addresses the issue during side letter negotiation, the investor may be prepared to adjust the procedural requirements in the side letter to expressly contemplate capital calls by the lender.

Alternatively, it may be possible to structure a solution in the finance documents. For example, the fund could provide the lender with undated drawdown notices signed by the relevant fund party and addressed to the investor for the lender to use on enforcement. The fund could also provide a specimen signature list to the investor which includes an employee of the lender as an authorised signatory of the manager or GP.

5. Excuse rights

Many investors, for internal policy reasons, negotiate the right to be excused from specific categories of investments. For example, investors may wish to be excluded from participating in investments in alcohol, firearms and tobacco or in geographies or industries to which the investor is politically or commercially sensitive. The investor has no contractual obligation to honour a drawdown notice with respect to any investment (or, typically, to repay sub-line debt which was used to make such investment) for which it has an excuse right.

Practical considerations

Excuse rights are relatively common. For many investors, such rights are a core requirement without which the investor will not obtain internal approval to invest. Generally, these rights are not negotiated away but are instead accommodated within the financing structure.

How would excuse rights be accommodated in a sub-line? Lenders generally require that excused investors do not count as part of the fund's borrowing base. The fund should ensure that the lender only excludes the investor from the borrowing base in respect of the *portion* of that investor's remaining capital commitments attributable to the excused investment.

Some lenders, particularly in the European and Asian fund finance markets, may also ask that an event of default is triggered if the amount of excused capital contributions at any one time, in aggregate, exceeds a cap (e.g., 15 or 20% of uncalled capital). The fund may wish to negotiate this. Excuse rights, by their nature, are investor-specific and do not indicate an issue with creditworthiness of investors generally or their appetite to fund capital calls. The fund may therefore view an event of default to be too onerous a consequence.

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6. Confidentiality restrictions

Lenders need certain basic information on each investor before they are able to undertake credit analysis on that investor. Certain types of investors (often sovereign wealth funds) insist on provisions that prohibit disclosure of such information, even to lenders. Side letter restrictions which prevent the disclosure of such information are likely to lead to a lender excluding the investor from the borrowing base. For example, if the name and/or contact details of the investor cannot be provided, the lender will not be able to enforce its security against that investor.

Confidentiality provisions also raise additional concerns for lenders that may not be fully addressed by exclusion of the confidential investor from the borrowing base. Fund documents typically require capital calls to be made from all investors, which the lender would be unable to do if the identity of one or more investors is unknown. In addition, lenders are required to carry out certain "know your customer" checks, which can be an issue for lenders if confidential investors make up a significant portion of the investor base.

Practical considerations

It is worth considering the exact scope of an investor's confidentiality requirements when negotiating side letters. The investor may be willing to accommodate exceptions to a blanket restriction on disclosure. For example, an investor may be comfortable with disclosure of its name and contact details to counterparties to the fund (such as a lender), provided the recipient is bound to keep the information confidential and/or the investor is notified of any such disclosure.

Where disclosure of an investor's name is restricted, the sponsor should ensure that it is permitted to provide redacted copies of such investor's fund documents (for diligence purposes). The investor may be willing to agree to disclosure of the investor's name if there is an event of default under the sub-line to enable the lender to serve a drawdown notice on the investor. Alternatively, the sponsor may agree with the lender to call capital from the investor on an event of default in light of the inability for the lender to do so.

7. Refusal to acknowledge third-party notifications

Investors may ask for express confirmation in a side letter that they will not have to sign any documentation in connection with a sub-line. These provisions can be problematic if prospective lenders insist on receiving investor letters, investor legal opinions or other additional documents from one or more investors as a condition to providing a sub-line.

Practical considerations

Funds should build into the LPA provisions that will facilitate the incurrence of sub-lines – for example, a waiver by the investors of any rights of set-off or any defences they may have in relation to their obligation to fund capital calls. The LPA should also incorporate certain basic investor representations, covenants and acknowledgments for the benefit of the lenders. If the LPA terms accommodate these points, lenders generally should not require investors to sign a supplemental investor letter in connection with their provision of a sub-line.

However, a risk may remain even if the LPA contains terms that the sponsor considers will satisfy lender expectations. If the side letter is entered into before

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the fund procures financing, the fund will not know for certain at the point of negotiating side letters whether such a restriction could be an issue. The fund could soften any absolute restriction by instead agreeing to use commercially reasonable efforts to ensure that the investor is not required to sign documents in connection with a sub-line.

Similarly, investors may also resist providing financial information to the fund and any sub-line lender. Lenders and investors often get comfortable with limiting the scope of financial information on an investor to publicly available financial information.

8. Restrictions on jurisdiction of enforcement

Investors may seek to limit the jurisdictions in which a fund can pursue claims against them. This may be problematic for lenders. Lenders expect flexibility to bring claims in any jurisdiction in the event that they enforce rights to call capital and the investor defaults with respect to payment of such capital.

Practical considerations

Investors that are most sensitive to the jurisdiction of proceedings tend to be sovereign investors, including U.S. state pension plans. Principles of sovereign immunity or statutes applicable to any such investor may prohibit the investor submitting to the jurisdiction of courts outside of its home jurisdiction. Accordingly, this investor request is usually non-negotiable. The prohibition on bringing a claim against the investor other than in its jurisdiction of organisation limits the enforcement rights of lenders. However, certain lenders may accept the limitations (and nonetheless include the investor in the borrowing base) on the basis of the credit-quality of the investor.

9. Sovereign immunity

Certain entities, including sovereign wealth funds and public pension plans, may benefit from sovereign immunity in relation to contractual claims and/or other lawsuits. Funds may seek a waiver of sovereign immunity by investors. Many sovereign investors will not agree to a waiver and may require a side letter provision that overrides the waiver and reserves such immunity. In some instances, investors will also seek express acknowledgment of the scope of their immunities. This can create an enforcement risk for a lender.

Practical considerations

There is limited scope to negotiate a side letter provision reserving sovereign immunity. It is important to understand the scope of the immunity and whether there are exceptions (such as for commercial contracts) to the immunity that preserve the ability for a claim to be effectively brought against the investor. At a minimum, the side letter of an investor that benefits from sovereign immunity should clarify that the reservation of immunity does not limit the investor's obligations to the fund (including making capital contributions when called). Whether or not a sovereign investor is included in the borrowing base will depend on the specific credit analysis of the lenders to the fund.

10. Transfers to affiliates

Some investors seek enhanced flexibility in connection with the transfer of their interests to an affiliate and may require that the GP or the manager agrees to consent to any such transfer.

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Practical considerations

Lenders will consider whether the affiliate transferee is as creditworthy as the transferor. The affiliate transferee may not be given as favourable treatment by lenders in the borrowing base or may be excluded entirely. Funds can mitigate this risk by limiting the affiliate transfer provision to allow transfers only to affiliates of creditworthiness acceptable to the GP or manager.

Funds may wish to negotiate that, under the sub-line, lenders do not have a consent right to investor transfers, or at least no consent right to transfers to affiliates. Historically, many lenders required a consent right to investor transfers above an agreed threshold, although transfers between affiliates were often carved out from the restriction. The primary rationale for such restriction is that an investor transfer may impact the creditworthiness of the lenders' ultimate source of repayment.

Recently, there has been some movement away from such restrictions as a result of objections by investors. The ILPA Guidelines publicly highlighted to investors that lender consent rights would inhibit investors' ability to transfer. Consequently, sub-line terms on investor transfers are evolving. Increasingly, sub-lines allow investor transfers as long as the transfer does not cause a breach of the borrowing base (with the fund able to control whether a breach occurs, because it can repay debt to ensure compliance with borrowing base requirements).

11. Overcall provisions and concentration limits

LPAs typically include shortfall funding provisions. In the event an investor defaults or is excused from an investment, the fund may call the shortfall from the other investors. Typically, only investors that have participated in the funding of an investment benefit from the returns that investment may generate. Investors may seek, either in the LPA or in a side letter, to limit the maximum amount they may be required to fund with respect to any investment in excess of the amount that would have been required had all investors participated in the relevant investment. Such overcall limitations can reduce the likelihood of a lender being fully repaid, as the contractual "overcall" protection against one investor failing to fund is weakened.

Concentration limits, which cap an investor's commitment to the fund at a specified percentage of aggregate commitments, similarly serve to restrict the amount of commitments available to repay indebtedness under a sub-line.

Practical considerations

The interests of the lenders are generally aligned with those of the fund with respect to these provisions, so there are no additional side letter points for a fund to negotiate with the sub-line in mind. Overcall and concentration limits will negatively impact a lender's credit analysis. However, lenders may get comfortable if the limitations are not too far-reaching and there is sufficient headroom above which the borrowing base exceeds the size of the facility.

12. Pay-to-play provisions (and other withdrawal rights)

As a result of regulations governing corrupt practices involving the use of placement agents, many public pension funds and other governmental investors insist on side letter provisions requiring the fund to represent that it has not used a placement agent, or paid any compensation to such investor's employees or related parties, in obtaining such investor's commitment. The consequences of a breach of such representation may include the unilateral right of such investor to withdraw from the fund.

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In addition, LPAs often include limited rights for investors subject to ERISA to withdraw from the fund if continued participation in the fund will give rise to issues for the fund or the investor under ERISA.

Practical considerations

Pay-to-play provisions are generally required by applicable law, so there is limited room for negotiation. However, the potential withdrawal of an included investor will be a major concern for potential lenders, and funds should take potential lender concerns into account in negotiating the side letter. One potential mitigant is to provide that the withdrawal right or termination of an obligation to fund capital calls does not apply to capital calls made in respect of debt incurred prior to such withdrawal or termination.

With respect to withdrawing investors, lenders will exclude such investors from the borrowing base. Lenders may also request that an event of default occurs if the aggregate of withdrawn commitments exceeds a threshold percentage of uncalled capital.

13. MFN provisions

"Most favoured nations", or MFN, provisions may allow investors to elect the benefit of terms negotiated in side letters with other investors (or, often, only other investors with a capital commitment equal to or less than the capital commitment of the electing investor). Only certain side letter provisions will be "MFN-electable". For example, the benefit of investor-specific requirements (such as sovereign immunity or internal policy requirements) cannot generally be elected by other investors that do not have the same requirements.

Practical considerations

If investors elect to take the benefit of side letters terms of other investors under MFN provisions, the adverse consequences for a lender of side letter terms that are detrimental to a financing structure are potentially multiplied. The issue highlights the importance of ensuring side letters do not contain terms adverse to a lender, as MFN provisions could exacerbate the consequences. The point remains relevant when negotiating a side letter with an investor that will be excluded from the borrowing base, as provisions in such an investor's side letter may be electable by investors that are included in the borrowing base through operation of the MFN. Funds may seek to mitigate this issue by carving out side letter provisions that could impact a financing from the scope of side letter provisions that are available for election under the MFN.

Conclusion

Sponsors and their counsel must consider financing flexibility when negotiating side letters. Investors often request side letter provisions that could reduce a fund's sub-line borrowing base, limit the scope of a fund's financing flexibility or entirely prevent a fund from raising fund-level financing.

Looking forward, we expect lenders to continue to focus their diligence around the side letter provisions. Anticipating and dealing with potential problems during the side letter negotiation process is critical to ensure that a fund avoids major problems with the financing down the line. Plan ahead for the pitfalls and perils!

* * *

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Designing subscription facilities to account for limited partner preferences

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Introduction

Funds use subscription facilities for a variety of reasons, including to partially or fully finance acquisitions, pay fees and expenses related thereto or otherwise applicable to the Fund, increase the Funds' internal rate of return, or give the Fund flexibility to issue letters of credit or support hedging transactions at lower rates. While subscription facilities can provide a number of benefits for Funds, it is important for practitioners to remember that the facilities are complementary to the core objectives of the Fund, namely investing and providing a return of capital to the Fund's limited partners.

While limited partners historically have been concerned with tax risks associated with borrowing at the Fund level,[1] that has largely changed. Now, most limited partners are familiar with subscription facilities and generally accept that Funds use short-term borrowings for bridge purposes and/or longer-term borrowings in lieu of equity contributions and third party financing in each case, instead of calling capital from investors. Nevertheless, while subscription facilities have become more familiar to investors, limited partners are not a monolithic group. As subscription facilities have evolved, limited partners have had different reactions to their use by Funds. This article discusses how Funds and their counsel may try to structure limited partnership agreements and subscription facilities to accommodate different limited partner preferences, and how to balance risks and obligations between the Fund, the investors and the lenders in a manner that accounts for the concerns of all.

In this context, the article will address: (1) the role of the partnership agreement; (2) length of borrowing; (3) lender interaction with investors; (4) access to information about the subscription facility; (5) confidentiality of limited partner information; (6) minimising costs of administering the subscription facility; (6) minimising costs of borrowings under the subscription facility; (7) the ability to put liens on partnership interests; and (8) maintaining flexibility in subscription facilities.

Assessing limited partner preferences: Negotiating the partnership agreement

There are two negotiations required when setting up a subscription facility. The first negotiation takes place with the limited partners, e.g., what is permitted in the limited

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partnership agreement (as modified by any side letters). The second negotiation takes place with the lender on the credit documentation. The initial negotiation with limited partners can help Fund management understand each limited partner's preferences early in the process and set expectations as the partnership agreement establishes the bounds of what is permissible under the facility. In other words, the subscription facility may have additional restrictions and limitations that are not in the partnership agreement, but the facility will always be limited to – and cannot override – the partnership agreement. Accordingly, it is preferable (from the vantage point of the Fund) to have expansive language in the partnership agreement, since the related terms can be more restrictive in the subscription facility.

This is not to say that that there can be no restrictions on the length of borrowing or a percentage cap on the amount of indebtedness, but these provisions should be negotiated thoughtfully with investors to allow for the reasonable use of subscription facilities and borrowings thereunder. In many instances, Fund counsel who negotiate with investors may be different from finance counsel who negotiate the subscription facility. When possible, finance counsel should also review the partnership agreement and any thorny side letter questions, particularly any provisions in side letters that may have "most favoured nation" implications, as these limitations can materially impact the ability of the Fund to borrow, especially if they spread to a number of investors in the Fund. Some specific limited partner concerns are discussed below. Many of these issues will come up early in side letter discussions and Fund counsel should take care to vet these issues with finance counsel so that the Fund manager can fully understand the implications.

Limited partner preference: Length of borrowing

As the market has developed from short-term bridge facilities of 90 days or less to subscription facilities that permit borrowings to remain outstanding for a year or more, limited partners have been evaluating how this impacts their return on investment and related risks and rewards. From the Fund perspective, it is important to communicate with limited partners the benefits and uses of subscription facilities and to ensure that adequate flexibility is built into the limited partnership agreement.

Why do some limited partners like longer term borrowings? In general, limited partners prefer to receive consistently-timed capital calls. Smaller, non-institutional investors may not have the administrative resources to fulfil frequent capital calls from multiple Funds, and even large institutional investors prefer to limit the number of resources devoted to administrative matters. Fewer and more consistent capital calls also mean limited partners are able to invest their money in other assets or investments pending capital calls, provided that the investor maintains the required liquidity. Finally, if Funds are able to quickly draw on the subscription facility for investments, the Funds can avoid calling capital from limited partners well in advance of an acquisition, only to then return the capital to the limited partners if the investment does not materialise.

At the other end of the spectrum, some limited partners may be opposed to longer borrowing terms for subscription facilities as it becomes harder to compare the rate of return for Funds with such long-length facilities, or they simply equate leverage with risk. For these reasons, many institutional investors have policies in place for lengths of borrowings related to subscription facilities and related requirements.

Ideally, the Fund will be able to reach an agreement with all investors on the permitted length of outstanding borrowings; however, if consensus does not form around optimal borrowing length, counsel may be able to identify other creative alternatives depending

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on the facts and circumstances. For example, the Fund could consider including those investors preferring short-term borrowings in a separate vehicle where capital would be called earlier. This is administratively burdensome but allows flexibility by keeping limited partners with a preference for shorter time timeframes happy.

To ensure that the preferences of the limited partners, rather than the terms of the credit agreement, are driving the frequency of capital calls, finance counsel can negotiate to conform any limits on borrowing in the credit agreement to what is required in the applicable limited partnership agreement. As length of borrowings has increased in the past several years, in addition to funding acquisitions, Funds have also used the subscription facility to pay for fees and expenses for the Fund, rather than calling capital to cover what is often a small amount. While most subscription facility lenders are aware that the Funds may use the facilities to pay for the Fund's fees and expenses, finance counsel still should review the use of proceeds provisions in the subscription facility and limited partnership agreement and ensure the language is broad enough to permit such borrowings. Ideally, the use of proceeds language in the subscription facility would track the language of the limited partnership agreement. Finance counsel may also request that the Fund be permitted to capitalise any interest or fees payable under the subscription facility itself, including commitment fees and letter of credit fees, thereby avoiding any need to issue a capital call to the limited partners for a relatively small amount. Capitalisation of interest and these expenses is the height of flexibility in these facilities.

Limited partner preference: Limit lender contact with investors

Generally, limited partners prefer not to have any direct contact or interactions with the lender. Funds are generally successful in limiting this contact. However, there are exceptions, largely driven by the lender's perception of the Fund's or Fund manager's historical track record, creditworthiness of the investor and the number of investors in the Fund. At the beginning of the credit agreement negotiation, Fund managers should discuss their specific expectations regarding investor contact with lenders and finance counsel.

From a limited partner standpoint, when negotiating with lenders the Fund should resist any requirement for investors to provide investor letters or opinions. Even though a lender would always prefer to have contractual privity with investors with respect to representations and covenants of the investors regarding the size of their commitment and when and where such investor will fund its capital commitment, lenders have generally moved away from requiring these investor documents for large sponsors with varied and well established investment records and investor bases. As noted above, there are certain situations where lenders will still ask for investor letters and opinions (for example, funds-of-one) based on the risk profile of the Fund and/or its investors.

Nevertheless, even for new Funds with less established investment records, it is possible to accommodate investor's preference to be insulated from lenders. To achieve this, finance counsel should work with Fund counsel when fund documentation is being negotiated to include the relevant provisions lenders would look for in the fund documentation itself to support the establishment of a credit facility and to allow them to exercise rights and remedies. In addition to these necessary provisions, Fund counsel and finance counsel will need to assist Fund management in determining whether to include provisions in the partnership agreement that constitute additional obligations of investors in favour of the lender, such as agreements to provide "investor letters", consents and opinions to the lender to support the credit facility. These letters typically provide information such as an acknowledgment of the amount of such investor's capital contribution, an acknowledgment of the lender's

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lien over uncalled capital commitments, and an agreement to fund capital commitments to a specified bank account at the direction of the lender. Lenders will almost universally prefer to receive these agreements and acknowledgments directly from the investor, primarily to assist in an exercise of remedies if ever needed, but from the investor's perspective this is an additional work stream, with documents and opinions that need to be reviewed, negotiated and delivered, that the investor would like to avoid. This can be achieved by including provisions in the partnership that clearly state that by signing the partnership agreement, the investor has consented to all the material aspects of the subscription facility, the general partner is authorised to negotiate and execute facility documentation (including the pledge of uncalled capital as collateral), and the investor need not be contacted for confirmations related to the subscription facility.

As an accommodation to investors, Funds should try to limit any direct contact between investors and the lenders and avoid requiring investors to take affirmative action in connection with the subscription facility. However, as discussed below, the Fund may be required to provide investors notice of the establishment of the facility. Accordingly, the Fund should generally update investors about the facility on a regular basis.

Another situation where a lender may have direct contact with an investor is during an event of default under the subscription facility that results in the exercise of remedies. In such a scenario, the lender (or an agent for the lenders) under the subscription facility has the right to issue a capital call notice to the limited partners in place of the Fund. However, limited partners prefer to only receive capital calls from the general partner, in part out of a concern that funding a lender-issued capital call would not be credited to their uncalled capital account, and are therefore more likely to fund calls from the general partner. Funds managers should seek the ability in subscription agreements in such circumstances to issue one (or more) capital call(s) before the agent is permitted to do so, which allows the agent to control the process while still limiting lender contact with investors in the first instance. This is potentially a better outcome for the lender as well, given that the likelihood of limited partners funding on the capital call notice is greater if it is viewed as a more ordinary course issuance. This situation is rare, but maintaining this control is important to manage the relationship between the Fund and its limited partners. If finance counsel is unable to negotiate for the Fund to first issue the capital call in an event of default, the Fund should request that the agent provide written notice before the agent issues any capital calls to the limited partners. This accommodation should allow time for proper communication between Fund managers and the Fund's limited partners.

Limited partner preference: Disclosure to investors

Subscription facilities are much more common in the private equity space than they have been in the past, and most limited partners understand how a subscription facility works. Fund management should nevertheless provide clear information about how it plans to use the facility, given the varieties of facilities available to Funds, so that expectations are clear for the investors. This article does not address legal disclosure requirements, but Funds should consult with the relevant specialists.

Disclosure of the subscription facility is often driven by local law. Depending on the Fund's jurisdiction, there may be different requirements to perfect the security interest in the uncalled commitments and right to call capital. Certain jurisdictions (such as the Cayman Islands) require the Fund, in its capacity as borrower, to deliver a notice of the security interest to the limited partners in order to perfect the lender's lien over uncalled capital of the limited partner. Other jurisdictions go further, requiring an acknowledgment of the

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notice by the limited partners. Fund managers should understand, at least on a preliminary basis, what the legal requirements are for the granting and perfection of a security interest in a jurisdiction that is being considered when a new fund or fund vehicle is being formed to ensure such jurisdiction's legal regime is supportive of the legal requirements of most lenders under a subscription facility.

Finance counsel should work closely with the Fund on the language in the notice to investors and means of delivery. If possible, Funds should resist requirements that investors provide any kind of acknowledgment unless absolutely necessary in the relevant jurisdiction. The notice should be written in plain language and avoid legalese. The Fund should be prepared to answer questions from the investors about the subscription facility after sending out the notice, and finance counsel can help craft those responses as well.

Finance counsel should also inform Fund counsel that notifications will be required to be sent to future limited partners who are admitted in an additional closing or via transfer. Fund counsel can then determine where to include this information in the investor materials that are sent to the limited partners (for example, the footnotes to the financial statements) so that investors are not bombarded with extra documentation. Any information provided to the limited partners should include a clear description of the lenders' collateral, rights and remedies as well as a summary of the information the general partner will provide to the lenders about the investors. Fund counsel may also include language in the limited partnership agreement stating that any required notices can be distributed via portal.

Limited partner preference: Preserve confidential information

Limited partners value confidentiality with respect to any information relating to the limited partner, including the fact of their investment in the Fund, the amount of their commitment, their financial information and any personal information to which the Fund may have access. These confidentiality concerns can sometimes be at odds with the establishment of a subscription facility. Fund managers are required to provide identifying information about the limited partners (including capital commitments, ratings (if such investor is rated), names and notice information) to the lenders in connection with the lenders' diligence for the lenders' own regulatory compliance purposes, and in determination of the borrowing base in a subscription facility that provides advance rates against specific limited partner commitments. However, Fund managers also have a responsibility to ensure the lenders uphold the confidentiality that is required by the Fund pursuant to the terms of the limited partnership agreement and any side letters. Subscription facilities should have clear confidentiality provisions in place that protect the limited partners and prevent the disclosure of confidential information by the lenders.

Protection of confidential information comes up in several different aspects of a subscription facility. When negotiating the assignment provisions of the subscription facility, the Fund manager should consider what consent rights exist for assignments and participations, as well as potential assignments and participations. While subscription facilities are generally not widely syndicated, the Fund will want to understand who and when a new party may get access to confidential information about the Fund itself and the Fund's limited partners.

Some limited partners are particularly concerned about keeping their names and information confidential, and may negotiate specific provisions in their respective side letters limiting the ability of the Fund to share limited partner names and/or subscription documents with any third party. If Fund counsel is aware that the Fund will be entering into a subscription facility, they can ask the limited partner for an exception to the confidentiality provision that applies to lenders under a subscription facility. Without this accommodation, the

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limited partner will be excluded from the borrowing base and there could be other potential issues, such as the potential lender being unable to complete its own regulatory compliance necessary for it to enter into a lending transaction with the Fund. Other potential solutions to this problem include disclosure of the limited partner by the Fund, but only if it did not fund its capital call in accordance with the provisions of the partnership agreement when requested.

Finance counsel for the Fund, in tandem with Fund counsel, should consider flagging any problematic confidentiality provisions in the side letters early in the negotiation with potential lenders. Similarly, they should take care to address any necessary carve-outs to the conditions and other relevant provisions in the subscription facility.

Limited partner preference: Costs of administration

Most limited partners are aware that Funds use subscription facilities and find that subscription facilities can minimise the administrative burden on the investors and the Fund, as well as allow Funds to move quickly to achieve investment objectives. However, by their nature, subscription facilities do require the Funds to incur additional costs, including commitment fees, agent fees, and legal costs and expenses, as well as the less quantifiable costs associated with maintaining compliance with the covenants in the subscription facility. It is in the interest of both the Fund and the limited partners to keep these costs as low as possible.

For larger Funds, the quantum of the subscription facility can be large enough that it is often syndicated to multiple lenders, and will include an agent to act for the syndicate (including by holding any liens or collateral that support the facility). In a syndicated deal such as this, it is important for the agent to have a centralised process for diligence and other communications. The agent alone should also manage any amendments, draws and repayments, changes in lender commitments and payoff of the facility, to ensure the facility operates smoothly on a day-to-day basis.

Finance counsel for the Fund may also be able to negotiate for the agent to have significant discretion in approving matters in the subscription facility, which also helps ensure efficient operation. For example, the agent may have discretion to: (1) permit alternative investment vehicles or qualified borrowers to join the facility; (2) determine if any limited partnership amendments are material; and (3) release any collateral. Such discretion, if carefully negotiated to make clear that the lenders have authorised the agent to act on their behalf, should limit the involvement of the full lender group in the management of the facility and limit amendments and secondary negotiations. However, different banks approach the role of agent differently, and some banks may be hesitant to fully exercise their discretion when acting in this capacity. Fund managers should be mindful of this when soliciting preliminary proposals and term sheets from financing sources, and try to understand early what approach the agent bank would take in administrating the facility.

Funds can also consider including an accordion feature in the subscription facility, which gives flexibility for additional borrowings under the existing facility. The accordion may be committed or uncommitted, and may be a permanent increase to the commitments or simply temporary, depending on lender and borrower negotiations. The benefit of the provision is that the Fund has the built-in ability to fund a potential unforeseen investment opportunity without needing to negotiate and execute a new document, thereby saving time and preventing unnecessary legal costs.

Many subscription facilities include the flexibility to add feeder funds, alternative investment vehicles and qualified borrowers (generally, portfolio companies in the Fund

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structure) as borrowers under the facility. This flexibility allows the Fund to accommodate limited partner and Fund deal team preferences for tax-structuring a specified investment. But adding feeder funds, alternative investment vehicles and qualified borrowers to the subscription facility can be costly, so finance counsel should pre-negotiate joinder forms and minimise required deliverables (including opinions of counsel) if possible, again saving future fees and allowing these vehicles to be joined to the subscription facility quickly and efficiently.

Limited partner preference: Minimising costs of borrowings

Limited partners also prefer that Funds minimise the cost of commitments and of borrowing loans under a subscription facility. As subscription facilities are relatively low-risk products for lenders (as referenced above, often designed to allow a specified advance rate of borrowings against specified limited partners), they typically have relatively low interest rates. Still, there is a market for these facilities, and there can be a range of interest rates and other terms offered by different banks. If possible, Fund managers should engage various banks in a competitive process for subscription facilities to ensure they are getting the best interest rates and lowest bank fees. However, Fund managers also need to balance rate and fee arrangements with having a facility that includes the flexibility and protective provisions referenced above, as well as a strong relationship with the agent or lender who will partner with the Fund to get the facility closed and manage the facility through its lifetime. A subscription facility with the lowest interest and fee structure may end up being more costly to the Fund (and therefore to the limited partners) if it does not also provide functional flexibility and ease of compliance.

Finance counsel should seek information from the Fund team regarding what kinds of borrowings the Fund will require. If the Fund expects to frequently use letters of credit, finance counsel can focus on negotiating fronting fees or other letter of credit fees. If the Fund expects to make acquisitions in a variety of currencies, finance counsel can prioritise negotiating the kinds of available currencies, the foreign exchange rate and the ability to incur secured hedges under the facility.

Finally, as referenced above, as many subscription facilities also include the ability to join qualified borrowers as borrowers under the facility (subject to a guaranty by the Fund), allowing access to credit at a rate that may be more favourable than what the qualified borrower could otherwise obtain on its own.

Limited partner preference: Maintaining flexibility

As many subscription facilities feature the borrowing base concept described above, it is in the best interest of the Fund to include as many limited partners in the borrowing base as possible. Subscription facility documentation will govern inclusion in the borrowing base by specifying "exclusion events" which, if occurring with respect to a limited partner, would exclude the limited partner from the borrowing base for the duration of such event (often requiring affirmative action by the agent or by the lenders to readmit such limited partner to the borrowing base).

Exclusion events can be negotiated to achieve the goals of the Fund, acknowledge the requirements of the lenders, or accommodate limited partner concerns. For example, limited partners occasionally request the flexibility to grant a lien on their limited partnership interest in the context of entering into an all-assets financing. A subscription facility can accommodate this by negotiating to remove any exclusion events based on liens on the limited partner's interest, or limiting such exclusion events only to after remedies are being pursued with respect to such lien.

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In addition, limited partners may require flexibility to be excused from certain investments due to internal policies or regulations, and the exercise of such excuse rights will potentially affect the inclusion of such limited partners in the borrowing base. A subscription facility could be designed to preserve flexibility for the limited partner by negotiating to exclude the relevant investor from the borrowing base only in relation to the relevant excused investment, preserving the legitimate policy-related requirement of the investor but also allowing the subscription facility to include the investor in the borrowing base for non-implicated investments.

Conclusion

As subscription facilities continue to mature and evolve, Funds should continue to communicate with their limited partners on the best way to use the subscription facilities. It is important during the negotiation and implementation of subscription facility to balance the risks and obligations of the lender and the Fund with the preferences of the limited partners so that these facilities can both accommodate these preferences and also benefit all the parties involved.

* * *

Endnote

1. Tax issues are not addressed in this article.

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Overview of the fundraising and fund finance market in Asia

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The Fund Finance Association's inaugural Asia-Pacific fund finance symposium was held in Hong Kong in June 2017. If the number of attendees is a barometer of interest in the fund finance product within Asia then that interest is significant, with nearly 300 attendees and 30 sponsors for the inaugural event.

That level of interest is borne out in the significant number of enquiries that we have received from sponsors, banks and intermediaries throughout the region over the last couple of years. There is clearly significant interest in the product, but what are we seeing in the region in practice and how do we expect that to develop in the coming year?

Overview of the private capital fundraising market in Asia

General market trends

While the lion's share of global growth in private capital investment is today driven by Asia, its burgeoning private equity market is still relatively small. Over the last decade, the amount of capital raised by funds with a focus on investments and businesses in the Asia-Pacific region accounts for approximately 14% of the US$5.9 trillion raised globally.

It is difficult to predict whether we are seeing an upward trend of private capital fundraising in Asia in the short to medium term. Asia has enjoyed a not-insignificant share of the total amount of private capital raised globally, despite the fact that in the first half of 2017 there was a steady decline in the absolute capital raised by closed-ended private capital funds in Asia. North America and Europe's private equity markets are now rebounding from a regular cadence of macro tremors that rattled their economies, and are regaining near-historic levels of fundraising. However, Asia's private equity and venture capital industry continued to represent less than 10% of global capital raised as at the end of the first half of 2017. The volume of deals carried out by private equity funds has also dropped from the high point for Asia private equity exits in 2014, when US$67.4 billion in proceeds were derived from approximately 700 transactions, to approximately US$44.7 billion generated from 400 deals in 2016.

The results from a recent survey conducted by Preqin have shown that despite over 50% of Asia-based fund managers indicating a real concern in fundraising activity in the first half of 2017, the same fund managers maintain an optimistic view on the potential of private capital in Asia for the second half of 2017. There appears to still be appetite from Asia-

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based investors to contribute capital to private funds and a number of the global private equity houses are continuing to undertake (or have undertaken) concentrated fundraising efforts in Asia in the second half of 2017. For example, KKR closed its Asia Fund III in June 2017, which had raised US$9.3 billion and as such represents the largest private equity fund dedicated to investing in the region. Previously, the largest pan-Asian fund was also held by KKR at US$6 billion in July 2013, then the largest pool of private equity capital ever raised for deployment in Asia.

Notwithstanding the relatively positive outlook on fundraising activity in the private equity space, Asia also faces some challenges that might hinder growth in this area (especially with new entrants to the market). Given the region's diversity, with huge variations in demographics, stages of economic development, investor appetite and sophistication, many funds have found it difficult to infiltrate and appeal to the regional investor base. In Asia, the largest concentration of private equity investors is located in the PRC and Japan (approximately 27% of investors are based in the PRC and 24% reside in Japan). South Korea, Hong Kong and India follow closely behind with investors based in those jurisdictions making up an aggregate of approximately 30% of the total Asia-based investors.

Overall, the general sentiment in the market is one of caution and risk-aversion as regards investment allocations. This is largely due to the fact that Asian private equity is still relatively unproven and Asia-focused funds have not consistently demonstrated the ability to deliver strong positive returns to investors. This could also relate to the culture of Asian investors where, generally, such investors tend to be risk-averse, and will often target established global private equity firms based on their brand, require relatively extensive due diligence, an understanding of the investment strategy of the fund, and a demonstrable track record from the fund sponsor. As a result, larger pan-Asian funds continue to grow in size, while first-time funds experience greater difficulty in identifying investors and sizing up. This is notable from the fact that six pan-Asian funds – Baring Private Equity Asia, RRJ Capital, Bain Capital Private Equity, PAG, MBK Partners and KKR – all raised funds in 2015 with aggregate commitments larger than earlier fundraisings, with KKR experiencing the largest jump (approximately 60%) from Fund II in July 2013 to Fund III in June 2017. These funds have the reputation, standing, network and track record to expand into different jurisdictions and are better placed to leverage local expertise, develop relationships to source new deals and to establish presence in new markets to widen their coverage into new sectors and economies.

The apparent advantage that pan-Asian or larger reputable funds have does not mean that there is no place for smaller or new funds with an Asian focus. Many founders of smaller or new Asian funds are bankers that have developed a significant degree of sophistication (and a network of investor contacts) through their international banking careers. The level of sophistication of such smaller or new private equity funds in Asia means that, whilst they do not necessarily compete for diverse multi-jurisdictional and multi-sector portfolios, they are able to focus on specific sector preferences and develop deeper industry insights to appeal to specific segments of the Asia-focused investor base. Mekong Enterprise Fund III is a good example of this: the fund was established in 2015 by Mekong Capital to focus solely on consumer-driven segments in Vietnam, after the country's economic downturn between 2011 and 2012.

Other specialised infrastructure or real estate funds that focus on investments around the region demonstrate that there is room for new and niche funds in an increasingly competitive environment. Those at the forefront include several sovereign wealth funds,

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followed closely by Asian pension funds and insurance companies. This specialisation strategy is long-standing in the US. While this strategy is less entrenched in Asia, there has been a proliferation of firms such as Mekong Capital that operate a sector preference, signalling a new development in the Asian private equity and venture capital markets. This sector-focused strategy is consistent with the general approach and culture of the relatively risk-averse Asia-based investors that desire low risk and steady returns. As such, Asia-based investors are keen to invest in funds run by specialised fund managers who are equipped with a solid understanding of their sector and more adept at pushing for favourable investment terms. Industry-specific focused funds also benefit from the growth in global interest in infrastructure investment and the political drive for infrastructure development around the Asian region. With Japan's Government Pension Investment Fund promulgating an infrastructure plan in April 2017 to focus its investments on brownfield projects in developed markets and China's sprawling One Belt One Road initiative providing the framework, it is highly likely that more Asia-based investors will seek to support such sector-specific funds and accelerate growth in the Asian infrastructure sector.

Type of funds

There are various fund structures used in the Asian region, determined largely by tax considerations (both for the fund itself and for the target investor base). Asia-focused private fund vehicles tend to be close-ended and established as Cayman Islands Exempted Limited Partnerships (**ELPs**), comprising at least one general partner (controlled by the sponsor), with the investors subscribing for limited partnership interests in the ELP. A Cayman ELP fund structure ensures tax neutrality – that is to say, no additional taxation will be incurred at the fund level (in addition to tax due downstream with respect to the fund's investments and upstream on returns paid by the fund to its partners) – and is generally considered a transparent structure for tax purposes. The Cayman Islands legal system is based on English common law – and originally on English corporate and partnership law – but with significant legislative developments to bring into play 'best in class' provisions seen in Delaware, Canada and elsewhere. This provides a flexible legal framework with appropriate regulatory oversight that is well understood by international investors and designed specifically for the conduct of cross-border fundraising and investment. The Cayman Islands are also at the forefront in developing new products for use by the global investment community, with the recent introduction of limited liability companies (again, heavily based on the well-used and understood Delaware model, but with additional flexibility) likely to prove popular for the structuring of certain private funds in Asia, and in particular for their general partner and investment management arrangements, and underlying investment portfolios. Based on statistics from the Registrar of Exempted Limited Partnerships in the Cayman Islands, approximately 20,000 ELPs were registered in the Cayman Islands by the close of 2016, representing a 12% increase from 2015.

In North Asia, it is rare to see an offshore fund that is domiciled in a jurisdiction other than Cayman. However, it should be noted that, in Asia more generally, funds may be domiciled in other jurisdictions such as BVI, Luxembourg, Singapore or Mauritius (and with US feeder funds often established in Delaware). Frequently, this is driven by a requirement for the fund in question to benefit from relevant double taxation agreement (**DTA**) provisions. This was illustrated in the wake of the Lone Star Fund's protracted arbitration proceedings, which brought to light the lack of DTA protection between South Korea and the Cayman Islands, such that a significant portion of proceeds from its sale of Korea Exchange Bank were to be withheld to cover capital gains tax to Korean authorities. The nature of investments and location of assets in which Asian funds invest, and the

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availability of appropriate DTAs to mitigate potential double taxation consequences, have seen jurisdictions like Singapore and Mauritius increasingly becoming viable options for fund establishment, in particular where Southeast Asian markets (such as Indonesia or India) are the funds' investment focus. The Japanese market continues to frequently utilise the unit trust structure (whether Japanese, particularly for the domestic market, or Cayman for international fundraising).

Cayman, as a tax neutral jurisdiction, does not have a network of DTAs (there being no tax at the Cayman end to offset on a double-taxation avoidance basis). However, the range of products on offer, the regulatory approach and flexible legal framework, and the familiarity of the Cayman offering, suggest that the Cayman Islands will continue its reign as the jurisdiction of choice for Asia-based investors, albeit with increased use of alternative jurisdictions, or a combination of other jurisdictions, where relevant.

The Asian fund finance market

The fund finance market in Asia has evolved over the last couple of years and now represents an increasingly key market for global fund finance houses. Although the size of the market – estimated to comprise approximately US$50 billion in aggregate commitments – is smaller than its counterparts in the US or in Europe, the potential for growth in Asia is significant. As discussed above, the private fund market represents an underweight proportion of the global market given the economic potential of the region, so the potential for growth in fundraising (and, alongside it, fund finance) is clear. In addition, it is estimated that not even 50% of the raised funds currently active in Asia make use of fund finance facilities. It is a product that is increasingly marketed in the region and is used significantly by the global and large regional players, but has not yet penetrated the Asian private fund market in the same manner as in the US or in Europe.

The fund finance product offering in Asia remains very much the subscription line facility at present. We have not yet seen any significant execution volume in downstream net asset value (**NAV**) or hybrid subscription / NAV facilities in Asia. There is limited use of general partner or investment manager facilities, though these tend to be small in size, limited in tenor and tailored to the specifics of the borrower fund in question.

Leveraged financing of downstream fund investments is ubiquitous, but outside the scope of this chapter.

<u>Asian subscription line facilities</u>

As elsewhere, the subscription line facilities offered in Asia are largely intended for short-term borrowing in order to bridge or smooth out investor capital calls, provide additional credit support for downstream investments or portfolio companies, and to allow the fund to consummate strategic investments without delay. Virtually every subscription line facility written in Asia is secured over the uncalled capital commitments made to the fund by its investors; it is increasingly rare to find an unsecured fund finance facility of any nature in the Asian region.

Larger facilities are typically written under English or US (New York or California) law, with the security package enforceable as a matter of Cayman law and priority of the security assured through written notice to the fund's investors. In these respects, the capital call facilities on offer in Asia look and feel very similar to those available in the US and European market, with the 'convergence to the mean' in the global fund finance space very much applying to the market for big-ticket facilities in Asia.

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There is a large volume of smaller facilities in the region often governed by Hong Kong or Singapore law where that is the preference of the local lender(s) or borrower (and otherwise frequently by the laws of the home market of the lender). These mostly bilateral facilities are provided by niche fund finance houses and written under facility documentation used in their home markets (for example, niche US west coast fund finance houses providing facilities in Asia governed by their largely standard, California law-governed, subscription facility documentation). Here, one might see more divergence in covenants, tenor or use of proceeds – and so less of a 'convergence to the mean' than the 'big-ticket' market – though for the most part, the security package tends to be as robust as that provided in support of larger subscription line facilities in the region.

Lenders

The Asian finance market remains very much relationship-based, with bilateral facilities (typically in the US$200–US$750 million range) offered as part of a bank's wider corporate or private wealth offering. Larger facilities – and in particular, those provided to the Asia-focused funds of global or large regional private equity sponsors – are often arranged by global or core regional (Australian, Hong Kong, Japanese or Singaporean) financial institutions that make structuring or credit decisions centrally, and are frequently syndicated among that group. For these reasons, they tend to mirror to a significant extent the subscription line facilities on offer in the US and European markets, further fuelling the 'convergence to the mean' we are seeing globally.

The key players in the 'smaller-ticket', sector-specific fund finance market remain largely west coast US and certain European banks, though we are starting to see increased activity by Chinese and Asian regional banks in this space.

Borrowers

The borrowing base comprises largely close-ended, private funds, ranging from single entity funds through master-feeder, umbrella, co-invest and consortium arrangements. For the most part, these entities will be established as Cayman Islands ELPs as discussed above.

It is very common for the Asia-focused funds of global or large regional private equity sponsors to employ a subscription line facility in their borrowing strategy. Historically, the fund finance product has been less frequently utilised by the smaller regional and single-country funds, which is likely to be caused by a combination of the lack of profile of the product (especially where banking facilities are provided by local banks) and its potential benefits to a borrower fund. This is changing, especially as the larger Chinese and other regional banks start deploying the fund finance product.

Defaults

Although there has been an uptick in defaults in recent years – though largely technical defaults, such as breaching notification covenants, rather than payment or other fundamental defaults – for the most part, the product has remained remarkably stable. A key factor in this track record is the conservative approach to investor base risk-weighted due diligence (including full reviews of any side letters that the fund has entered into with its investors) in calculating an appropriate loan to uncalled capital value ratio, as well as the robust covenant package typically included in the facility documentation.

What is the outlook for 2018 and beyond?

Absent any global or regional negative macro-economic or political events, the increasing size of the Asian private fund market – and the relative lack of penetration of the fund

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finance product throughout the Asian fund universe currently – suggests that the Asian fund finance market will continue to expand.

Although Chinese banks have participated in a number of fund finance transactions over the last couple of years, we are seeing a marked increase in interest in the product from these (and other regional and international) institutions recently. We anticipate that, as that interest and product understanding develops, we will see an uptick in the penetration of subscription line facilities, particularly to Chinese banks' local and regional private funds clients. In addition, it is likely that there will be increased demand for NAV and hybrid products in line with the increasing size and sophistication of many funds active in the Asian market (and as we have seen in the US and Europe).

As the volume and sophistication of fund finance facilities increases in the Asia-Pacific region, and competition amongst financial institutions seeking fund finance business grows (particularly with the entry of Chinese banks to the market), we are likely to see much more divergence in structure, terms, approach to security, due diligence and pricing on offer in the market. This ultimately suggests a larger and more innovative, dynamic fund finance market developing in Asia in the coming years.

* * *

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Australia

Tom Highnam, Rita Pang & Victoria Johns
Allens

Overview: Fund finance and funds landscape in Australia

Fund financing activities in Australia have remained strong in 2017, with particular focus on infrastructure, private equity funds and private debt funds, which have taken advantage of the additional liquidity and funding flexibility in this market. While there is no standard industry data-reporting source tracking fund financing facilities in Australia, based on the transactions we have seen, and speaking to the major financiers active in the Australian market, the domestic market has continued its stable activity in the past 12 months. Based on anecdotal evidence from market participants, the size of the market in fund financing for private equity and venture capital funds in Australia is estimated to be in the region of A$2.3bn to A$2.8bn. New market entrants in the private equity and venture capital space have been in part responsible for this activity. Adding infrastructure funds to that mix would increase the size to approximately A$7bn to A$7.5bn.

Lenders' confidence in this asset class remains strong. Some offshore commercial banks and investment banks have shown a growing interest in, and have entered, the Australian market as a result of the strong history of near-zero investor defaults, as well as the opportunity to establish and strengthen relationships with funds and their financial sponsors. While there has been some diversification in the market in terms of the type of facilities being offered, Australian facilities have typically been capital call (or subscription finance) facilities and NAV-based facilities. Secured facilities continue to remain a relatively inexpensive means to obtain capital quickly for investment opportunities and working capital needs.

In response to the need to bolster Australia's global presence in attracting foreign investment capital, in December 2015 the Australian Government announced that it will introduce two new collective investment vehicles (***CIVs***), which will have close similarity to other common types of investment vehicles available in other jurisdictions. As a result, there is potential for growth in fundraising activities with the availability of these new structures and, as a corollary, the opportunity for further market penetration for fund finance facilities in the Australian market. Sovereign wealth funds and superannuation funds are emerging as the significant investors in Australian funds, bringing new considerations for lenders' credit assessment and deal structuring. As Australian domestic banks and major offshore lenders continue to counter regulatory capital pressures by deleveraging risk-weighted assets, this has fuelled the activity of debt funds, superannuation funds and further developing fund financing opportunities in the Asia-Pacific region.

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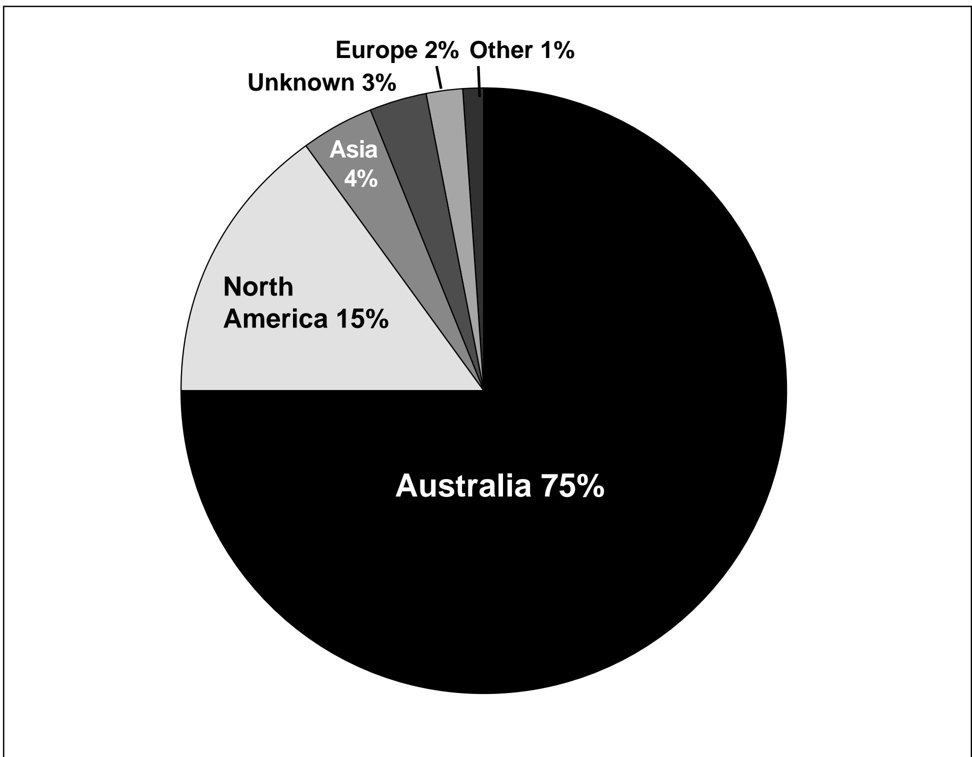
The funds landscape in Australia

The Australian private equity and venture capital industry saw a continuation of significant fund activity over the course of the 2017 financial year, with overall fundraising and investment levels remaining strong.[1] While private equity fundraising was marginally lower than the previous year at approximately A$2.03bn, investments by the industry grew slightly by 1% to A$3.38bn.[2] In contrast to private equity, venture capital fundraising rose to record levels, with A$1.32bn raised in the 2017 financial year (more than double the A$568m raised in the 2016 financial year).[3] Venture capital investment is continuing to perform strongly with approximately A$429m deployed (up 24%) into 117 businesses during the 2017 financial year. This growth has been encouraged by Australian Government policy initiatives through the National Innovation and Science Agenda (announced in December 2015) such as the A$500 million Biomedical Translation Fund.

Private equity funding primarily came from superannuation/pension funds (37%), fund of funds (21%) and sovereign funds (19%), with a majority of investors from Australia (63%), North America and Asia.[4] For venture capital fundraising, over 94% came from Australian investors, with superannuation funds being the biggest sources of commitments (32%) and the public sector (27%).[5] As of 30 June 2017, approximately A$7.69bn of dry powder was also available for investment by Australian private equity and venture capital fund managers, a 10% increase on the previous year's total.[6] According to the Australian Private Equity and Venture Capital Association, the high levels of fundraising and dry powder signal strong investment activity over the next few years.[7]

Sources of new PE and VC commitments in FY2017 by region (A$ millions)



Source: AVCAL 2017 Yearbook

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The demand for infrastructure and the increased availability of debt financing, together with the high levels of dry powder available to fund managers, have led to increased competition for infrastructure assets. Infrastructure is one of the fastest-growing asset classes globally, with target infrastructure allocations increasing significantly over recent years. In particular, public and private sector superannuation funds and sovereign wealth funds have demonstrated greater appetite for infrastructure over the past year. At the end of the third quarter of 2017, unlisted infrastructure funds raised approximately $39.02bn.[8] Fundraising was down globally during the third quarter, including in the Asia-Pacific, with $1.62bn raised.[9] However, by the end of the third quarter in 2017, more capital had been raised by private infrastructure funds than during the same period in 2016.

In 2017, private infrastructure funds and superannuation funds not only heeded the federal and state governments' call to bridge Australia's infrastructure gap by investing in infrastructure assets, those funds have also been prominent in their participation. GIP Australia Infrastructure Fund's investment in the Port of Melbourne privatisation, and Hastings Funds Management and First State Super's successful A$2.6 billion bid to operate a 35-year concession of the land titling and registry operations of New South Wales Land and Property Information, are examples of this. It is likely that the demand for fund finance facilities in Australia will remain steady, in order to keep up with the financing and investment needs of infrastructure funds and sponsors to facilitate acquisitions.

Fund formation and fund financing

Fund formation and new developments

In regard to fund structure, Australian funds are predominantly set up as a unit trust or a series of stapled unit trusts. Typical limited partnership structures do not offer the same beneficial tax treatment afforded to a trust and are therefore a less popular funding structure in Australia. While common in Australia, a unit trust is not considered a standard investment vehicle in many other jurisdictions. Australian funds may also be set up as a venture capital limited partnership (***VCLP***) under the *Venture Capital Act 2002 (Cth)* to take advantage of certain tax benefits, especially for foreign investors. However, VCLPs can only invest in Australian businesses with total assets of not more than A$250m by acquiring shares, options or units.[10] It is not uncommon for Australian mid-market private equity funds to be structured with a VCLP, stapled with one or more special purpose trusts in order to provide greater flexibility for investment.

As mentioned in our 2016 article, the Australian Government has announced that it will introduce two CIVs as a tax-effective alternative to current Australian pooled investment trusts, the aim of which is to grow Australia's share of the global mobile capital. The new vehicles will be a corporate CIV (***CCIV***) (which has been modelled on the English and Welsh open-ended investment company (***OEIC***) and the Luxembourg SICAV) and a limited partnership CIV (***LP CIV***). The Federal Government released the exposure draft bill on 25 August 2017 for public consultation. Submissions closed on 25 September 2017 in relation to CCIVs and the Federal Government has announced that it will look to introduce an LP CIV once the CCIV has been introduced.

It is expected that the availability of these new CIVs will significantly enhance the competitiveness of Australian funds by allowing fund managers to offer investment products using vehicles that are commonly used overseas and better understood by foreign investors than our current trust-based funds.[11] However, with the parameters of such vehicles still uncertain, it remains to be seen what the market update of these new structures will be.

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The CIV structure is similar to the Undertakings for Collective Investment in Transferable Securities (***UCITS***), which is a popular structure for offering collective investments in the European Union. The new CIVs will be required to meet similar eligibility criteria as managed investment schemes, such as being widely held and engaging in passive primary investment. Ultimately, their close similarity to other common types of investment vehicles available in other jurisdictions will increase certainty and attractiveness for foreign investors, particularly Asian investors.

Fund documentation

Unlike many offshore funds, it is not common for Australian fund documentation to include provisions that expressly contemplate fund financing facilities, including the grant of the required specific security over capital commitments, the ability to make capital calls by the fund to repay debt during and after the investment period, or mechanics to facilitate investors consenting to security being given by the fund. Typically, the fund documentation does contain a general permission for the fund to borrow, give guarantees and the ability to grant security. As the market is gradually maturing, we have seen Australian fund documentation develop, albeit the process remains gradual, to import the technology utilised in offshore fund documents to cater specifically for capital call financing.

As mentioned above, a common fund structure in the Australian market is that of stapled fund entities. One focus for lenders is whether the trust deed or partnership agreement allows for cross-collateralisation of investor commitments in the stapled funds.

Fund document terms vary depending on the asset classes and investment strategy of the particular fund. Accordingly, it is essential to ensure that the credit and security terms are consistent with the fund document terms and that the lender is able to properly enforce its securities. While investor side letters are a common feature, financing provisions are seldom integrated in those documents.

Another key consideration when drafting the fund's governing documents is to ensure that investors explicitly allow the fund to pledge all capital commitments. There should also be express wording included whereby each investor acknowledges its obligation to make the capital contributions without any right of set-off, counter-claim or waiver. These provisions are fundamental to protect a lender. If this authorisation is not included in the partnership agreement/trust deed, lenders will generally require that investors deliver consent letters in connection with a fund financing. This is discussed in more detail in the section, 'Investor consent', below.

Types of financings

In the Australian market, fund financing facilities are more commonly provided on a bilateral or club basis rather than syndicated. Funds utilise fund financing facilities for two primary reasons. For those funds that have longer-term investments, such as infrastructure, property or private equity, the facility is used to provide certainty of funding during the asset acquisition phase. Funds that have shorter-term investments or that are more likely to have prepayments, such as mezzanine debt, prefer to use the facility to provide an internal rate of return boost for the fund. In terms of product diversification, capital call facilities and NAV facilities are the predominant product types used in Australia, with pockets of activity in relation to hybrid facilities, umbrella facilities and unsecured facilities.

Australian fund financing facilities are typically traditional capital call facilities, generally structured as senior secured revolving loan facilities. It is common for fund governing documents to limit the use of borrowings to relatively short-term borrowings (90 to 364

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days). Terms of facilities are generally structured in alignment with a fund's investment period, and are usually for less than three or four years. While term and revolving loans are the norm, lenders are also open to provide letters of credit and bank guarantee facilities to meet the financing and investment needs of the fund. These facilities are mostly committed, although some lenders may make uncommitted facilities available on an exceptions basis. The obvious driver for uncommitted facilities is that it means that commitment fees need not be payable. However, this needs to be balanced with the risk the fund bears for funding uncertainty.

Domestic lenders have also provided NAV-based financing to funds, which are secured against the underlying cash flow and distributions that flow up from the underlying portfolio investments or the equity interests of holding companies through which the fund may hold such investments. These types of facilities are attractive to funds, particularly private equity or special situations funds, where there is an urgent requirement for liquidity at the fund level but no distributions from the portfolio imminent. They require the lender to "look down" for recourse against the underlying investments rather than "looking up" to the investor commitments. The creditworthiness of the investors of the fund is less important than the value of the underlying assets. The returns for lenders are generally higher than the returns for traditional capital call facilities or asset-backed facilities. However, lenders providing these facilities may be structurally subordinated to other lenders that have provided finance that is secured directly against the underlying portfolio companies. These types of facilities may increase in popularity as the 'dry powder' of private equity and venture capital funds in Australia decreases and as funds approach the end of their investment periods.

Hybrid facilities, where the facility is secured by both the uncalled capital commitments of the fund as well as the underlying portfolio assets of that fund, are used by funds that have started to mature in terms of their investment lifecycle. However, as mentioned this kind of facility is less prevalent in Australia than the other abovementioned facilities and is often provided by incumbent financiers who have previously provided capital call facilities to that fund.

Security arrangements

The defining characteristic of the capital call facility is the security package, which comprises the fund granting security over:

- the rights to call the unfunded capital commitments of the fund's investors and to enforce the associated rights under the fund documents to call capital; and
- the deposit account into which the investors deposit their capital call proceeds.

Security is not typically taken over the underlying assets of the fund. The specific security is usually supported with an express power of attorney granted by the general partner of the fund in favour of the lender. This allows the lender to exercise capital call rights in a default scenario.

Where the fund is Australian or is otherwise subject to the *Corporations Act 2001* (Cth), the specific security may be accompanied by an all-assets security interest that operates as a 'featherweight' security to minimise moratorium risk on an administration of the fund. The security structure depends on the nature of fund and the credit requirements of the respective lender. For example, in a recent loan facility for a large Australian infrastructure fund utilising features of a capital call financing, this was supported by an irrevocable power of attorney under which lenders have power to exercise capital call rights of the fund upon a default rather than a security interest over those rights, and accompanied by security over

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the collateral account into which call proceeds are deposited. This transaction is considered very bespoke, but is nonetheless a low-water mark in terms of the tolerance of lenders for minimum collateral requirements.

Security is typically granted by the fund and the trustee or general partner (as applicable), as they will hold the deposit account, the rights to call capital and related rights. Where the borrower is a portfolio special purpose vehicle of the fund, a guarantee from the head fund may also be required. In Australia it is common for the general partner or trustee to delegate the power to call capital and other functions to a manager. If there is a delegation of the power to call capital to a manager, or a custodian arrangement is put in place, security is usually sought from the manager and custodian, as applicable.

The lender will need control over the deposit account to enable it to secure capital call proceeds upon a default. The deposit account may be required to be opened with the lender on day one of the facility, but this is not always mandated. Where the deposit account is held by another Authorised Deposit-taking Institution (***ADI***)[12] who is not the lender, an appropriate account control arrangement between the lender, the ADI and the account holder will be required, such as an account bank deed. Where the lender holds a security interest over an account maintained by another ADI, the security interest in that ADI account is perfected by registration of a financing statement on the Personal Property Securities Register (***PPSR***). However, without an account control arrangement, any security interests which the ADI takes in respect of the account will have priority over the lender's security interest (even if perfected by registration on the PPSR), because the ADI is said to have perfected its interest by control over the account for the purposes of the *Personal Property Securities Act 2009* (Cth). Where the bank accounts are held outside of Australia, it is necessary to seek advice from foreign counsel regarding the fund documentation and security arrangement.

<u>Investor consent</u>

An investor consent letter serves three main purposes:

- The fund gives notice to the investor of the loan facility, the security over the trustee/general partner's rights to make a capital call against that investor and, upon a default, the ability of the lender to make such a call to the exclusion of the trustee/general partner.
- The fund directs the investor to pay any capital calls at the direction of the lender upon a default under the financing.
- The investor acknowledges such arrangements in favour of the lender, giving the lender privity of contract and, accordingly, the ability to have direct recourse to that investor.

The letter can also be the instrument under which the investor agrees to waive certain of their set-off rights and sovereign immunity rights. In some situations, funds may be sensitive about approaching investors to obtain such a letter because of the administrative burden. The investors may themselves be reluctant to provide such acknowledgment. In these situations, the lender needs to evaluate the reputation and creditworthiness of the underlying investor to see whether the uncalled capital commitments remain commercially 'bankable' despite the lack of a direct acknowledgment.

More sophisticated funds (particularly those established in the Cayman Islands and British Virgin Islands) have investor acknowledgments built into the fund documents, which avoids the need for separate investor consent letters. Australian fund documents generally do not contain such an acknowledgment. In Australia, as a minimum, notice of the assignment and security interest granted in favour of the lender should be given to the investors to satisfy the common law rule in *Dearle v Hall*,[13] which provides that where there are competing

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equitable interests, the person to first give notice to the debtor gets priority. The notice should contain a short statement confirming the name of the security document, its date, the parties to the document and that the security comprises an assignment of the call rights and the related proceeds. The notice should explain to whom the obligations are owed, especially once there is an event of default under the loan facility. Depending on the governing law of the security document, the security perfection requirement of that jurisdiction should also be adhered to.

In Australia, investor consent letters are still obtained but have become less common, with a number of fund borrowers having successfully resisted these requirements, particularly where the relevant provisions are included in the fund documentation in a form acceptable to the lenders. In our experience, for funds where investor consent letters are not able to be obtained, notices of the assignment and security interest may be given at the time of the grant of security or by way of notice in the next regular newsletter to the investors. The form of this notice is agreed in advance with the lenders and the actual issue of such notice is monitored. However, as is always the case, each transaction is determined on its merits and rarely does one deal replicate the next.

Key developments

Sovereign wealth funds and sovereign immunity

In the past five years, there has been a significant increase in sovereign wealth fund investors in funds as well as the size of their investment. In 2017, the total assets of sovereign wealth funds globally is in excess of $6.59trn.[14] Given their prevalence and size of their investment, lenders have needed to become more familiar and commercially comfortable with their quality of credit.

Sovereign immunity, which may protect a sovereign wealth fund or other foreign or domestic government body from enforcement action or shield them from liability in its entirety, has become a focus area for lenders. Whether an entity has the benefit of immunity is a matter of the local law, where the sovereign wealth fund or government body is established, and a function of the ambit of the local law as to what matters the immunity applies. It is worth noting that commercial transactions of a sovereign entity tend to be an exception to the immunity coverage.

In Australia, the *Foreign States Immunities Act 1985* (Cth) provides that a foreign state is not immune with respect to a commercial transaction.[15] A commercial transaction is a commercial, trading, business, professional, industrial or like transaction into which the foreign state has entered, or a like activity in which the state has engaged. It is a broad concept and includes an agreement for a loan or some other transaction for, or in respect of, the provision of finance and a guarantee or indemnity in respect of a financial obligation. Therefore, entry into a fund finance facility will be considered a commercial transaction rather than a governmental action, so immunity will not apply.

In a default scenario, where a sovereign wealth fund has assets in Australia, if a lender has obtained a judgment overseas with respect to that entity, the judgment may be recognised under the *Foreign Judgments Act 1991* (Cth). However, this Act only applies to the superior courts in select countries, such as the United Kingdom, Cayman Islands and Switzerland, with a notable exception being the United States.[16] For excluded countries, the common law provides that the lender may enforce a judgment obtained in a competent court of a foreign country by bringing an action for a liquidated sum, relying on the foreign judgment as imposing an obligation to pay.

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In our experience, where an investor has the benefit of sovereign immunity, there is generally no express waiver of such immunity. Rather, the lender typically requires an express acknowledgment from the investor of such immunity. Where there is an investor consent letter provided in favour of a lender, a similar acknowledgment of sovereign immunity is typically required in the consent letter, with a further acknowledgment from the investor that, notwithstanding the immunity, the investor's obligations under the fund documents, including to make payment to the fund, apply. Lenders with longstanding relationships with the relevant investors may be willing to allocate borrowing base credit for their commitments based on prior dealings with them, but this is carefully analysed on a case-by-case basis and advance rates are generally discounted.

SPV investor structural issues and confidential investors

Some investors may choose to invest in a fund via a special purpose vehicle (***SPV***) rather than investing directly into that fund. Where an investor implements a SPV structure, one issue that the lenders face is to determine where the ultimate credit of the investor lies.

While lenders can obtain a level of comfort by performing due diligence on the SPV and the financial robustness of that SPV to assess whether that entity is sufficiently capitalised to meet capital calls, lenders will look for recourse to the ultimate investor. Under Australian law, lenders will encounter the legal obstacle of the requirement for privity of contract. In order to get direct recourse to the ultimate investor of that SPV, a contractual nexus between the ultimate investor and the lender will need to be established. In practice, lenders will often receive an acknowledgment from the ultimate investor in favour of the lender with regards to its liability in respect of the obligations of the SPV entity. It is usually a matter of commercial negotiation as to the level of assurance the ultimate investor is required to provide. In terms of the spectrum of comfort that an ultimate investor usually provides, it ranges from a direct acknowledgment that it guarantees the performance of the SPV's obligations to letters of comfort from the ultimate investor that the SPV is its subsidiary and that it will use best efforts to ensure that the SPV has sufficient resources to meet its limited partnership agreement of fund document obligations.

Moreover, we have observed an emergence of confidentiality provisions in investor side letters that may restrict a fund from disclosing certain investor details, including the identity of that investor or the ultimate, to a lender. This has raised issues for lenders' ability in assessing the creditworthiness of that investor, and the bankability of the fund generally.

Superannuation funds

Superannuation funds are key candidates for development in the Australian fund finance field. At the end of the September 2017 quarter, the assets under management of Australian superannuation assets in aggregate were approximately A$2.53trn, growing by 8.7% in total superannuation assets.[17] The last 12 to 18 months have seen larger superannuation funds growing in sophistication, evolving from being passive investors by investing through fund managers to becoming actively involved in direct investment in assets via co-investment structures or in their own capacity. For example, First State Super made its first direct investment in 2017. In addition, like the pressures of other private capital funds, the driver to maintain alpha by superannuation fund managers has also seen superannuation funds becoming increasing active in direct lending more generally, and not just in areas where it is necessary to 'plug the gap' in industries where typical lenders are pulling back.

It is important to note that there is a prohibition in the *Superannuation Industry (Supervision) Act 1993* (Cth) (the ***SIS Act***) that restricts the scope of the types of borrowings

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a superannuation fund may undertake and the granting of security over the fund's assets. Subject to certain exceptions, a trustee of a regulated superannuation fund must not borrow money, or maintain an existing borrowing of money.[18] By employing innovative funding structures that utilise the technology of fund financing methods, there is the potential to allow superannuation funds to facilitate their investments in Australia with fund finance facilities.

Shadow banking regulation – potential disruptor?

A notable development in Australia in 2017 is the Australian Prudential Regulation Authority's (***APRA***) growing interest in the shadow banking sector and potentially expanding its purview to encompass shadow banking participants. APRA's prudential requirements (in particular, in relation to capital adequacy) apply only to Authorised Deposit-taking Institutions (***ADIs***) and this has resulted in those regulated lenders retreating from certain sectors, including residential property development. The shadow banking sector has been active in trying to bridge this funding gap.

While direct lending activities in Australia are statistically much lower than in Europe and the US, in the last 12 to 18 months, there has been marked growth in non-bank lenders participating in this alternative asset class. The shadow banking sector now accounts for 7% (or approximately A$500bn by value) of the financial system.[19] However, it should be highlighted that this is still less than half of the size of the shadow banking sector in 2007.

The growth of the shadow banking sector has not escaped APRA's attention. The Australian Government announced in the 2017–18 Budget that it would act to ensure that APRA is able to respond flexibly to financial and housing market developments that pose a risk to financial stability. Essentially, APRA will be provided with new powers in respect of the provision of credit by shadow banking entities.

An exposure draft of the *Treasury Laws Amendment (Non-ADI Lender Rules) Bill 2017* (***Draft Bill***) has been released, the purpose of which is to give APRA the power to restrict shadow banking if it may add systemic risk to the financial system.[20] To achieve this, the Draft Bill proposes to grant APRA the ability to make rules in relation to lending finance which must be complied with by all, a specified class of, or one or more shadow banking entities. This power does not mean APRA will regulate the shadow banking sector on an ongoing basis but rather is described as a 'reserve power'.[21]

Further, the other main power proposed is for APRA to have the ability to issue directions to direct any shadow bank entity to comply with a rule APRA makes, to refrain from lending money, or to refrain from carrying out activities that result in the funding or organising of a loan or other financing.

Nevertheless, this Draft Bill has not had an uncritical reception. It has been described as 'too broad' to achieve the Draft Bill's purpose, as well as blurring the fundamental ambit of APRA's power, being one of regulating licensed ADIs, not unlicensed non-ADIs.[22] While the Draft Bill remains in consultation phase, it has the potential to curb what is considered a relatively nascent revival of the direct lending industry.

Year ahead

We are optimistic that the fund financing market will maintain its steady growth in Australia. In addition to new lenders that we anticipate will enter the Australian fund financing market, we also expect market penetration of the uptake of subscription finance facilities by funds and their managers.

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Lending to private equity, venture capital and infrastructure funds will continue to dominate the Australian fund financing market; however, real estate funds, debts funds and superannuation funds are the key potential growth areas. As the domestic 'big 4' banks and other major offshore banks seek to deleverage against risk-weighted assets, the participation of debt funds is primed for growth as they exploit the opportunity in bridging the funding gap of the borrower, as well as the opportunity to deploy capital towards assets that can provide returns for investors. While the potential change in regulatory landscape may temper this growth, it is still early days in terms of being able to assess the impact of the Draft Bill. Until then, we are of the view that the demand for fund financing capabilities to support the ongoing investment mandate of funds will remain strong.

* * *

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Bermuda

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Overview

Bermuda is a major centre in the international offshore investment fund industry with over US$200bn of fund assets domiciled here. In addition to over 600 investment funds registered in and operating from Bermuda, there are also a significant number of unregulated investment funds, being primarily closed-ended investment companies and limited partnerships that fall outside of the Investment Funds Act 2006. As closed-ended funds are not required to be registered with the Bermuda Monetary Authority (**BMA**), it is not possible to estimate with accuracy the number of such funds domiciled in Bermuda.

The Bermuda fund industry sees investment predominantly from North America and Europe and therefore trends in the Bermuda fund finance market track the major onshore markets. Although there is no overall data reporting service for the fund finance market, anecdotal reports from many of the major facility lenders as well as Appleby practitioners anticipate that there will continue to be a strong period of fundraising through 2017 and into 2018, as well as an increase in demand for bespoke structures, such as funds of one and segregated accounts.

Bermuda as a jurisdiction is highly responsive to evolving market demands and over the past two years key stakeholders, including the government, the financial services regulator (the BMA) and investment industry professionals have collaborated to make legislative changes that serve to cement Bermuda's position as one of the premier offshore jurisdictions for private equity funds. A review of the most significant changes from a private equity fund perspective is set out in the 'Key developments' section below.

Fund formation and finance

(i) Investment funds – overview

The Investment Funds Act 2006, as amended (**IFA**) governs the exclusion, exemption and authorisation of investment funds and contains certain requirements for the formation of investment funds, their operation and the offering of shares or interests of investment funds. An 'investment fund' is broadly defined under the IFA and means any arrangements with respect to property of any description, including money, the purpose or effect of which is to enable persons taking part in the arrangements to participate in or receive profits or income arising from the acquisition, holding, management or disposal of the property or sums paid out of such profits and income.

Investment funds are prohibited from being operated in or from Bermuda unless they are authorised or exempted under the IFA. The requirement to be authorised or exempted does not apply to investment funds that are deemed to be private (such as master funds). An investment fund is a private fund (or an excluded fund) if the number of participants is 20 or

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less, and if the promotion, communication and offer to participate in the investment fund are restricted and not made to the general public. An operator of an excluded fund is required to serve a notice on the BMA of the fact that the private fund qualifies for the exclusion as soon as practicable following the formation of the fund.

(ii) Regulatory approval

The formation of companies, partnerships and limited liability companies (**LLCs**) is subject to the approval of the Registrar of Companies (**Registrar**) and the BMA (the Registrar and BMA being the principal regulatory bodies). The BMA is the principal body responsible for the regulation of investment funds, including those listed on the Bermuda Stock Exchange (**BSX**). The Registrar is responsible for the registration of companies, partnerships and LLCs and has powers pursuant to, *inter alia*, the Companies Act 1981 (**Companies Act**), the Partnership Act 1902, the Limited Partnership Act 1883, the Exempted Partnerships Act 1992, the Segregated Accounts Companies Act 2000 and the Limited Liability Company Act 2016. While the Registrar and the BMA do not regulate the formation of unit trust funds, a unit trust fund is required to apply to the BMA for authorisation or exemption under the IFA, and must also seek the permission of the BMA under the Exchange Regulations to issue units (as further defined and explained below).

(iii) Anti-money laundering (AML) and anti-terrorist financing (ATF)

The Bermuda AML and ATF framework, set out in the Proceeds of Crime (Anti-Money Laundering and Anti-Terrorist Financing, Supervision and Enforcement) Act 2008, requires that AML and ATF regulated financial institutions as well as independent professionals establish policies and procedures to forestall and prevent money laundering and terrorist financing. Such policies and procedures must cover:

(a) customer due diligence measures and ongoing monitoring;
(b) reporting;
(c) record keeping;
(d) internal control;
(e) risk assessment and management; and
(f) the monitoring and management of compliance with and the internal communication of such policies and procedures in order to prevent activities related to money laundering and terrorist financing.

The policies and procedures should be developed using a risk-based approach. The nature and extent of such policies and procedures will depend on a variety of factors, including the nature, scale and complexity of the business; the diversity of its operations, including geographical diversity; and its customer, product and activity profile.

(iv) Private equity funds

Closed-ended, private equity funds are typically formed as limited partnerships or companies incorporated with limited liability.

A Bermuda-exempted company (e.g., companies exempted from the provisions of Bermuda law that stipulate that at least 60% of the equity must be beneficially owned by Bermudians) incorporated with limited liability can be established with a single shareholder, any amount of authorised share capital, unrestricted objects, and the capacity and powers of a natural person.

In general terms, the Companies Act restricts an exempted company from carrying on business in Bermuda except to the extent that it has been granted a licence by the Minister of Economic Development. There are certain activities that are expressly excluded from the requirements

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of a licence, including doing business with other exempted companies in furtherance of the business of the exempted company that is being conducted outside Bermuda, and dealing in securities of exempted companies or partnerships.

Approval is sought from the BMA for the intended beneficial ownership of those with voting rights in the company. Any information provided to the BMA is treated in the strictest confidence (pursuant to Section 31 of the Bermuda Monetary Authority Act, 1969). Ordinarily, an incorporation can be accomplished within 24 to 48 hours. An exempted company can only commence business or issue shares after it has been organised and the requisite BMA consents have been obtained.

(v) Investment funds

Historically, investment funds have typically been formed as mutual fund companies or limited partnerships, the optimal structure depending on a number of factors including where and to whom the investment opportunity is to be marketed, the nature of the investor base, and the identified portfolio of investment assets.

Mutual fund companies

A mutual fund company is a company incorporated with limited liability, that is incorporated for the purpose of investing the monies of its members for their mutual benefit, having the power to redeem or purchase for cancellation its shares without reducing its authorised share capital, and stating in its memorandum of association that it is a mutual fund. In the case of a mutual fund company, the shares of which are to be sold in overseas markets, an exempted company is the appropriate vehicle. However, shares of a Bermuda mutual fund company, which is an exempted company, may also be offered inside Bermuda to both local and international investors.

Typically, a mutual fund company is incorporated with two share classes: ordinary voting shares (non-participating) held by the investment manager; and non-voting, participating, redeemable shares held by the investors.

The timeline for incorporation of a mutual fund company, after submission of the application to the BMA, is usually 24 to 48 hours. A mutual fund company may only commence business and issue shares after it has been organised and the consents under Bermuda's exchange control regulations (**Exchange Regulations**) and the IFA (if required) have been obtained.

Limited partnerships

Investment funds may also be formed as exempted limited partnerships. A limited partnership consists of one or more general partners (which may be bodies corporate, or general or limited partnerships, formed under the laws of Bermuda or another jurisdiction) and one or more limited partners (namely investors) whose relationship is governed by a partnership agreement. In Bermuda, partnerships (both general and limited partnerships) are not legal entities separate from their partners unless a specific election has been made by the partnership to have legal personality. Nevertheless, a partnership may in any event function as an 'entity', and may sue and be sued and carry on business in its own name. If an election is made by the partnership to have separate legal personality, such election is irrevocable and the partnership will continue regardless of whether all the partners die or are declared bankrupt or if there is a change in its constitution.

General partners are fully liable for partnership debts and obligations. In the case of limited partnerships, the general partners will have such general liability to third parties, while generally speaking, the liability of the limited partners is limited to the value of the money and any property that they contribute (or agree to contribute) to the limited partnership. It

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should be noted that the limited partners may forfeit their limited liability status in certain circumstances if they participate in the management of the partnership.

Limited Liability Companies

LLCs are an exciting new development in the Bermuda market and are discussed in more detail in the 'Key developments' section below. It is anticipated that the Bermuda LLC will prove to be an attractive alternative in the investment fund arena.

Security package in fund financings

A key consideration in any fund financing transaction (whether it be a capital call facility, subscription facility or equity bridge facility) is the collateral package which the lender can secure. Typically security will be granted over the rights to call for contributions from investors, with the security interest in uncalled capital commitments perfected by the delivery of a notice of the assignment of such capital commitments to the investors. Additionally, the lender will want security over the account into which investors' capital contributions are funded.

There is no Bermuda law requirement that the collateral account be a local one (although of course, the local banks are very familiar with such requirements should it be preferable to secure a local account).

Bermuda law does not stipulate that the security package must be governed by Bermuda law, and most frequently we see the security agreements mirroring the governing law of the applicable credit facility. Bermuda as a jurisdiction is very familiar with New York law as the preferred governing law for US facilities, and English law for European facilities. Of primary concern therefore, from an offshore perspective, is to review the validity and priority of the offshore-based security.

Bermuda recognises the concept of a security agent and there are no restrictions under Bermuda law on the enforcement of rights or security interests solely because those rights or security interests are held by an agent. An agent is treated in the same way as any other secured party and is subject to any applicable Bermuda law. It should also be noted that there are no Bermuda law restrictions on granting security to foreign lenders and that it is not necessary under Bermuda law for a security agent to be registered, licensed or otherwise qualified in Bermuda in order to enforce any of its rights.

There are no restrictions under Bermuda law on a company or partnership making payments to a foreign lender under a security document, guarantee or loan agreement, and exempted companies and partnerships are designated by the BMA as "non-resident" for exchange control purposes, which means that they are free to deal in any currency of their choosing, other than "resident" Bermuda dollars.

The Stamp Duties (International Businesses Relief) Act 1990 abolished stamp duty on most documents executed by exempted undertakings (including exempted companies and partnerships, and this also applies to limited liability companies).

Following execution of the security document, lenders will want to ensure that their security package is appropriately registered. Charges over the assets of Bermuda companies in Bermuda (except charges over real property in Bermuda or ships or aircraft registered in Bermuda) which are granted by or to companies incorporated outside Bermuda, are capable of being registered in Bermuda in the office of the Registrar of Companies, pursuant to the provisions of Part V of the Companies Act. Registration under the Companies Act is not compulsory and does not affect the validity or enforceability of a charge, and there is no time limit within which registration of a charge must be effected. However, in the event that questions of priority fall to be determined by reference to Bermuda law, any charge registered

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pursuant to the Companies Act will take priority over any other charge which is registered subsequently in regard to the same assets, and over all other charges created over such assets after 1 July 1983, which are not registered.

Partnerships which have elected to have separate legal personality can also register with the Registrar of Companies and therefore ensure priority in a similar way to the regime for companies, as discussed further below.

Key developments

Amendments to partnership legislation

During 2015 and the first half of 2016, Bermuda implemented a series of innovative changes to the existing partnership legislation. These changes were driven by industry demand and following consultation with key stakeholders, led to a renewed focus from the regulators and the legislature on the partnership products offered in Bermuda.

The amendments introduce a register of charges to be maintained by the Registrar of Companies, which register can be used by and in relation to partnerships which have elected to have separate legal personality. The creation of a register of charges, and therefore statutory priority, provides increased certainty and operational efficiency, as this is the same regime that has been in place for companies for some time. Any person (including the partnership itself) who is interested in a charge created on the assets of such a partnership can apply to have that charge registered. Any charge registered on or after the effective date of the new legislation will have priority based on the date that the charge is registered (and not on the date of its creation) and will have such priority over any unregistered charges.

Charges created prior to the effective date of the new legislation will continue to have the priority they had previously, although these charges can also be registered and will continue to have the priority they had prior to such registration.

Much like with the registered security regime for companies, the Registrar of Companies has the statutory ability to both amend the register of charges and to correct the register of charges in prescribed circumstances. Traditionally, the ability to take security in Bermuda over partnership assets has been unnecessarily different from companies, and this amendment is certainly a welcome change to practitioners and clients that deal frequently with secured financings.

Introduction of Limited Liability Companies

Key among the recent legislative changes is the introduction of the Limited Liability Company Act (**LLC Act**), which came into force on 1 October 2016. A limited liability company or "LLC" is a hybrid legal structure allowing the contractual and operational flexibility of a partnership to be housed within a corporate entity. Like a Bermuda-exempted company, an LLC has separate legal personality and the liability of its members is limited. Whilst members of a Bermuda company receive shares, members of a Bermuda LLC will each have an interest in a capital account in a similar way to partners in a partnership. Under the Bermuda LLC Act, parties can create bespoke vehicles, having the contractual freedom to set out in the LLC agreement the terms of operation and management of the LLC as well as expressly agreeing the allocation of profits and timing of distributions amongst its members. A Bermuda LLC may be managed by one or more members (a "managing member"), or a manager may be appointed who may or may not be entitled to share in the profits of the LLC.

Whilst the LLC vehicle may be utilised by clients in a broad range of sectors, the Bermuda LLC is an attractive structuring option for operators of investment funds and, in particular,

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closed ended private equity funds, as the flexible corporate governance structure allows "managing members" to manage the fund (in a similar way to a general partner) but without unlimited liability for such members in respect of the fund's losses. At the moment it is not yet clear what the lender collateral package will look like in respect of LLC funds, although arguably use of LLCs as opposed to partnerships may serve to simplify the security package, as security would only have to be granted by the LLC itself and not its manager.

Register of Directors

In keeping with the global trend towards increased transparency, it is now a requirement under the Companies Act 1981 that a Register of Directors of every Bermuda company be lodged with the Registrar of Companies, where it will be publicly available for inspection. The Register of Directors must contain the following information with respect to each director of a Bermuda company: (i) if an individual, her present first name, surname and address; or (ii) if a company, its name and the address of its registered office. Whilst there is a requirement to disclose the identity of the directors, there is no requirement for such directors to be registered or licensed with a governing body or to satisfy any additional disclosure or regulatory requirements.

Anti-money laundering and anti-terrorist financing

Amendments to Bermuda's anti-money laundering and anti-terrorist financing regulations also came into effect on 1 January 2016. These changes, which ensure Bermuda achieves compliance with the 40 recommendations of the Financial Action Task Force, serve to further strengthen the regulatory oversight in Bermuda, ensuring that the jurisdiction continues to have a "gold standard" regulatory framework.

The year ahead

We are seeing an increase in the number of tailored investment structures and single-investor vehicles being utilised in Bermuda. These "fund of one" structures are especially popular with funds of funds (**FoF**), in which the investor, in this case the FoF, is the sole investor in a specific vehicle or fund. These structures allow the FoF to create a bespoke investment rather than investing in a target fund as an ordinary limited partner. As 'fund of one' structures continue to grow in popularity, we anticipate that the subscription credit market will also look to expand its offering to facilitate lending to these types of structures. Another innovative legal structure which Bermuda offers and where there is increasing interest, is the segregated accounts company. Under the provisions of the Segregated Accounts Companies Act 2000, a mutual fund company may be registered as a segregated accounts company, enabling it to create different share classes, each representing a segregated portfolio of assets. Accordingly, where a multi-class structure is desired with a separation of liability between classes, it is not necessary to incorporate multiple companies in an umbrella form. Instead, a single segregated accounts company may be incorporated with segregated accounts representing each share class. Such accounts enjoy a statutory division of liability, effectively ring-fencing each segregated account from the general liabilities of the company, and from other segregated accounts. Bermuda segregated accounts can invest in other segregated accounts in the same company creating a master/feeder structure, making it possible to invest and redeem without the capital leaving the company and creating a capital transfer.

Bermuda will continue its commitment to developing new and innovative products and we will continue to see a 'collaborative effort' by regulators, government and industry professionals to ensure Bermuda continues to provide innovative fund products and maintains its position as a leader in the offshore funds world.

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Brazil

Fernando J. Prado Ferreira & José Paulo Pimentel Duarte
Pinheiro Neto Advogados

Our history

Pinheiro Neto Advogados is a Brazilian, independent, full-service firm specialising in multi-disciplinary deals and in translating the Brazilian legal environment for the benefit of local and foreign clients.

Founded in 1942, Pinheiro Neto Advogados was one of the first Brazilian law firms to serve foreign clients as well as the first Brazilian law firm to specialise in corporate clients. With clients in almost 60 countries, the firm was recognised in 2014 by the Brazilian government as the number one exporter of legal services from Brazil.

The firm has grown organically, and developed a distinctive, tight-knit culture, with a low associate-to-partner ratio. Its unique, democratic governance structure promotes transparency and consensus-building among the partners.

With a focus on innovation, the firm has kept its competitive edge throughout the years, and is widely hailed as an institution of the Brazilian legal market.

In order to maintain its status as a valued strategic partner to its clients, the firm invests heavily in professional development, not only through strong on-the-job training, but also by means of the highly structured Pinheiro Neto Professional Development Program, the first of its kind in Brazil. In addition, our lawyers can take advantage of the largest and most complete private legal library in Brazil.

The firm advises and represents both local and international clients in a broad range of sectors, including automotive, banking and financial services, construction and materials, energy and natural resources, environment and waste management, health care, oil and gas, real estate and technology.

Overview

The Brazilian fund industry is unquestionably an important element of investment strategies in the country. In October 2017, the total assets under management reached BRL 4 trillion (approximately US$ 1.2 trillion),[1] which represents almost two thirds of the national GDP. In addition, the total amount of BRL 232 billion (approximately US$ 70 billion) in net sales[2] registered until November represented the highest recorded amount of net sales since 2002.

In view of the country's rapidly falling inflation rates deriving from the deep recession of the Brazilian economy experienced in the past three years, the Central Bank of Brazil (CBB) has consistently reduced the official interest rates, currently at 7% *per annum* – the lowest level since 1986. This has led to a significant increase in investors' risk appetite, who, seeking higher returns than the traditional fixed-income funds, have intensified their

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investments in multimarket investment funds (i.e., those that are not limited to any specific risk factor).

Therefore, out of the BRL 232 billion net sales registered in 2017 so far, BRL 91.7 billion were directed to multimarket funds, whilst BRL 67.7 billion were directed to fixed-income funds.

In terms of performance, fixed-income funds have accrued 11.34% and multimarket funds, 12.59%. Equity investment funds have posted even more expressive results, with a yearly yield in excess of 21%.

With regard to investor segments, retail investors represented 63% of the net sales of fixed-income funds in the year and 11% of multimarket funds. Multimarket funds are traditionally more sought-after by the private sector, which still represented 53% of such funds' net sales in the year. However, the higher participation of retail investors is evidence of the increased risk appetite of investors.

It is also worth mentioning that the Brazilian investment fund market consists of a well-established regulatory framework enacted and enforced by the Brazilian Securities Commission (*Comissão de Valores Mobiliários* – CVM), which has been subject to a great level of modernisation in recent years, with the enactment of new rules promoting higher transparency and efficiency to market participants. In addition, the industry has benefited from a high level of product governance, provided for in self-regulation rules established by the Brazilian Financial and Capital Markets Association ("ANBIMA"). Such combined structure has been paving the way for a steady growth of the industry, irrespective of the country's adverse political and economic scenario, enabling the total assets under management in Brazil to grow from BRL 740 million in 2005 to BRL 4 trillion in 2017.

Fund formation and finance

As part of the modernisation process of the regulatory framework applicable to investment funds and securities portfolio, the CVM has enacted, for example:

- Instruction No. 539, of November 13, 2013, which provides for suitability rules;
- Instruction No. 554, of December 17, 2014 ("CVM Instruction 554"), which provides the definitions for qualified and professional investors;
- Instruction No. 555, of December 17, 2014 ("CVM Instruction 555"), which provides the general rules applicable to the creation, operation, management and marketing of investment funds; and
- Instruction No. 558, of March 26, 2015 ("CVM Instruction 558"), which provides the rules applicable to the accreditation, ongoing obligations and rules of conduct for securities portfolio managers, as further detailed below.

More recently, on November 17, 2017, the CVM enacted Instruction No. 592 ("CVM Instruction 592"), which, similar to CVM Instruction 558, provides the rules applicable to the accreditation, ongoing obligations and rules of conduct for non-discretionary investment advisors.

<u>Portfolio management</u>

The local professional management and administration of securities portfolios can only be carried out in Brazil by a natural person or a legal entity duly authorised by the CVM. It is important to highlight that, for such purposes, the natural person must reside in Brazil and the legal entity must be organised and headquartered in Brazil.

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CVM Instruction 558, effective as of January 4, 2016, introduced important amendments to the securities portfolios management activities in light of the industry development.

A first significant innovation is the regulatory recognition of a practical distinction already developed by the industry; that is, the two categories of portfolio managers with different areas of expertise: (i) fiduciary administrators, with direct or indirect responsibility for the custody and control of assets and liabilities and, generally, for the supervision of the markets; and (ii) asset managers, with responsibility for the decision-making process on investments.

As a result, portfolio managers, depending on the activities they perform, shall request their registration under the fiduciary administrator category, under the asset manager category, or under both.

Further, CVM Instruction 558 introduced the need to assign certain responsibilities to statutory officers (e.g. compliance and risk management) in addition to the asset management responsibilities. It also improves the rules of conduct, information duties and segregation rules, with the purpose of promoting a higher level of governance and structure by portfolio managers.

As part of the CVM's efforts to promote a higher level of transparency for investors, CVM Instruction 558 also requires portfolio managers to prepare a reference form similar to a prospectus applicable to listed companies. This reference form must be annually filed with the CVM and posted on the portfolio manager's website, where it shall be kept up-to-date. Portfolio managers must also publish their internal policies and manuals on their website.

Furthermore, the new rule brought the possibility for portfolio managers to distribute quotas of managed funds, an activity generally the province of duly licensed entities pertaining to the Brazilian securities dealership system (e.g. financial institutions).

This provision seeks to eliminate a significant obstacle for new or small portfolio managers to access the market, being now authorised, even if not accredited as securities distributors, to distribute quotas of managed funds (i.e., they are not authorised to distribute quotas of third-party funds). Nevertheless, portfolio managers who intend to distribute quotas of managed funds must follow specific CVM rules applicable to securities distributors.

Investment funds

As mentioned above, the creation, management and operation of most investment funds in Brazil are currently regulated by CVM Instruction 555, effective as of October 1, 2015.

Nevertheless, it is worth mentioning that certain types of funds are subject to specific CVM regulations, including, for example: receivables investment funds (FIDCs); real estate investment funds (FIIs); and private equity funds (FIPs).

Under Brazilian law, investment funds are characterised as a pool of funds incorporated under the form of a condominium (i.e. they are not legal entities) intended for investments in assets traded in the financial and capital markets, pursuant to the terms and conditions set forth in their bylaws.

A condominium is a type of unincorporated entity in which two or more persons hold joint title to certain assets, being attributed a notional part (quota).

Even though they do not have a legal personality apart from that of their quotaholders, orders for the purchase and sale of securities are carried out in the fund's name.

Investment funds can be divided into closed-ended and open-ended funds. Generally, open-ended funds are characterised by the possibility of quotaholders to redeem their quotas at any time, and a prohibition, as a general rule, on quotas being assigned or transferred.

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Closed-ended investment funds, on the other hand, do not allow the redemption of quotas at any time, except in case of liquidation of the fund; and their quotas may be transferred, by means of a term of assignment and transference, or through a stock exchange or over-the-counter (OTC) market.

Pursuant to CVM Instruction 555, investment funds are incorporated and legally represented by fiduciary administrators, who are, *inter alia*, responsible for registering the fund with the CVM, controlling the fund's assets, and their compliance with the regulations and the fund's bylaws, as well as communicating with investors and the CVM. The investment decisions of the fund are subject to the discretionary management of asset managers, pursuant to the investment policy outlined in the fund's bylaws.

The fiduciary administrator may also hire other service providers on behalf of the funds, more commonly represented by custodians and distributors.

The CVM has also simplified the existing types of funds, which are now represented by just four classes (with possible subclasses) as opposed to the seven classes provided for in the previous regulation. The new classes of funds are: (i) fixed income, focusing on the variation of interest rate and/or price indices; (ii) equity, focusing on the price variation of equity securities traded in the organised market; (iii) foreign exchange, focusing on the price variation of foreign currencies and/or exchange coupons; and (iv) multimarket, with multiple investment strategies in different markets.

Among the changes introduced by CVM Instruction 555 to the Brazilian investment fund industry, the following are also worth mentioning: (i) the possibility of all communication with quotaholders being carried out electronically; (ii) higher threshold and flexibility for offshore investments by investment funds pursuant to the target investor; (iii) new rules regarding performance and rebate fees; and (iv) a new set of mandatory fund documents seeking higher transparency and celerity.

CVM Instruction 555 establishes that investment funds are, as a general rule, prohibited from taking and/or providing loans. Investment funds may, however, use their assets to provide collateral on proprietary transactions, as well as borrow and lend financial assets – provided that the loan transactions are carried out exclusively by means of authorised services by the CBB or the CVM.

Investor classification

CVM instruction 554, which came into effect on October 1, 2015, jointly with CVM Instruction 555, better defined the investor type classification. The rule now differentiates three types of investor categories: (i) retail; (ii) qualified; and (iii) professional.

Apart from specific entities that are directly classified either as professional or qualified investors, the rule generally defines that professional investors are individuals or entities with total financial investments in excess of BRL 10 million, and that qualified investors are individuals or entities with minimum financial investments in excess of BRL 1 million.

Retail investors are, therefore, those that do not fall under the previous categories (by exclusion).

International investments

It is possible to say that the aforementioned regulations also have the purpose of facilitating Brazilian investors to access foreign investments.

From a general perspective, CVM Instruction 555 raised the limits for investment funds to invest offshore when compared to the previous regulation.

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In that respect, it is worth mentioning that retail investment funds may now invest up to 20% of their total assets under management in foreign products. In addition, with the new investor classification, there are clearer and simpler rules for investment funds aimed at professional or qualified investors to invest all of their assets under management abroad.

Another innovation is that there is no longer a minimum investment required in order to acquire quotas of such foreign investment funds, but rather that investors be professional or qualified investors as the case may be.

Similarly, the CVM and the CBB have also enacted rules with the purpose of facilitating foreign investments in the Brazilian capital and financial markets. An example is the possibility of depositary receipts to have debt securities (also known as global depository notes – GDNs) as underlying securities. Previously, only equity securities (shares or other securities that represent equity rights issued by publicly held companies in Brazil) were authorised to be traded abroad via depositary receipts.

This means that Brazilian publicly held companies and financial institutions may issue depositary receipts in foreign markets that represent, among others, bonds, notes, certificates of real estate receivables, all of them issued in Brazil.

Foreign investments in the Brazilian capital and financial markets must be duly registered with the CBB and the CVM, as well as meet other additional requirements provided for in the applicable regulations. As a general rule, such investments must be made in organised capital markets (e.g., stock exchanges and OTC markets).

In addition to investing in the Brazilian capital and financial markets, foreign investments can also be made directly in the form of equity of Brazilian companies. Such investments shall also be registered with the CBB, under the Electronic Registration System – Foreign Direct Investment.

Foreign exchange

Brazil still has very strict controls on foreign exchange transactions (i.e., on the inflow and outflow of funds to and from the country). Pursuant to the Brazilian foreign exchange regulations, all exchange transactions must be carried out through an authorised exchange entity in Brazil.

In addition, a relevant foreign exchange contract containing, *inter alia*, the parties, date, nature of the transaction and exchange rate, must be signed. All foreign exchange transactions must also be registered at the CBB electronic data system (SISBACEN).

Offering of foreign securities in Brazil

Under Brazilian law, the offering of foreign securities is subject to regulation that affects the possibility of offering such products on a public basis in Brazil.

The public offering of securities in Brazil is primarily regulated by the Brazilian Securities Market Law and CVM Instruction No. 400, of December 29, 2003, as amended, which, as a general rule, establishes that public offerings must be previously registered with and authorised by the CVM.

Apart from specific rules regarding the registration of Brazilian depositary receipts, foreign securities are generally not eligible for registration in Brazil. Therefore, in order for foreign entities to offer their products in Brazil, they shall adopt certain procedures to avoid their public disclosure in Brazil.

It is also important to stress that there is no definition under Brazilian law of what constitutes a private placement of securities. Consequently, the concept of private placement is based

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on what would not constitute a public offering under Brazilian law and, therefore, would not require registration with the CVM.

Individuals or legal entities resident in Brazil are permitted to invest abroad, provided that information relating to such assets owned abroad is fully disclosed to the CBB and the Brazilian tax authorities. The obligation to disclose to the Brazilian authorities the existence of assets owned abroad lies exclusively with the owners of such assets.

Nevertheless, specific entities of the Brazilian financial system, such as pension plans, insurance and reinsurance companies, governmental entities, banking companies and investment funds, have certain limitations when it comes to investing abroad (e.g., rules regarding portfolio diversification and asset concentration limits per investor and type of asset).

Key developments

As detailed above, the regulations dealing with the fund industry in Brazil have been subject to significant change in recent years. It is important to note that such changes largely result from the evolution of market practice and demands made by market participants, with proposed rules being set for public hearing by the CVM and open to comments from the public.

The new regulations have been designed to bring more efficiency, transparency and competitiveness to the fund industry. They also mark a maturity of the local market, requiring improved structures, governance, transparency and professionalism from market participants.

Such rules also demonstrate that the regulator has been mindful of the industry's dynamic, facilitating investment opportunities demanded by the market, with more flexibility and simplicity. An example is the creation of the simple funds, which is a subclass of fixed-income funds, targeted to retail investors for basically allocating investments in federal public bonds as an alternative to savings accounts.

Further, as mentioned above, investment in foreign markets has become more accessible to Brazilian investors, and an increase of investment funds aimed at investing offshore has been noted.

In addition, Brazilian regulatory authorities have been demonstrating a stricter stance on compliance. Since the strengthening of the anti-money laundering regulations in 2012 with the enactment of Law 12,683, of July 9, 2012, important anti-corruption rules have also been enacted (Law 12,846, of August 1, 2013, and Decree No. 8,420, of March 18, 2015).

The year ahead

The Brazilian industry has demonstrated its resilience in the face of adverse external factors, and well-established structure and improving regulations paving way for its continuous growth.

It is also worth mentioning that the new regulatory framework is still recent, with market participants, and the CVM itself, still in the process of better understanding and testing the new regulations.

In that respect, it is important to stress that by increasing monitoring and disclosure duties of portfolio managers, CVM Instruction 558 tends to, directly or indirectly, generate additional costs to all market participants, irrespective of their size. The CVM's intention was to generally promote better-structured portfolio managers, as well as facilitate analysis and comparison between portfolio managers by investors.

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Externally, with the decreasing trend of interest rates, projected for 2017 at 2.88% *per annum*, the CBB lowered interest rates to 7% *per annum*. This, as observed, incentivised the investor appetite for riskier and diversified products, including in the investment fund industry.

CVM Instruction 555 offers new and efficient investment opportunities for local and foreign investors, especially with regard to the accessibility of foreign markets by Brazilian investment funds. This should generate greater interest for the development of new feeder funds designed for allocating local clients' investments abroad.

The growing trend of accessing global products may also benefit the ever-increasing pension fund segment. Nevertheless, it still faces regulatory barriers that limit pension funds to investing only up to 10% of their total assets under management abroad, and only through local investment funds. In addition, each pension fund may not hold more than 25% of the total assets under management of an investment fund.

The evolution of the sales of global products in Brazil also depends on another external factor – currency stability – given that local investors are still averse to assuming a currency risk that may exceed the return on investments made abroad.

In conclusion, the investment fund industry has presented rapid growth in the last decade, with a recent period of stagnation. Nevertheless, the latest numbers show that the growth rate has increased once more, and should intensify if macroeconomic adjustments are made to boost the Brazilian economy.

* * *

Endnotes

1. Based on information provided by the ANBIMA Investment Funds Report released on December 7, 2017.
2. Meaning the difference between the amounts related to new investments versus redemptions.

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Canada

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General industry overview

The general consensus in Canada is that fund formation activity has decreased slightly over the previous year.[1] Whether that is attributable to a general build-up of "dry powder" in existing funds, uncertainties in key global jurisdictions or other factors is less certain. One thing is certain – it is not attributable to a general decrease in fund activity, as fund-backed acquisitions and investments continued to close at a dizzying pace in 2017.

Though not as mature as the corresponding markets in the United States and the UK, the subscription credit facility (commonly referred to in Canada as a "**capital call financing**") has evolved significantly from its relationship-based, demand-bridge loan roots. Generally speaking, and notwithstanding the relatively small size of the market for this product (particularly after you remove a modest number of large facilities for a handful of the largest Canadian private equity funds), capital call financing structures have successfully evolved to meet a number of requirements and/or demands of the Canadian private equity market. For the funds that seek out financings of this nature, capital call facilities have proven to be an efficient tool to provide for, among other things, a more predictable capital call schedule, payment of normal-course operating expenses, more flexible timing of fund investments, long-term leverage not previously available at the fund level, smoother capital call processes, and enhanced internal rates of return.

Subscription financing in Canada

Acquisition finance transactions aside (these are generally provided at a subsidiary company level at the time of an acquisition), capital call financings continue to be the most common form of credit made available to private equity funds in Canada. In their purest form, capital call financings are not secured by the general assets of the fund (or those of its operating or project level subsidiaries) but rather, as the name suggests, by the unfunded capital commitments of the investors in the fund. As is the case in other, larger markets (where capital call financings are more common due to the depth and breadth of the private equity markets), lenders on these capital call financings generally focus on, and follow a comprehensive due diligence regimen in order to confirm, the underlying credit strength of the investors and their legal obligation to fund capital commitments pursuant to the applicable fund documents.

Like other jurisdictions, the core collateral package on a typical capital call financing in Canada includes: (i) a pledge of the unfunded capital commitments of the investors in the fund; (ii) an assignment of the fund's right to make a call on such capital commitments and the right to enforce payment of the capital commitments once called (including a covenant

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to ensure all payments are made into certain bank accounts); and (iii) a pledge of such bank accounts into which the capital commitment proceeds are to be deposited. Unlike certain other jurisdictions, however, and notwithstanding that the market in Canada has evolved significantly, material differences in approach still exist from lender to lender with respect to certain of the remaining characteristics of the structure.

What makes Canada different?

In Canada it is not uncommon (particularly for mid-market or small funds) for lenders to provide capital call financing facilities based on varying security packages, varying covenant packages and varying reliance on capital call diligence. Though we are cautious not to generalise (we acknowledge that a number of factors contribute to the structure and security package on any financing), we believe this reflects, at least partially, the fact that a certain segment of the capital call financing market in Canada is still heavily relationship-based. We have set out below some of the key differences or attributes of a capital call financing in Canada.

Account control agreements – Unlike the United States, the common law jurisdictions in Canada do not require an account control agreement (or any other form of control) to perfect a security interest over bank accounts. Perfection of a security interest over a bank account happens by way of registration pursuant to the applicable provincial Personal Property Security Act. Consequently, on a purely domestic transaction (Canadian lender(s) and a Canadian borrower with bank accounts in Canada only), lenders do not generally require account control agreements. Account control agreements can provide other benefits and foreign lenders (accustomed to taking them in their home jurisdiction) often require them, but many of those benefits can be addressed in the other loan documents.

Limited partner acknowledgments – The requirement for limited partner acknowledgments varies greatly from transaction to transaction in Canada. We see transactions structures with: (i) no such requirement; (ii) limited requirements where only certain investors are required to provide acknowledgments; (iii) a requirement for every investor to provide an acknowledgment of a limited nature; and (iv) a requirement for every investor to provide a comprehensive acknowledgment. Our general sense is that where proper diligence is being done and the fund documents are well prepared, this requirement is falling away. Moreover, where certain large institutional investors have a significant influence on the fund documents, limitations are being imposed on the managers to prevent them from approaching investors for such acknowledgments (and certain diligence materials like financial statements) in connection with third party financings. This can lead to significant issues where the fund documents do not otherwise contain capital call-friendly provisions regarding, among other things, authorisation to enter into such facilities, setoff, waiver of certain defences, and the assignment of the capital call commitments.

Included and excluded investors – A limited number of capital call financings in Canada do not contain "included investor" and "excluded investor" concepts. Instead, the borrowing base will include all investors, and does so on an equal basis. Given the typical reliance on the strength of the investor capital call commitments, it might seem particularly strange to treat all investors equally, but this particular approach is generally paired with other attributes (a lower margin rate, small deal size, 90-120 day, demand-bridge loan, a general security agreement ("GSA"), etc.) which mitigate overall risk. The more common approach in Canada aligns with what you might expect to see in other jurisdictions: a strong focus on the investors of the fund, including detailed investor eligibility criteria in the credit

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facility; and a list of ongoing exclusion events that operate to remove an investor from the borrowing base during the life of the facility. Certain credit facilities in Canada also include multiple margining rates.

Diligence – As can be expected in a jurisdiction where a meaningful portion of the capital call financings are relationship-based, we still see a broad range of approaches to diligence in Canada. Our general advice on any capital call financing is to follow a comprehensive and regimented review of the fund documents, including, among other things, the offering materials, limited partnership agreements, subscriptions agreements and side letters. In certain circumstances, lenders still obtain comfort based on a limited review of certain key issues: authorisation re. borrowing and assignment of the capital call commitments; limited partner acknowledgments; investment periods; defaulting investors provisions; capital call periods; and use of capital calls to repay loans. Other lenders take a more comprehensive approach and request the same of their counsel. To be clear, there's nothing particularly special about the structure of a Canadian capital call financing (versus a capital call financing in the United States or the UK, for example) that allows for or encourages a more limited approach to diligence. Furthermore, given the make-up of the fund market in Canada (like many jurisdictions, it includes a broad range of funds in terms of size, fund formation experience and capital call financing experience), a comprehensive and regimented approach is warranted in almost all cases – even where cost sensitivities, relationship, timing, additional GSA security or other factors might suggest otherwise. Notwithstanding that many funds in Canada are extremely sophisticated and are both proactive (in their fund formation documentation) and protective (with respect to what they accept in subscription agreements and side letters), we still experience situations where the diligence leads to: (i) amendments to the fund formation documents; and/or (ii) a request for acknowledgments from fund investors where acknowledgments were not originally contemplated. This is never the intended purpose of the diligence process, and we are very mindful of the investor/fund relationship, but we raise these examples to highlight the importance of the diligence process on these transactions.

General Security Agreements – The GSA operates to grant a security interest in all of the personal property of a fund. In certain circumstances, lenders in Canada still require a GSA in connection with a capital call financing. This, of course, reflects a divergence from the premise that the lender is focused solely on the investors and the legal obligation of such investors to provide capital contributions once called upon pursuant to the fund documents. For some funds (particularly those accustomed to capital call financing structures in the United States), this is of material concern. In certain instances, after accounting for the fund's future acquisition financings with third party lenders, the overall benefit of the GSA is limited and can result in the need for future intercreditor agreements and/or waiver letters with such third party lenders. Furthermore, certain of the risks addressed by the GSA can be addressed in the credit agreement and the other loan documents through the use of more stringent operating and reporting related covenants. After taking into account where the general global market has been heading for a number of years, we expect GSAs to be used less frequently in connection with capital call financings in Canada.

Mature market structures – Though the market in Canada continues to evolve, we acknowledge that Canada still trails more established markets such as the United States and the UK. As previously mentioned, the depth and breadth of the private equity markets in those jurisdictions are far greater than Canada's. Consequently, the capital call finance markets in those jurisdictions have evolved at a quicker pace. That said, and notwithstanding that single borrower, demand-bridge loan structures are still prevalent in Canada, we also see

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certain lenders becoming comfortable with (or at least considering) more sophisticated fund structures involving committed facilities, multiple funds (feeders, AIVs and parallel funds, etc.), a more singular focus on the investors and the capital call rights in the fund documents and, in limited circumstances, cascading security and/or mixed asset/hybrid borrowing bases.

Multiple fund structures – Certain multiple fund structures have become more common in Canada. Most lenders are now comfortable lending into funds with borrowing bases that involve multiple levels of funds (including, for example, feeder funds in the Cayman Islands for international investors) on closing, and/or allow for multiple levels of funds to be used going forward. The key to these arrangements is a strong understanding of the fund documents in connection with, among other things: the mechanics of how each fund operates on its own and with the other funds in the structure; what each fund can or cannot be jointly liable to pay; and how the capital call rights may be impacted by the use of additional funds.

Cascading security – Though not as common in Canada as they may be in other jurisdictions, cascading security packages are a viable option in Canada and have been implemented by certain lenders (for example, where certain feeder funds cannot be directly liable to the lender for tax or other reasons). As described in greater detail in other chapters of this text, this structure relies on multiple levels of pledges and security to ultimately put the lender in a position similar to the position it would have otherwise been in if each of the funds guaranteed and provided security packages directly to the lender. As is the case in other jurisdictions, lenders in Canada generally try to avoid cascading security packages and prefer to rely on direct guarantee and assignment structures.

Hybrid borrowing bases – Again, these are not as common in Canada as they might be in more mature capital call finance markets. These facilities combine standard capital call borrowing bases (based on investor capital commitments) with asset-based borrowing bases for other asset classes (for example, real estate assets held in the fund's subsidiaries) under one credit agreement. These structures generally involve coordination among multiple groups within a particular lender organisation and we have seen fairly limited use and/or consideration of hybrid borrowing bases in the Canadian market. That said, where the desire for such a structure exists, there are no issues (from a purely legal perspective) to structuring these facilities in a manner that properly protects the lender's interests.

Enforcement

Typical steps to enforcement in a Subscription Credit Facility – Though there may be slight variations in enforcement depending on whether the lender has obtained a GSA, proceedings will be identical so far as the capital call enforcement is concerned. Therefore, in this section our intention is to focus on that latter aspect of enforcement.

(a) Notice

Enforcement in Canada will generally require the lender to give the debtor notice of the default under the loan agreement and a reasonable amount of time to cure the default, before any enforcement action can be taken. This notice period is usually 10 days although, in some cases, the courts have extended the length of time for which notice is required. In cases of urgency (e.g. fraud), an application to the court can be made to waive or abridge the 10-day period. Once this default notice period expires, the lender would then be in a position to enforce its security interest. Where the lender has the typical capital call security package, the lender would not have to send notice to all creditors of the fund, only the investors.

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(b) Enforcement

Where the lender has the typical capital call security package, enforcement will involve taking possession of the fund's deposit account(s), and advising the fund and its investors that the lender is enforcing its security interest and exercising its capital call rights pursuant to the pledge (and any power of attorney granted thereunder) of the investors' unfunded capital commitments. The notice to investors would direct them to deposit their unfunded capital contributions into the debtor's deposit account, of which the lender would have taken possession.

Ability to appoint a receiver – Where appropriate, a lender in Canada may choose to apply to a court to appoint a receiver for the purpose of enforcing the lender's security interest in the specific collateral. This results in additional professional costs but provides court protection for the lender's enforcement. It may also ensure that the investors in the fund are obliged to comply with any capital call requirements that the court-appointed officer may assert pursuant to the fund formation documents. This may be beneficial where limited partner acknowledgments have not been obtained, or the fund-formation documents do not make it express that the capital call rights can be assigned as part of any permitted financing. In such a scenario the receiver would be exercising the rights of the fund to call on the capital commitments of the investors.

Insolvency – The foregoing analysis is not impacted should the fund become subject to insolvency proceedings, either voluntarily or involuntarily. The rights and remedies available to the lender in any type of insolvency proceeding are not altered regardless of the type of security package.

Insolvency proceedings in Canada can be either voluntary or involuntary. If the fund owes CAD$5 million or more, then the fund can initiate proceedings for protection under the *Companies' Creditors Arrangement Act*, R.S.C. 1985, c. C-36 ("CCAA"), or it can opt to reorganise under the *Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B-3 ("BIA"). The BIA has no minimum debt requirement. In either case, the commencement of proceedings results in an initial 30-day stay of enforcement proceedings against both secured and unsecured creditors. A stay of proceedings could prevent exercise of the assignment rights, and the lender may have to apply to the court to seek permission to enforce. It is uncertain how a court in Canada would address the competing interests. There is one notable BIA exception: if the lender has delivered a notice of intention to enforce its security more than 10 days before the BIA proceeding commenced, then the stay will not apply to that lender under that statute (but would still apply under the CCAA).

The future of capital call financing in Canada

The Canadian market with respect to capital call financings continues to evolve, moving steadily from early-stage, relationship-based facilities to more mature facilities comparable to those prevalent in other global markets. However, the evolution to more sophisticated and more standardised lending practices is hampered to some degree by the paucity of large fund players in the Canadian private equity market compared to those of the United States or the UK. The result is a bifurcation within the Canadian capital call finance market between the more pure capital call financings provided by certain lenders to the larger or more experienced private equity funds at one end of the spectrum, and the more traditional, smaller, relationship-based, demand-bridge facilities being provided at the other end of the spectrum.

That said, we continue to witness positive momentum and an increasing awareness of the potential of this market. Almost all lenders now have dedicated sponsor coverage teams,

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and certain institutions have now established dedicated teams to review, promote and sell (or participate in) capital call financings within the Canadian market. Additionally, we continue to see Canadian lenders participate in significant syndicated capital call financings out of London and New York – and that, in our view, generally bodes well for the market here in Canada.

* * *

Endnote

1. At this time, we do not have access to year-end industry statistics.

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Cayman Islands

Simon Raftopoulos, Benjamin Woolf & Anna-Lise Wisdom
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Overview

The Subscription Credit and Fund Finance markets have continued to grow steadily into the fourth quarter of 2017. Strong credit performance is still the norm in this market, and although the authors are aware of a couple of technical defaults, it remains the case that there have been no publicly reported events of default. Indeed, the use of subscription lines has expanded and this use has "become one of the most talked-about issues in the private funds universe in the last year".

The Cayman Islands continues to be a pre-eminent offshore jurisdiction for the establishment of private equity funds, particularly for North American fund managers, and the exempted limited partnership (**ELP**) continues to be the private equity fund vehicle of choice. According to figures published by the Cayman Islands Registry of Exempted Limited Partnerships, at the end of 2016, there were 19,937 active ELPs in the jurisdiction, reflecting a 29% growth rate for this type of vehicle. 3,277 ELPs were registered in the Cayman Islands in 2016, and 2,442 ELPs have been registered in the Cayman Islands through August 2017.

No doubt buoyed by the familiarity of US counsel and fund managers with Delaware LLCs, the use of the Cayman limited liability company (**Cayman LLC**) as a business vehicle has also increased since its introduction in July 2016. According to figures published by the Cayman Islands Companies Registry, 417 Cayman LLCs were registered in 2017 through August. This represents a significant increase in the use of this vehicle over the period starting with its introduction through December 2016, which saw 205 Cayman LLCs registered. The relative success of the Cayman LLC can, at least in part, be attributed to the decision by legislators, in collaboration with the private sector, to introduce a vehicle that is similar to the Delaware LLC. Familiarity with this type of vehicle facilitates usage and offers the benefit of operational consistencies across the onshore and offshore segments of fund structures. One year after its introduction, we note that Cayman LLCs are being most commonly used as joint venture vehicles, carried interest vehicles, downstream blockers, and investment management vehicles. The authors are also aware that a handful of Cayman LLCs have been used as investor-facing fund vehicles, including by Asian-based fund managers.

Successful public and private sector discussion and collaboration are some of the factors contributing to Cayman's market leading position in this space. Others include: (i) historical familiarity with the jurisdiction by investors and fund sponsors; (ii) the increasing convergence of hedge fund and private equity sectors, as more fund managers offer and operate both products from the same platform; and (iii) Cayman law's English common law roots, supplemented, as necessary, by local legislation, which ensures that Cayman Islands funds are recognised as internationally accepted vehicles.

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Globally, Preqin's Q3 2017 Updates report that while the total capital raised by private equity funds has been lower in Q3 than in Q2, Q3 2017 saw $38bn more capital raised compared to Q3 2016, even though 51 fewer funds held a final close. This supports the view that the more established general partners continue to account for the largest proportion of aggregate capital raised by funds closed. In addition, the number of private equity funds in the market continued to grow in Q3 2017, with 2,022 funds having come to market by the beginning of Q4 2017, targeting $706bn in institutional capital. The continued growth in this area correlates with growth in the fund finance space, where Appleby's Cayman office has seen steady growth over last year in the subscription credit facility market. Indeed, Appleby's Cayman office continues to be a market leader in this area, representing 19 of the 20 largest global banks on a variety of different financing structures.

Fund formation and finance

Lending to Cayman Islands funds

Cayman Islands private equity funds have historically been registered as ELPs under the Exempted Limited Partnership Law, as amended (**ELP Law**). The Cayman LLC, registered under the Limited Liability Companies Law, as amended (**LLC Law**), is a relatively new hybrid form of business vehicle, merging certain characteristics of a Cayman Islands exempted company and an ELP.

Though registered pursuant to the ELP Law, an ELP is not a separate legal entity. Rather, an ELP reflects a contractual agreement between the partners, where the general partner is vested with certain duties and powers with respect to the business and its assets. Any rights and obligations of the general partner and the limited partners are therefore contractual in nature and will be governed by the provisions of the limited partnership agreement and any subscription agreements (and/or side letters) signed by the limited partners. The ELP's rights and property of every description, including all *choses in action* and any right to make capital calls and to receive the proceeds thereof, are held by the general partner in trust as an asset of the ELP. A Cayman LLC, on the other hand, is a body corporate with separate legal personality and limited liability. It can therefore hold such property and assets and incur obligations and liabilities in its own name.

The legal treatment of an ELP and the corresponding role of the general partner has a number of implications for lenders (**Lenders**) offering subscription credit facilities to Cayman Islands vehicles when structuring the related security package. Limited partners of an ELP will usually commit in the partnership agreement and/or subscription agreement to fund investments or to repay fund expenses when called upon to do so by the general partner from time to time. This contractual obligation of a limited partner to fund its capital, to the extent that it has not already been called (**Uncalled Capital**), and the corresponding right of the ELP to call for Uncalled Capital (**Capital Call Rights**) are the backbone of the subscription credit facility. Given that these rights, or *choses in action*, are contractual in nature, the appropriate form of security over such rights is an assignment by way of security. As discussed above, legal title to such assets ultimately vests in the general partner of the ELP, and being contractual in nature, such rights are exercisable by the general partner for the benefit of the ELP.

Consequently, the proper parties to any grant of security are the general partner as well as the ELP (acting through the general partner), as the ultimate beneficiary of such assets. Where the obligor in a subscription-secured credit facility is a Cayman LLC, however, legal title to Uncalled Capital and to Capital Call Rights should vest in the Cayman LLC

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itself, with the manager having such power and authority as set out in the LLC agreement to make calls for Uncalled Capital and to receive capital contributions from the members in accordance with the terms of their subscription agreements. Accordingly, where a Cayman LLC is the obligor, the security package could be simplified in that only one entity – the manager on behalf of the Cayman LLC – need be a party to the relevant security agreements. The LLC Law allows considerable flexibility in the structuring, governance and administration of the Cayman LLC, as it defers in many instances to the LLC agreement. Members of a Cayman LLC will therefore have relative freedom to introduce features typically associated with ELPs such as capital accounts, capital commitments and capital calls, provided that the provisions of the LLC agreement do not contravene the LLC Law or any other laws of the Cayman Islands. Each member of the Cayman LLC will also typically enter into a subscription agreement setting out the terms on which it agrees to be a member and to fund its capital commitment to the Cayman LLC.

In all instances, the optimal security package would incorporate an express irrevocable power of attorney in favour of the Lender to exercise effectively the general partner's or the Cayman LLC's Capital Call Rights following the occurrence of an event of default.

In addition, the security package will typically include the grant of a security interest over a designated bank account under the control of the Lender. Although the security over Capital Call Rights can be granted under a Cayman law document, it is increasingly common for such security to be granted under a New York or English law-governed security agreement. Assuming that the grant of security is permitted under the Cayman law-governed limited partnership agreement or the LLC Agreement, Cayman courts would recognise the grant of security even if such security were granted under a foreign law-governed security agreement. However, in such a situation, the Lender will need to ensure that the local law opinion covers not only the assignability of the Capital Call Rights, as a matter of Cayman law, but also the recognition of the security assignment, the choice of foreign law to govern same, and the steps taken to establish priority as a matter of Cayman law.

The terms of the limited partnership agreement or the LLC Agreement play an integral role in the structuring of the collateral package and must be reviewed in detail in order to ensure a number of key elements are present, including but not limited to: (i) the ability of the ELP or the Cayman LLC to incur indebtedness and enter into the transaction; (ii) the ability to grant security over (x) the Uncalled Capital, (y) the right to make and enforce capital calls, and (z) the related contributions; (iii) the ability to apply the capital contributions towards the secured obligations; and (iv) acknowledgment by the limited partners or the members of the Cayman LLC of the security assignment and their obligation to fund their capital commitments.

Perfection of security

With the exception of land located in the Cayman Islands, vessels flagged in the Cayman Islands, Cayman Islands-registered aircraft and interests of limited partners in an ELP, generally no perfection steps are required in Cayman and, further, there is no general register of security interests in the Cayman Islands accessible to the public.

Perfection over the Capital Call Rights is achieved through the delivery of written notice of the grant of security (**Notice**) to the ELP's limited partners or the members of the Cayman LLC. According to conflicts of laws principles, the priority of two competing security interests in a *chose in action* is determined by the law governing that *chose in action*. Where a security interest is granted over Capital Call Rights set forth in a Cayman law-governed

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limited partnership agreement or LLC Agreement, priority of the security interest as against any competing security interest will therefore be determined in accordance with Cayman Islands law. As a matter of Cayman Islands law, where successive assignments of a *chose in action* are concerned, priority as between creditors is determined based on the English court decision in *Dearle v Hall* (1828) 3 Russ 1, according to the order in which written notice is given to a third-party obligor (i.e. the limited partners or the members of a Cayman LLC). Priority is not established in accordance with the time of creation of the relevant security interests. A delay in the delivery of the Notice will therefore open up the Lender to the possibility that the Cayman LLC, or a general partner on behalf of the ELP, may (quite unintentionally) grant a competing security interest or an absolute assignment over Capital Call Rights to a subsequent assignee. Provided that Notice of the second assignment is given to the limited partners or to the members of the Cayman LLC ahead of Notice of the first assignment, the subsequent assignee will rank for repayment ahead of the first assignee.

Equity holders in Cayman Islands vehicles are increasingly aware of subscription facilities and familiarity with the product means that there is now much less resistance by such vehicles to giving Notice to their equity holders. This has led to Notices typically being circulated to the equity holders immediately upon execution of the security documents, in order to ensure priority is achieved at closing of the subscription credit facility.

Given the importance of actual delivery of the Notice to equity holders, evidence of the Notice having been received also assumes some importance. It is increasingly common for partnership agreements or LLC Agreements to include provisions that specify the circumstances in which Notices delivered in accordance with their terms are "deemed" to have been received by the equity holders. Where a partnership agreement or an LLC Agreement contains such provisions, a Lender can take some comfort in proof of delivery of the Notices in accordance with the provisions of such partnership agreement or LLC Agreement, rather than proof of receipt by way of a signed acknowledgment by the equity holders. In all cases, the recommendation would be that the general partner or an authorised person on behalf of the Cayman LLC sign and deliver the Notices to the equity holders in accordance with the provisions of the limited partnership agreement or the LLC Agreement governing service of Notices on the equity holders, with a copy delivered to the Lender.

Apart from establishing priority, delivery of a Notice to equity holders of an assignment of Capital Call Rights has other distinct advantages, two of which are discussed below:

- It prevents equity holders from obtaining good discharge for their obligations to fund their Uncalled Capital in any manner other than as specifically indicated in the Notice. Once notice of the assignment has been delivered to each equity holder, indicating that equity holders are to make all payments with respect to Uncalled Capital into a designated Lender controlled account, the equity holders will not be in a position to discharge their obligations to make such payments in any other manner.
- It prevents set-offs from arising after the date of service of such Notice. This rationale is based on the common law principle that set-off works between the same parties in the same right. If there is notice to one party of the assignment of a right to a third party (i.e. a Lender), set-off will no longer operate in the same manner. However, the service of notice on equity holders does not have the same effect with respect to claims which might have arisen prior to the date of service of the Notice. Most limited partnership agreements, LLC Agreements and/or the accompanying subscription documents will now incorporate express waivers on the part of equity holders confirming that they will not rely on any right of set-off in order to reduce their obligations to fund their Uncalled

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Capital. Usefully, these contractual waivers survive the insolvency of the ELP, as the insolvency provisions of the Cayman Islands Companies Law (which apply to ELPs by virtue of Section 36 of the Cayman Islands ELP Law and to Cayman LLCs by virtue of Section 36 of the LLC Law) expressly provide that the collection in and application of property on the insolvency of a company (or partnership, as the case may be) is without prejudice to and after taking into account, and giving effect to, any contractual rights of set-off or netting of claims between the entity and any persons, and subject to any agreement between the entity and any persons to waive or limit the same.

Although there is no public registry relating to the grant of such security in Cayman, there is a statutory requirement for Cayman Islands exempted companies and Cayman LLCs to enter particulars of all mortgages and charges created over their assets (wherever located) in a register of mortgages and charges maintained at their registered office. Importantly, the statute does not aim to impose perfection requirements, and failure to enter such particulars will not invalidate the security. However, exempted companies and Cayman LLCs are expected to comply with the requirement and failure to do so will expose such companies to a statutory penalty.

While there is no corresponding requirement for a Cayman Islands ELP to maintain a register of mortgages and charges with respect to charges over its assets, where the general partner of an ELP is incorporated as a Cayman Islands exempted company or a Cayman LLC and such general partner has granted security in its own right, the general partner will be subject to the statutory requirement discussed above. In the context of a subscription credit facility secured by an ELP's Capital Call Rights, given that legal title to the ELP's assets will be held by the general partner, details of security granted by the general partner in its own right and on behalf of the ELP should therefore be recorded in the register of mortgages and charges of the general partner. In practice, this puts any person inspecting such register on notice as to the existence of the security.

Key developments

On 1 July 2017, legislation requiring Cayman Islands companies and Cayman LLCs to maintain registers of beneficial ownership at their registered offices (the **New Regime**) came into force. As a result, barring any applicable exemptions, such companies must now take "reasonable steps" to identify individuals qualifying as "beneficial owners" or corporate vehicles qualifying as "relevant legal entities". Beneficial owners are defined as those individuals who hold (i) directly or indirectly, more than 25% of the shares, Cayman LLC interests or voting rights in the company, or (ii) the right to appoint or remove a majority of the board of directors or managers of the company. If no individual meets these conditions, the New Regime looks to those persons who directly or indirectly exercise significant influence or control over the company through direct or indirect ownership or interests. Generally, "relevant legal entities" are intermediate holding companies registered in the Cayman Islands through which beneficial owners hold their registrable interests.

The New Regime extends the Cayman Islands' commitment to help combat tax evasion, terrorist financing, money laundering and other serious and organised crimes, by providing greater transparency on beneficial owners, as was initially agreed with the UK Government and other Crown dependencies and overseas territories in April 2016.

The potential significance of the New Regime for lenders in a fund financing transaction lies in the remedy available to a company in the case of non-compliance by an equity holder with a request for beneficial ownership information. If a company does not receive such

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information within one month of requesting it, it may issue a "restrictions notice" in respect of the relevant interest held by the equity holder. Until such notice is withdrawn by the company or ceased by court order, any transfer or agreement to transfer the interest is void, no rights are exercisable in respect of the interest, no shares may be issued or additional rights granted in respect of the interest or in pursuance of an offer made to the interest holder, and no payment may be made from the company in respect of the interest, whether in respect of capital or otherwise. Further, other than in a liquidation, an agreement to transfer a right to be issued any shares in respect of the relevant interest or a right to receive payment in respect of the interest will be void.

Given that (i) the New Regime currently applies only to companies and Cayman LLCs (and not to ELPs) and only where an exemption from the New Regime is not applicable, (ii) regulated investment funds and funds (including private equity funds) having a manager or administrator who is regulated in Cayman or in a jurisdiction approved by the Cayman Islands' Anti-Money Laundering Steering Group fall outside the scope of the New Regime; and (iii) a restrictions notice may not be served in respect of an interest that is subject to the security interest of an arm's length security holder, the enforceability of an unaffiliated lender's security package in subscription financing transactions should remain relatively unaffected by the New Regime.

The year ahead

As fund managers seeking opportunities to access the wider European Union market establish funds in AIFMD-compliant jurisdictions such as Ireland and Luxembourg, and market parallel funds in jurisdictions where Cayman funds have traditionally been prominent (such as the USA and Asia), we have seen an increasing number of Cayman/Irish and Cayman/Luxembourg parallel structures in the market. We believe that opportunities for Lenders to partner with fund sponsors as they seek to make returns on their investments will continue to grow on a global scale.

The demand for fund finance solutions has increased to unprecedented levels, and is being satisfied by an increasing number of sophisticated lenders willing to offer attractive and diverse financing options which include not only lending against the Capital Call Rights and Uncalled Capital, but also against the net asset value of a fund's investments. Such evolution and innovation are testament to the sophistication of the market players and the strong collaborative relationships between Lenders and fund sponsors alike. The market will continue to evolve and is poised for continued growth in 2018 and beyond.

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England & Wales

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Summary

What makes a fund finance transaction "English"?

There are a number of features of a fund finance transaction that can give it a significant nexus to England and Wales, including:

- the facility agreement being governed by English law;
- a lender or the arranger being incorporated in, operating from, or leading the transaction from England and Wales;
- the fund manager being incorporated in or operating from England and Wales;
- the fund vehicle being domiciled in England and Wales (usually as an English limited partnership); and/or
- one or more investors being domiciled in England and Wales.

In practice, it is the first two of these factors that most clearly define a fund finance transaction as "English", and it is the market of transactions with those two features that this chapter chiefly focuses on. However, these transactions are rarely entirely domestic in nature. The location of the fund manager and investors varies significantly from transaction to transaction, and the fund vehicles used in these transactions are often domiciled in other jurisdictions, as explained in more detail below. Fund financiers operating from other jurisdictions (such as continental Europe) also use English law to govern some of their facilities, and so commentary below on English law contractual matters is also potentially relevant to fund finance transactions that are not in other respects strictly "English".

When and why did the English fund finance market develop?

Outside North America, England & Wales is the most mature fund finance market, having its genesis in the early 2000s. The main drivers for its initial development were:

- a growing need and desire for fund-level liquidity from (principally) private equity fund managers; and
- the close relationship between the small group of financial institutions that first began to provide these types of products and the end-user PE managers (sometimes in an investor capacity), giving them access to the fund-level information that is essential for the assessment of the credit quality of the collateral underpinning the financing.

Whilst many very large transactions were being carried out at this time (generally bilaterally), the size of the market then was comparatively small as a result of:

- a limited number of financial institutions offering this type of product and offering it

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as a relationship-enhancing product in conjunction with more traditional credit lines, such as portfolio company leverage; and
- a limited number of fund managers being considered to be appropriate users of this type of financing – typically top-quartile European and global private markets managers with high-quality diversified investor bases and underlying assets and proven track records.

How has the English fund finance market changed between then and now?

Fast forward to the start of 2018 and the market has grown exponentially both in depth and breadth. Notwithstanding the continuing political and economic uncertainty characterising much of the last couple of years, in 2017 Dentons, London advised on "English" fund finance transactions totalling over £15bn (including a €5bn subscription facility which we believe to be one of the largest ever arranged in Europe) and, whilst there is no publicly available data for the English fund finance market (or indeed, any fund finance market given the private and confidential nature of these types of transactions), we believe the size of the English fund finance market last year exceeded £70bn.

The main drivers of this growth have been:

- an increasing number of financial institutions with capital to deploy looking to these products to deliver an attractive risk-adjusted return and facilitate a wider and deeper relationship with private markets fund managers;
- the attractiveness of the continued "low default" and "zero loss" record of these transactions;
- as the products have become better understood and more widely recognised, a greater willingness and appetite to make these products accessible to mid/small cap managers across all asset classes and in nascent fund finance jurisdictions (such as Germany, Spain and Italy) where English law remains the governing law of the financing;
- an increase in the prevalence of different types of fund finance products outside the traditional pure LP-backed facility, including hybrid, asset-backed facilities, GP/executive support facilities, umbrella, co-invest facilities, facilities used for differing purposes, including end-of-life facilities and re-caps and single account financings; and
- as allocations to the private markets increase with dry powder sitting at over $1trn globally, the desire of fund managers to use fund finance products to facilitate the use of that capital as efficiently as possible.

A top-down analysis

The three most important shapers of the English fund finance market are:

1. ***Investor sentiment.*** With prevailing low interest rates, the private markets continue to play a crucial role in the investment strategies of institutional investors, given the historically high levels of returns generated by alternative assets and several consecutive years of record levels of net distributions. 2017 saw yet another bumper year for fundraising globally with a record $453bn being raised, surpassing the previous record of $414bn raised in 2007. The year was characterised by the "mega-fund", and we saw the largest global buy-out and European buy-out funds ever raised. This drove many larger transactions in 2017 than we saw in 2016. What is clear is that the number of funds closing is reducing year on year, yet the levels of capital and average sizes of funds across Europe and globally is increasing. With funds in the market looking to surpass even those records, and 2,296 funds in the market at the time of writing this article seeking in aggregate $744bn in investor commitments, a slow-down in both fundraising and activity does not appear likely.

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2. ***The asset manager's perspective***. The robust levels of fund-raising, in particular, have surpassed many managers' expectations, with many managers reaching final close more quickly than before, and many exceeding their final close targets. However, this brings with it significant pressure to deploy record levels of capital and deliver high returns in a competitive market where entry prices for assets are high and managers must continuously differentiate themselves.
3. ***Debt focus.*** There are approximately 30 providers of fund finance products in the English market. However, a number of those lenders have tended to occupy different niches within it, so the market overall has not been particularly deep. The factors which have tended to differentiate lenders historically are:
   - **Sector:** e.g., venture, infrastructure, buy-out.
   - **Geography:** reflecting the preferred geographic focus of the lender.
   - **Cross-selling opportunities:** the potential to provide ancillary products and arranger/agency roles.
   - **Facility complexity/pricing returns and revenue levels:** some lenders favour more complex products and the returns that accompany them.
   - **Balance sheet capacity/facility size:** as private markets managers' requirements for the size, duration and type of facilities increases, lenders that previously have been able to meet all of the manager's financing needs now need to bring in other lenders to meet this high level of demand. Conversely, there are a number of newer entrants in the market with large balance sheets that are using this capacity as a market differentiator.
   - **Risk/capital limits:** this has resulted in some lenders focusing on key clients only and/or preferring to offer uncommitted facilities.
   - **LP diversity:** some banks require greater LP/underlying asset diversity than others.

   The number of banks offering these facilities has increased significantly over recent years as the product has become more mainstream and its yields continue to be attractive compared to other debt products. These returns, coupled with some of the ancillary business opportunities that are available, continue to make fund finance in its various guises a compelling product for lenders. Nevertheless, with many lenders still tending to have their own niche, the lender market is a Venn diagram of appetite which can limit the numbers of lenders with the ability to participate in any particular facility.

   Following the general trend in debt capital markets products, and fuelled by increasing levels of competition, we continue to see pricing on some subscription credit facilities begin to tighten. This has reduced the appetite of some lenders to provide this type of product, and is resulting in an increased focus on ancillary business and/or a move towards more structured fund financings. Yet despite the number of new entrants to the market in the past three years, it is interesting that the number of lenders with credit appetite to provide wholly or partially backed asset-backed fund finance products is significantly less than for subscription credit facilities.

Fund finance structures

Developments and trends

Historically, subscription credit facilities have been the most prevalent type of facility in the English fund finance market. However, over the past six years we have seen a significant

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increase in other types of fund finance products – mainly, asset-backed (whether hybrid or pure asset-based), GP/manager/exec financings and umbrella facilities. This has mainly been driven by the increasing levels of competition in the subscription credit facility market driving lenders to seek better returns, and private markets managers looking to be more creative in their usage of these types of facilities as they become more commonplace and better understood. We have seen a number of trends emerge with each of these types of products in the English market, as outlined below.

Subscription credit facilities

Secured or unsecured. Prior to the global financial crisis, many of these facilities in the English market tended to be structured on an unsecured basis with a security power of attorney often being the only piece of security taken on the transaction. The rationale for this was:

- the market at this point comprised only very high-quality experienced private markets managers with whom the lenders had close institutional relationships;
- importantly, the terms of the facilities precluded any other indebtedness within any fund vehicle sitting between the lender and the lender's ultimate source of repayment, i.e., the contractually committed but uncalled capital of the investors and/or the underlying assets of the fund;
- these facilities were niche bespoke products at that time and whilst the fund documentation expressly contemplated the fund having the power to borrow, the security package that is now widely accepted as a staple part of these transactions was often not expressly contemplated; and
- these transactions were only carried out in circumstances where the lender received a legal opinion from either the fund or its own counsel confirming that its claims under the finance documents would at all times rank ahead of the claims of the investors (being the only other potential "creditors" of the fund).

As the market has grown and developed with many lenders and funds no longer having these relationships or features, so the emphasis on security has become greater and significantly fewer transactions nowadays are written on an unsecured basis, even with very high-quality private markets managers.

Umbrella facilities. Designed to be a one-stop financing solution for private markets managers, these facilities can be used across a number of different funds managed by the same manager (or, indeed, executives within a manager) at any time on a several basis. We have seen an uptick in volume of these types of facilities over the past few years as managers have become more creative in their use of fund finance products and lenders look to differentiate themselves by offering more bespoke financing solutions.

Defaults. As far as we are aware, there has been no default under an English law fund finance facility which has resulted in a lender taking enforcement action. However, we have seen an increasing number of defaults on transactions in the past few years, mostly technical, but some where those defaults have been material (albeit very rarely as a result of financial covenant or borrowing base breach). As these facilities become more prevalent and accessible to managers across all asset classes and fund sizes (including many who have not previously utilised these types of facilities and are unfamiliar with the reporting and administration requirements involved in implementing them), we expect to continue to see more minor/technical defaults.

Committed versus uncommitted. Historically, many facilities were structured on an uncommitted basis, enabling lenders to benefit from favourable regulatory capital treatment

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under UK regulation. Private markets managers using these facilities had done so on a regular basis for many years and took comfort from their experience with the lenders providing them over this time that they would not be withdrawn without serious cause. The size of these facilities often ran into the hundreds of millions, if not billions, and the savings made by private markets managers on commitment fees were considerable, particularly given that these facilities tended historically not to be heavily drawn. We still see a number of uncommitted transactions (or transactions with an uncommitted element) in the English market, but as the market has opened up to new entrants, both on the fund and lender sides, managers have become less confident with uncommitted facilities and the savings have reduced as the lines have tended to become more heavily drawn.

Changing investor base. We have seen a significant increase in sovereign wealth funds' allocations to the private markets in Europe over the past year, which has resulted in them beginning to occupy a material portion of the LP base on subscription credit facilities. This has resulted in lenders and their advisers having to undertake analysis in non-traditional jurisdictions around the recourse position of these investors to assess the enforceability of a lender's claims against these entities in a default scenario.

Increase in volume of hybrid facilities. We have seen a number of private markets managers looking to both restructure their existing facilities and structure new facilities in each case on a hybrid basis, allowing a manager to use the line through and beyond the relevant fund's investment periods. Although we have seen a number of managers achieve this, there are far fewer lenders with credit appetite to lend against the underlying assets of a fund in the English market, particularly outside of credit. As a result, many managers are either having to accept a "soft" obligation whereby a lender agrees to consider, but will not commit to, converting the facility into a hybrid facility at a later stage or pay more to structure the facility as a hybrid at its outset.

Single account financing. Over the past few years we have seen the emergence of single account vehicle financings as private markets managers respond to investor demand to invest significant amounts of their capital through segregated accounts. Notwithstanding that amounts invested via these structures are becoming increasingly significant, appetite for this product has not increased at the same rate and, like asset-backed fund finance products, the lender market for this product is comparatively small given the lack of LP diversification.

Leveraged/asset-backed facilities

Increase in volume. As with hybrid facilities, we have seen a significant increase in volume in these types of facilities, principally in the secondaries, fund of funds and private debt asset classes. However, as private markets managers find themselves under significant pressure to continue delivering high levels of returns to investors in a competitive environment, managers of all alternative asset classes are looking to these facilities to create additional liquidity and accelerate liquidity to investors. We are even beginning to see this now to an extent in the primary markets.

GP/Manager support facilities

LTV versus management fee lines. Whilst we have seen some increase in management fee recourse facilities, facilities which are advanced against the interest of the GP or manager in the fund and its assets remain relatively low in number. This reflects the limited number of potential financiers for this type of financing and the fact that it is considered a relationship product, generally reserved for managers with whom the relevant lender has a strong institutional relationship with a proven track record. In most cases,

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the level of financing for this type of facility would be small compared to the amount of work that goes into structuring it. However, as the level of commitment expected from managers by their investors has increased, we have seen an increasing level of demand from managers for this type of product, particularly as fund sizes are becoming larger and the GP commitment required for these funds now represents a very significant amount that needs to be raised and contributed by the GPs.

Fund domicile in English law fund financings

Whilst Guernsey, Jersey and the Cayman Islands continue to be popular when it comes to fund domiciliation in English law fund financings, over the past four years we have seen funds domiciled in Luxembourg (particularly in the credit fund space) and Ireland feature increasingly. It is beyond the scope of this chapter to comment on the particular legal issues that arise when structuring facilities for funds domiciled in these various jurisdictions, however, one or more of these jurisdictions will feature in the vast majority of English fund financings, as they invariably represent the domicile of one or more fund parties involved in the transaction.

Comparatively few English law fund finance transactions involve English-domiciled funds. This is at least in part because, until recently, the law governing English limited partnerships was considered antiquated, with the key statutes, the Limited Partnership Act 1907 and the Partnership Act 1890, having changed little since they were originally introduced.

However, on 6 April 2017, the Legislative Reform (Private Fund Limited Partnership) Order 2017 came into force with the specific purpose of making English limited partnerships more attractive to private equity, venture capital funds and other private funds. In particular, it introduced the concept of "private fund limited partnership". Some of the usual rules, restrictions and administrative burdens that previously applied to all limited partnerships and their limited partners do not now apply to these "PFLPs". Following other jurisdictions, such as Cayman and Guernsey, it also seeks to add certainty for investors by introducing a non-exhaustive white-list of activities that a limited partner can undertake without "taking part in the management of the business" and therefore losing its limited liability status. This is likely to be particularly helpful for single account structures.

It remains to be seen how effective these changes will be in encouraging the use of English limited partnerships by private funds. English limited partnerships still do not provide all the potential advantages of limited partnerships in some other jurisdictions. For example, in England there remains an obligation to register the details of the limited partners publicly. There is no equivalent obligation in a number of offshore jurisdictions, such as Guernsey and Cayman.

With the rise of these non-traditional jurisdictions over these past few years, we have seen an increasing number of different types of vehicles being used as fund-raising vehicles – particularly corporate structures – which can present challenges in putting a subscription or hybrid facility in place. The challenges depend on the structure, jurisdiction and terms of the fund documents but include addressing and providing the lender with control over the additional steps that need to be taken in order to complete the call-down process or, as we have seen recently, structures which prohibit call-downs on investors in certain circumstances.

Whether or not it is possible to work a subscription credit facility around this structure will depend on the circumstances of the particular fund and its documentation. On the whole,

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we have been able to navigate these issues to create a solution which works for the lenders and the fund but in a few instances, notwithstanding both sides' desire to use one of these types of facilities, it has simply not been possible. A reminder that whilst these facilities are increasingly prevalent and available in the market, due diligence around the structure is imperative.

The outlook for 2018 – some crystal ball gazing…

Brexit

At the time of writing, it is nearly 18 months since the UK's referendum vote on 23 June 2016 to leave the EU. The referendum result triggered a significant, immediate and sustained drop in the value of sterling against both the dollar and the euro. But the legal implications of Brexit (and indeed the longer term economic implications) are, if anything, less clear now than they were a year ago. Throughout the last 12 months, the UK government's official strategy has been to seek a new arrangement with the EU in which the UK sits outside the EU's single market and customs union. However, in the meantime a general election has drained the UK government of domestic authority, and negotiations with the EU have made limited obvious progress, making the final outcome impossible to predict.

Although in no way a fund finance-specific issue, the withdrawal of the UK from the single market would be likely to make it more difficult for UK-based lenders to provide loans to borrowers operating within the EU27. Although lending outside the consumer credit sphere is unregulated in the UK, many other EU jurisdictions do require entities lending from or into those jurisdictions to be authorised locally under their own domestic laws, unless they are an EU credit institution regulated under CRDIV. To date, UK banks have been able to rely on this "EU passport" when lending into other EU jurisdictions, and so not concern themselves with obtaining local authorisation. If UK bank lenders lose their passporting rights on Brexit, they will need to take local law advice when seeking to lend into or from EU27 jurisdictions. So the potential withdrawal of this EU passport may complicate loans from UK-based syndicates to European funds. But it does not necessarily create fundamental problems. For example, our colleagues in Luxembourg (arguably now the most common fund domicile in the EU27) are of the view that fund finance loans from UK lenders into Luxembourg funds should not ordinarily create any local Luxembourg licensing issues.

The potential loss of EU passporting rights is also relevant at fund level. The Alternative Investment Fund Managers Directive (AIFMD) sets out the current EU regulation of alternative investment managers (such as private equity firms) that are based in the EU or who market their funds in the EU. Broadly, a UK-based manager of a UK fund authorised to manage and market an AIF in the UK currently benefits from a UK passport to do the same in other EU jurisdictions. This EU passport is likely to disappear on Brexit, and it remains unclear whether a third country passporting mechanism based on equivalence will be available. Otherwise, UK managers will be treated as third country managers and so could only market in other EU jurisdictions under those jurisdictions' domestic private placement rules (if any).

However, the potential impact on the fund finance market should not be overstated. On an increasing number of transactions we work on, both the fund and the manager are domiciled in an EU27 jurisdiction (in particular, Luxembourg and Ireland) – these will be unaffected. On transactions where this is not the case, it is common to see a manager and/

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or fund from outside the existing EU member states. Where that is the case, the manager falls outside the current passporting regime under AIFMD anyway, with the manager marketing in EU jurisdictions, if necessary through local private placement rules. Many such funds do not focus on investors in EU27 jurisdictions.

At a transactional level, we anticipate that Brexit will have relatively limited impact on fund finance documentation. In particular, Brexit will not materially affect the substance of English contract law, and therefore its suitability as a governing law of facility agreements. The following Brexit-related developments in facility documentation are possible:

- *Jurisdiction clauses.* In transactions with funds domiciled in EU-domiciled jurisdictions, it is possible that we may see some change to jurisdiction clauses in facility agreements – for example, increased use of arbitration – on the basis that English courts and English court judgments could fall outside the scope of the current EU-wide rules on jurisdiction and mutual recognition and enforcement of judgments. However, it would be surprising if the UK and the EU27 did not seek to continue to apply equivalent rules: Switzerland, Norway and Iceland have already agreed similar rules on jurisdiction and recognition of judgments with the EU under the 2007 Lugano Convention. Even if that did not happen, there are a number of fall-back options.
- *Bail-in clauses.* Under Article 55 of the EU Bank Resolution and Recovery Directive (BRRD), EEA financial institutions must include a “bail-in clause” in most of their non-EEA law agreements. A bail-in clause recognises that the institution’s obligations under the relevant document are subject to an EEA regulator’s exercise of its write-down and conversion powers under BRRD implementation legislation. If (as expected) the UK leaves the EEA on Brexit and no other solution were found (such as recognition of the UK’s equivalence at state level), financial institutions in other current EEA jurisdictions will therefore have to start including contractual “bail-in” clauses in any English law facility agreements they enter into, or materially amend, after Brexit. Although not necessary under current law, we may start to see some financial institutions adopt this approach pre-Brexit as a precautionary measure.
- *Designated entity clauses.* In light of the potential difficulties for UK institutions lending into EU27 jurisdictions post-Brexit (as described above), it may become more common for facility agreements into EU27-based borrowers to include “designated entity” language, allowing a lender to designate an authorised affiliate to make loans in its place without a transfer of the loan commitment. In April 2017, the Loan Market Association published a recommended form of designated entity clause for use in syndicated facility agreements.

LIBOR discontinuation

On 27 July 2017, Andrew Bailey, the CEO of the Financial Conduct Authority (FCA), announced that the FCA will no longer use its regulatory powers to support LIBOR after 2021. Since then, the FCA has confirmed that all 20 of LIBOR’s panel banks have agreed to support the benchmark until the end of 2021. But without regulatory support after this transitional period, it is probable (though not certain) that LIBOR will ultimately be discontinued.

New fund finance transactions will increasingly have tenors extending beyond 2021. Where interest on those facilities is to be charged at LIBOR plus margin, parties will need to consider how to address the risk of LIBOR disappearing during the facility term. Despite regulators promoting the use of risk-free rates such as SONIA in place of LIBOR (and other IBORs), they are different types of rate and so cannot be substituted on a like-

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for-like basis. As a result, our experience to date is that parties are generally leaving facility terms largely untouched in light of this development, accepting that they may need to agree an amendment to the facility terms at a later point if LIBOR were to be permanently discontinued.

Other IBORs (such as EURIBOR) may also be phased out. The inherent problems with LIBOR – that it is based on panel banks' expert judgment rather than market data because the relevant interbank market is not sufficiently active – applies to most other IBORs too.

Other developments

Despite the shadow of this large Brexit-shaped elephant continuing to be cast over the market, continued growth in capital-raising is expected in 2018 globally and in Europe, and growth will continue to be aided by a benign interest rate environment which is unlikely to disappear soon. Despite recent increases in official interest rates in the UK and US, these are from historically low levels and central banks are likely to remain nervous about rapid rate increases in the future. The volatility arising from the UK Brexit vote (and other global macro/geo-political events giving rise to economic uncertainties) has and will see funds well placed to take advantage of the investment opportunities that are presented, and their desire to grow has been fuelled by investor appetite, with both factors playing to each other. As a result, fund finance will continue to play a pivotal role in the way these funds operate and compete for investment and/or buy opportunities and accordingly, demand for these facilities is also expected to continue to grow.

2018 is likely to see a continued rise in non-traditional fund finance facilities as lenders react to the pricing squeeze being experienced in some parts of the subscription credit market and look to the less crowded asset-backed, hybrid and GP financing markets. We expect demand in these areas to remain strong, fuelled by busy primary and secondaries markets and managers continuing to respond to pressure to deliver returns.

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France

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Overview[1]

Since 2013, France's private equity fundraising has been picking up. French private equity players, members of the *Association Française des Investisseurs pour la Croissance* (the French private equity and venture capital association) ("**AFIC**"), raised €8.1bn in the first half of 2017, and €14.7bn in 2016 (a 51% increase as compared to 2015), confirming the resurgence of activities recorded since 2012 (€5bn in 2012, €8.2bn in 2013, €10.1bn in 2014 and €9.7bn in 2015).

Of this total €14.7bn raised through 127 vehicles, €4bn came from just one Paris-based private equity firm, Ardian, which demonstrated that the French private equity market has gained world-class players.

During the first semester of 2017, funds raised from French investors increased to €5.4bn from €3.2bn in the first semester of 2016, and now represent 67% of total funds raised. The financing of French funds came mainly from the public sector (23%), insurance companies (20%), individuals and family offices (19%) and corporates (9%).

Olivier Millet, the chairman of AFIC, says: "French private equity activity in the first half of 2017 confirms the excellent 2016 figures. Funds raised, the number of companies funded and market liquidity through successful exits continue to trend-up, despite the French presidential and legislative elections during the period, which generally encourage investors to "wait and see". Measures announced by the French government should create a favourable environment for funneling considerably more savings into financing start-ups, SMEs and mid-caps. They should enable companies to open up their capital more extensively to fund their transformation and ultimately create more mid-caps. The growth trajectory in recent years of the French private equity sector has not only brought within reach the objective of a two-fold increase in annual fundraising to €20bn by 2020, but has also positioned it to become Europe's leading market."[2]

Encouraged, among other things, by low interest rates, French investment funds are now turning to equity bridge financings.

Equity bridge financing is an effective and powerful tool to manage capital calls. It allows the management company to call investors on a specified date, for example, once or twice a year. In the meantime, it allows investors to better anticipate capital calls.

Equity bridge financings also enable the management company to simplify the implementation of investments, since the management company is no longer bound by the time period stated in the By-Laws of the Fund and granted to the investors in order to pay their capital calls. It avoids the situation where the fund calls the investors' undrawn commitments while the deal does not go through, or where one or more investors default

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in paying their undrawn commitments. This form of bridge financing gives a fund the certainty that the portion of the purchase price of an investment, to be funded from the investors' capital calls, is available when the purchase price has to be paid. Equity bridge facilities enable management companies to close acquisitions quickly, without relying on the capital commitments of investors.

Finally, it improves the competitiveness of funds by increasing the funds' IRRs. The calculation is simple, since the investors will usually only be called one or twice a year, after the investments have been made. The yield is therefore calculated over a reduced duration.

Contrary to English and US funds, French funds for professional investors (typically structured either by way of a *Fonds Professionnel de Capital Investissement* ("**FPCI**"), a *Fonds d'Investissement Professionel Spécialisé* ("**FIPS**") or a *Société de Libre Partenariat* ("**SLP**")), started using bridge loans only recently.

Bridge loans facilities are specific types of products, but have become increasingly popular in the French fund finance market in the last four years. There is no publicly available data for the French fund finance market (or indeed, any fund finance market given the private and confidential nature of these types of transactions). However, we set out below the deals which have been published in the past years.

We note that in 2014, Natixis set up an equity bridge financing in an amount of €350m for funds managed by Antin Infrastructure. In June 2014, PAI Partners put in place equity bridge facilities of €600m granted by Lloyds Bank for its funds PAI EUROPE VI, refinanced in July 2016 by a second equity bridge financing of €960m granted by Crédit Agricole Corporate and Investment Banking and BNP Paribas Fortis SA/NV. In April 2016, Crédit Agricole Corporate and Investment Banking granted an equity bridge financing in an amount of €300m to Apax France IX. In 2016, Astorg Partners put in place an equity bridge financing made available to Astorg VI, managed by Astorg Assets Management. Investment funds in France are increasingly showing interest in this new form of financing.

In any event, on the basis of the information we have, we believe that the size of the equity bridge finance market for 2017 in France was around €6bn.

Fund formation and finance

Changes in French law

From a legal standpoint, recent years have seen major changes that have opened the way for a booming interest in equity bridge financings to French funds, in particular further to the implementation of the Alternative Investment Fund Managers Directive 2011/61/EU (the "**AIFMD**") in France via Ordinance n°2013-676 of 25 July 2013 and Decree n°2013-687 of 25 July 2013.

Before the implementation of the AIFMD, it was considered that FPCIs were not authorised to grant security interests over undrawn commitments of investors.

Further to Decree n°2013-687 of 25 July 2013, article R. 214-205-III has been inserted in the French Monetary and Financial Code pursuant to which, "[T]he management company may enter with third parties into agreements relating to the management of the fund's investments and including contractual undertakings other than of delivery, as well as into agreements granting to third parties rights over the fund's assets and the undrawn amount of subscriptions, including security *in personam* or *in rem*, within the terms and conditions defined in the fund's By-Laws."

The management company has therefore the possibility to grant security, either by way of

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security *in personam* or security *in rem*, over the assets of the FPCI and over the investors' undrawn commitments. Therefore, pursuant to Decree n°2013-687 of 25 July 2013, lenders can benefit from the right to call capital commitments of the investors if the management company has failed to call the investors, in order to obtain reimbursement of the amounts lent to the FPCI. In any event, investors cannot be called for an amount higher than their uncalled commitments.

We note that article R. 214-206 of the French Monetary and Financial Code limits borrowings of an FPCI up to 10% of its assets. In practice, borrowings are made at the level of a special purpose vehicle set up by the FPCI, with the FPCI granting to the lenders, a guarantee (*cautionnement*) of the obligations of the special purpose vehicle.

The French legislator has also decided to simplify the range of regulated investment vehicles, with the aim of making France's financial markets more attractive, by creating a vehicle capable of grouping together domestic and international institutional investors. As the French asset management industry was faced with growing international competition, the French parliament, as part of Law n°2015-990 of 6 August 2015 for growth, activity and equal economic opportunities (*pour la croissance, l'activité et l'égalité des chances économiques*), created a new category of fund – the *société de libre partenariat* ("**SLP**") – a type of alternative investment fund with legal personality which falls under the definition of alternative investment fund ("**AIF**"), as set out in the AIFMD.

The main goal in the creation of the SLP was to establish a new category of fund, comparable to the English limited partnership or the Luxembourg *société en commandite simple / spéciale* (SCS/SCSp). The SLP benefits from a governance adapted to the requirements of foreign investors, based on two categories of partners: general partners (*associés commandités*) with unlimited liability; and limited partners (*associés commanditaires*), which are liable for the debts of the SLP only up to the amount of their respective capital contributions. Dedicated from the government's point of view to private equity, the use of the SLP may be extended to the financing of infrastructure and real estate assets. One of the most important characteristics of this limited partnership *à la française*, is a very high degree of flexibility. There is no investment restriction and most of the rules governing the investment portfolio may be freely determined in the By-Laws of the SLP. From a tax standpoint, the SLP can benefit from the same tax regime as FPCIs. The shareholders of an SLP are taxable only upon the distribution of its profits. Contrary to an FPCI, there are no legal or regulatory borrowing restrictions for SLPs, provided that no such restriction is provided for in their By-Laws.

Structuring of the financing

In France, an equity bridge facility will usually be structured via a committed term facility (which can be "replenished" upon repayment of each loan), but the facility also sometimes includes an uncommitted line, such uncommitted line reducing the costs of the facility for the lender in terms of regulatory capital. In order to avoid the management company being considered to be using leverage for the purposes of Commission Delegated Regulation n°231/2013 of 19 December 2012, "supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision", loans should be temporary in nature and should relate to and be fully covered by capital commitments from investors, and revolving credit facilities should not be considered as being temporary in nature.[3] It is usually considered in France that loans with a maximum duration of 364 days should be considered as temporary, provided that they relate to and are fully covered by capital

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commitments from investors. Depending upon the activity of the fund, the facility can be utilised only by way of loans or by way of loans and letters of credit.

Finally, depending upon the size of the facility, such facility is either syndicated or bilateral. Transactions are typically structured using a special purpose vehicle, fully owned by the fund, which will make borrowings under the facility in order to carry out its investments. As mentioned above, the lender will typically require a guarantee from the fund to support the obligations of the borrowing vehicle.

French law security package

Usually, the obligors' obligations under the facility agreement will benefit from: (i) a pledge over the bank account of the fund into which the investors pay their capital calls (and possibly, over certain other bank accounts of the fund); (ii) a pledge over certain bank accounts of the special purpose vehicle (if any); and (iii) the right of the lender to draw down investors' uncalled commitments, if (a) there is a default under the facility, and (b) the management company has not sent drawdown notices to such investors, or the management company has sent drawdown notices to such investors but such investors have failed to pay the amounts due and payable under the facility agreement.

We have started seeing transactions recently, where security has been taken in the form of a pledge over the undrawn commitments of the investors. However, under most of the transactions, the lenders have relied on a power of attorney granted by the management company in order to call the investors or a third party drawdown right granted by the investors in the By-Laws of the fund, called *stipulation pour autrui*, both the power of attorney and the *stipulation pour autrui* being exercisable upon the occurrence of the two enforcement events listed in the above paragraph.

Under French law, a power of attorney can always be revoked by the donor, even if stated to be irrevocable, subject to damages being due by the donor to the beneficiary of the power of attorney.

A *stipulation pour autrui*, as used in France in equity bridge financings, is an undertaking made by the investors (at the request of the fund), directly in the By-Laws of the fund, pursuant to which each investor agrees to pay, at the request of the lender, its undrawn commitments into the collection account of the fund, opened with its French depositary, up to the amount owed by each investor to the fund under the By-Laws. Under a typical equity bridge financing, such collection account is pledged to the benefit of the lender. Since at the time the By-Laws are signed, the name of the lenders is unknown, such *stipulation pour autrui* cannot refer to the name of such lenders. However, the lenders can rely on the terms of the *stipulation pour autrui,* notwithstanding the fact that their name is not specifically indicated in the By-Laws of the fund, since such *stipulation pour autrui* is like a third party right which benefits any future lender. At the time the *stipulation pour autrui* has been accepted by the lender, it cannot be revoked by the fund. Such acceptance is typically made by way of a simple one-page acceptance letter executed by the lender on the date of signing of the facility agreement.

A *stipulation pour autrui* is not a security *in rem* as such and does not grant any preference right to the lender, which means that if another creditor of the fund wants to seize the undrawn commitments of the investors, or if the fund has granted a pledge over such undrawn commitments (even if this would be done in breach of the negative pledge provisions of the facility agreement or in breach of the limits to indebtedness inserted in such facility agreement), such seizure would prevail at the time it is carried out, and the pledge would prevail at the time it is notified to the investors or enforced. Lenders on the French market

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have obtained comfort on the absence of pledge due to: (i) the specific nature of the funds, dedicated to investments, which means that, in principle, a fund should not have other financial indebtedness and therefore, should not have other competing debt creditors with respect to such indebtedness; and (ii) the negative pledge clause inserted in the facility agreement. From what we have seen, lenders have also taken a view on the quality of the investors and the potential side business which could be generated as a result of entering into an equity bridge financing with such fund. A lender may avoid this risk by taking security *in rem* in respect of the undrawn commitments. However, as noted, as a matter of French market practice, if lenders benefit from such a *stipulation pour autrui*, we have not seen additional pledges being granted to such lenders over the undrawn commitments of the investors.

A pledge of receivables can be enforced by notification to the investors, asking them to pay the pledgee. A pledge can also be enforced by contractual attribution of the claim which has been pledged, without the need to go to court. Such pledge could, in theory, also be enforced by way of judicial attribution but, due to the existence of the two above enforcement methods, such judicial method, in practice, is never used. There are no judicial expenses related to an enforcement by way of notification or contractual attribution. Depending upon the law applicable to the By-Laws and the location of the investors, other formalities may be required in order for the pledge to be enforceable, as detailed, among other things, in the Regulation (EC) n°593/2008 of the European Parliament and of the Council of 17 June 2008 on the law applicable to contractual obligations (Rome I) and in French case law.

French insolvency issues

Neither an FPCI, an FIPS nor an SLP can be subject to insolvency. For the FPCI and the FIPS, this is due to the fact that they do not have legal personality, since they are co-ownerships of assets. For the SLP, the French Monetary and Financial Code has specifically provided that the French insolvency regime does not apply to SLPs.[4] Since the French insolvency regime does not apply to such French funds, the enforcement regime of the above-mentioned security interests is not affected by the French rules applicable to insolvency (Book VI of the French Commercial Code) and enforcement is very much based on the principle of "first come, first served".

However, under article 1343-5 of the French Civil Code, a borrower may ask a judge for a grace period which the judge may or may not grant, for a maximum period of two years. The criteria where a borrower can apply for a grace period will be decided on a case-by-case basis by the judge. Article 1343-5 of the French Civil Code is very general and the judge will mainly decide on the basis of the situation of the borrower and the needs of the lender. The judge can decide that the rescheduled amount owed by the borrower will bear interest. The judge can also provide that such grace period will be subject to the accomplishment by the borrower of certain acts which may facilitate or secure the payment of the debt. Article 1343-5 of the French Civil Code cannot be excluded from the scope of the security or disapplied since it is a mandatory provision of French law. In practice, however, we are not aware of any instances of a judge having granted such grace period in a fund finance context.

The FPCI/FIPS/SLP insolvency protection regime described above, does not extend to the management company of a French fund. Although insolvency of the management company would have an impact on a power of attorney, the insolvency of the management company would not have an impact on a *stipulation pour autrui*.

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Key developments[5]

Until recently, French investment funds were not able to grant loans directly to French borrowers due to the French banking monopoly, which generally prevents lenders other than licensed credit institutions from lending in France. There are various exemptions to such French banking monopoly, including the possibility for certain French funds to purchase matured claims (the acquisition of non-matured claims falling within the French banking monopoly).

French Law n°2015-1786 of 29 December 2015 (*loi de finances rectificative pour 2015*) and French Law n°2016-1691 of 9 December 2016 (Sapin II law on transparency, the fight against corruption and modernisation of the economy) amended the French Monetary and Financial Code in order to allow certain French alternative investment funds ("**AIFs**") to extend loans.

FPS (*Fonds Professionels Spécialisés*) ("**FPS**") pursuant to Article L214-154 of the French Monetary and Financial Code, and FPCIs pursuant to Article L214-160 of the French Monetary and Financial Code, are now authorised to extend loans, either in accordance with the EU regulation on European long-term investment funds (Regulation (EU) 2015/760 of the European Parliament and of the Council of 29 April 2015 on European long-term investment funds) or under the conditions set out in the Decree n°2016-1587 of 24 November 2016 (the "**Decree**"). We do not develop in this Chapter the conditions in order for an FPS or an FPCI to be authorised to lend as a European Long Term Investments Fund ("**ELTIF**").

Pursuant to the Decree, a FPS or a FPCI can grant loans directly to French borrowers subject, in particular, to the compliance by such FPS or FPCI, with the following conditions:

- the loans should only be granted to entities carrying out an activity which is neither a financial activity nor a collective investment activity;[6]
- the loans should have a maturity which is shorter than the fund's residual life,[7] to prevent any maturity transformation;
- the management company must be licensed by the French Financial Market Authority (*Autorité des Marchés Financiers*) in accordance with the AIFMD and have a programme of operations that allows for the possibility to grant loans.[8] If the French investment fund is managed by a non-French management company, the management company must be authorised by its home state regulator to manage funds which grant loans and must be subject to the same conditions as those applicable to the above-mentioned French management company; and
- the management company must report quarterly to the French Financial Market Authority (*Autorité des Marchés Financiers*) on all the loans which have been granted by the AIFs it manages.[9]

A management company wishing an AIF (including an ELTIF) that it manages, to grant loans, must put in place a rigorous organisation, in particular in terms of credit analysis system, valuation, risk monitoring and control, management experience, use of an external service provider to prepare the credit analysis, legal analysis and assessment of capital requirements, conflicts of interest and debt recovery.

Another milestone has been reached recently with Ordinance no. 2017-1432 dated 4 October 2017 (the "**Ordinance**"), which aims to improve the legal framework applicable to French securitisation and debt organisations. Most of the provisions of the Ordinance will enter into force on 3 January 2018.

The Ordinance establishes a new category of collective investment scheme, namely "finance organisations" (*organisme de financement* or "**OF**"). OF include the existing securitisation

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organisations (*organisme de titrisation* or "**OT**") and the newly created "specialised financing organisations" (*organismes de financement spécialisés* or "**OFS**").

The Ordinance introduces new exemptions to the French banking monopoly rules. Both an OT and an OFS may carry out lending activities, subject, however to certain restrictions. With respect to an OT, the Ordinance confirms the reform introduced by Law n°2016-1691, which permitted the granting of loans to non-financial companies. Similar restrictions apply to an OFS, unless such OFS is an ELTIF (in which case it can provide loans in accordance with the terms of Regulation (EU) 2015/760). The lending limitations applicable to OT and OFS (other than ELTIFs) will be set out in a pending decree.

These changes in legislation can play a big role in creating a Europe-wide direct lending market, and may bring down costs for borrowers. Banks represent about 80% of long-term corporate lending in Europe, compared to 20% in the US, according to figures from ICG, an alternative asset manager. It opens the banking monopoly in France, which is quite restrictive.[10]

The year ahead

With management companies and investors becoming more knowledgeable with equity bridge financings, the equity bridge finance market should become wider. Equity bridge financings are used mainly by upper-mid or large cap funds, whether positioned in the infrastructure or in the private equity sector, but it gradually expands to smaller funds. We note that the French equity bridge financing market is becoming increasingly sophisticated with transactions where collateral is over the assets of the funds, and not only over the undrawn commitments of the investors.

* * *

Endnotes

1. These data are based on a report entitled "*Activité des acteurs français du capital-investissement 1er semestre 2017*" from the AFIC which can be accessed at http://www.afic.asso.fr/fr/Etudes-Statistiques/Les-statistiques-du-capital-investissement/Activite.html.
2. http://www.afic.asso.fr/en/Publications/Press-releases.html.
3. Whereas (14) of Delegated Regulation of the Commission Delegated Regulation n°231/2013 of 19 December 2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council.
4. Article L214-162-1.I. of the French Financial and Monetary Code.
5. We state the law as of 18 December 2017.
6. Article R214-203-4 of the French Monetary and Financial Code.
7. Article R214-203-5 II. of the French Monetary and Financial Code.
8. Article R214-203-3 I. of the French Monetary and Financial Code.
9. Article R214-203-8. of the French Monetary and Financial Code.
10. https://www.ft.com/content/e1cfabf4-f765-11e5-96db-fc683b5e52db.

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Germany

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Overview

The most significant developments in the German funds finance market in recent years are the new regulations reflecting the German Federal Financial Supervisory Authority's ("BaFin") changed view on allowing debt funds as well as insurance companies and certain other investors to invest in leveraged funds. Since the changes to the debt funds regulations, we have seen increasing activity by debt funds in Germany.

There is also a growing interest by German funds in subscription credit facilities as a means of bridging the financing needs between capital calls. As opposed to the United States or the United Kingdom, the German market for subscription credit facilities is at a very early stage. Subscription credit facilities transactions are still rare and German banks do not seem to be engaging in this type of business yet. However, sponsors of German funds increasingly include provisions in the limited partnership agreements allowing the funds to take up subscription credit facilities.

Debt funds in Germany

Recent changes in regulations for debt funds

Historically, Germany was not a good place to be for funds wishing to originate their own loans or restructure and/or extend the duration of loans originated by third parties, as these activities were (with few exceptions) restricted for funds and only permissible after obtaining a banking licence (with a cumbersome licensing process) or establishing a work-around mechanism, which entailed a certain degree of legal uncertainty. Following ongoing concerns expressed by industry practitioners and lobbying groups as well as to keep pace with European legislative developments, Germany has since opened up (a little) in 2016.

Back in March 2016, the German legislator – following a change in the administrative practice of the German Federal Financial Supervisory Authority ("BaFin") in May 2015 – amended the German Capital Investment Act ("KAGB") and the German Banking Act ("KWG") in order to permit certain alternative investment funds ("AIFs") to issue loans as well as restructure and extend the duration of unsecuritised loan receivables.

Prior to this change, the granting of loans by a German AIF would have required a banking licence under the KWG, which in practice was not a feasible option for an AIF. Instead, if the German AIF intended to originate loans it would rely on a so-called fronting-bank model, where a fully licensed German bank granted the loans and then subsequently transferred the loan receivables to the German AIF. Utilising such fronting-bank model is now no longer necessary. A banking licence is not required anymore, provided the

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specific AIFs meet certain requirements. Then loan origination is no longer deemed a banking activity subject to the KWG, but rather a "collective investment management activity" subject to the KAGB. The same can be said for restructurings including maturity extensions of existing loans. The KAGB henceforth thus supersedes the KWG in this regard.

The most important restrictions and requirements introduced to be met by German AIFs, and their respective German AIFMs, in order for them to fall outside the requirements of the KWG are:

- the AIF must be closed-ended and may only admit professional and semi-professional investors as investors ("*Spezial-AIF*"). An investor is considered semi-professional if it is sophisticated and experienced and invests at least €200,000 in such AIFs;
- the AIF may not grant loans to consumers;
- the AIF may not incur fund-level debt of more than 30% of its aggregate contributed and undrawn committed capital available for investments (after deduction of any costs and expenses borne by investors) ("Investment Capital");
- the AIF may not grant loans to any one borrower in an aggregate principal amount in excess of 20% of the Investment Capital; and
- the AIFM managing the AIF must also satisfy the following requirements:
  - certain risk management requirements consistent with the risk management requirements applicable to the loan origination businesses of banks; and
  - reporting obligations for loans in a principal amount of €1 million or more.

EU and third-country debt funds

The above requirements only explicitly apply to German AIFs and German AIFMs. Consequently, EU AIFs and EU AIFMs may engage in loan origination in Germany without meeting any specific German requirements. The loan origination business of such AIFs is subject only to home state regulations.

Third-country AIFs (and their AIFMs), however, will benefit from the new rules only if they are admitted for marketing to semi-professional investors or retail investors in Germany. Such marketing approval requires that they agree to comply with all requirements under the KAGB, which in practice only very few third-country AIFs/AIFMs are willing and able to do.

Loan origination by SPVs held by AIFs

One point of great debate within the industry was, and still is, whether or not Special Purpose Vehicles ("SPVs") held by AIFs may also benefit from the above exemption. The newly introduced wording in the law explicitly only exempts AIFs and AIFMs from the banking licence requirement, but is silent with respect to SPVs. This is unsatisfactory to say the least, as European AIFs often do not lend directly, but through wholly-owned SPVs. Until this point is further specified by BaFin or the German legislator, the better (and prudent) reading of the law is to – unfortunately – assume that licensing requirements of the KWG will apply to loans originated by SPVs.

Shareholder loans at fund level

In the course of the recent changes to the KAGB, new requirements regarding shareholder loans at fund level have also been introduced. The new requirements are less restrictive than the requirements for debt funds: not only closed-ended Spezial-AIFs, but also open-ended Spezial-AIFs as well as closed-ended retail AIFs may generally grant shareholder

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loans. Spezial-AIFs (closed and open-ended) may grant up to 50% of their Investment Capital as shareholder loans to any entities, provided:

- such entities are subsidiaries of the Spezial-AIF;
- the shareholder loan is subordinated; or
- the shareholder loans granted do not exceed twice the amount of the acquisition costs of the equity stake held in the company.

Provided the Spezial-AIF itself does not take up loans in excess of 30% of its Investment Capital, it may grant subordinated shareholder loans in excess of the 50% threshold stipulated above.

The restrictions for closed-ended retail AIFs are a bit narrower than for Spezial-AIFs, as a closed-ended retail AIF may not grant more than 30% of its Investment Capital as shareholder loans and the loans may not exceed the acquisition costs of the equity stake in the subsidiary.

Subscription credit facilities

German funds are increasingly interested in subscription credit facilities as means of short-term bridging of financing needs between capital calls. Under a credit facility, borrowed funds typically can be made available within a day, while under a typical limited partnership agreement, capital calls may take 10 business days or more.

Regulatory environment

The use of subscription credit facilities or other means of financing by German funds was traditionally very limited, as fund financing may have a negative impact on the ability of certain investors to invest in funds due to possible regulatory constraints. Pursuant to the Solvency II regime, which came into effect in January 2016, EU insurance companies are subject to rules determining the risk weightings applicable to the different categories of assets they hold in order to calculate their prudential capital. Investments in private funds are generally subject to high capital requirements for such insurance companies. However, closed-ended EU funds not using leverage benefit from a special treatment for Solvency II purposes, which means that such funds are subject to lower capital requirements.

From a German law perspective, until very recently private equity funds were only eligible investments for regulated investors that are subject to the German Investment Ordinance (*Anlageverordnung*) (i.e., pension funds and small insurance companies) and those which, according to their internal rules, comply with the Investment Ordinance (insurance companies and certain pension schemes), if their borrowing was short-term and limited to 10% of the value of the fund. Both restrictions were problematic, because the meanings of "value of the fund" and "short term" were unclear. Very helpfully, though, those limitations have been removed in the latest BaFin circular, and borrowing at the fund level is now permitted for bridging capital calls. Unfortunately, uncertainty remains with respect to a fund of funds because BaFin has retained the 10% limitation, and the short-term requirement there.

Although the 10% limit has been abolished for private equity funds, it is still common to limit the ability of the fund under the limited partnership agreements to take up financing to 10% of the commitments only.

Moreover, under certain circumstances, i.e., if a fund is structured to be deemed not to be in business (*vermögensverwaltend*) under German tax law, taking up financing by German funds may be considered as a business activity from a German tax perspective,

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which would have negative tax consequences. For this type of funds, there will often be provisions in the limited partnership agreements according to which taking up subscription credit facilities by the fund is permissible if and to the extent it does not constitute a business activity of the fund from a German tax perspective.

Financing and security structure

Subscription credit facilities typically take the form of a senior secured revolving credit facility secured by the unfunded capital commitments of the fund's investors. The facilities are subject to a borrowing base determined based on the value of the assigned/pledged commitments of investors satisfying specified eligibility requirements, with advance rates based on the credit quality of the relevant investors.

Subscription credit facilities are typically secured by a security interest in the unfunded capital commitments. The security package will usually require the general partner to delegate, assign, pledge or otherwise create a security interest over its right to issue drawdown notices (and the fund to assign, pledge or otherwise create a security interest over the right to receive capital contributions). It is also common to pledge the deposit account into which investors are required to fund their contributions. The fund's underlying investments are typically not part of the security package.

From a German law perspective, the security interest in the rights to the unfunded capital commitments can be established by way of a pledge or by way of a security assignment. While a pledge requires a written notification to the investors in order to perfect the security, a security assignment can be made on a silent basis (although a notice of assignment may provide the lenders with some additional comfort).

Recent discussions regarding subscription credit facilities

The recent discussions about subscription credit facilities within the international funds community, including the guidelines for the use of subscription facilities issued by the Institutional Limited Partners Association ("ILPA") in 2017, have been carefully noted in the German market.

So far, the impact of these ILPA guidelines has not dramatically changed the way the limited partnership agreement and the subscription credit facilities are structured. But we have noted in recent transactions that investors pay more attention to disclosure requirements in the limited partnership agreements, including information on: (i) the terms of the subscription credit facility and costs to the fund; (ii) the calculation of IRR (with and without the use of the facility); (iii) the balance of the facility; and (iv) the current use of the proceeds from the facility. The limited partnership agreement may also provide for a limit to the interest expenses payable by the fund.

Other developments

With the implementation by the German legislator of the requirements for granting loans, the reference values for the borrowing limits and restrictions on encumbrances with respect to closed-ended retails AIFs were also amended and brought in line to reflect developments at a European level. Now the reference value, instead of the net asset value used before, is also the Investment Capital. The aim of the legislator was to have a less volatile reference value than the NAV, to provide more comfort to investors. As the amount itself was not to be changed, but only the reference value, the restrictions were accordingly adjusted from 60% to 150% of Investment Capital.

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The year ahead

There are ongoing efforts to try and convince BaFin and the German legislator that the current understanding of the law, whereby SPVs are not exempt from the banking licence requirement, is detrimental to the cause which the German legislator was trying to achieve with the amendments – namely promoting non-bank-based forms of financing. Not granting SPVs the benefits of the exemption thus essentially means that EU loan funds are currently restrained from entering the German loan market as they are not able to utilise the structures they have in place. Softening the exemption up to also include SPVs would send a positive signal towards the loan funds market in Germany.

Given the increased use of provisions in limited partnership agreements allowing subscription credit facilities and low interest rate levels, we expect the German market for subscription credit facilities to develop and grow in the year ahead. The latest discussions regarding the effects of subscription credit facilities are unlikely to change the trend as such, but will certainly lead to more extensive disclosure obligations for the fund managers. We also expect US and UK banks to continue to dominate the subscription credit facilities market in Germany.

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Guernsey

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Overview

Guernsey is a leading funds domicile with more than 50 years' proven track record as an international financial centre, and as such is increasingly recognised by fund sponsors and promoters as a leading centre for the formation, administration and cross-border distribution of investment business such as private equity, alternative investments, property funds, hedge funds and funds of hedge funds. As at the end of 2017 there were over 1,000 funds domiciled in Guernsey, with the overall value of institutional and retail funds under management and administration in Guernsey standing at £256 billion.

There are a range of factors contributing to Guernsey's leading position in this space, including: (i) over 800 years of independent self-governance as a Crown Dependency of the United Kingdom; (ii) an AA-credit rating from Standard & Poor's representing Guernsey's very strong capacity to meet its financial commitments; (iii) historical familiarity with the jurisdiction by investors and fund sponsors; and (iv) the increasing dominance of the private equity sector in the funds market. In addition, Guernsey law, which is derived from a combination of English common law, Norman customary law and local legislation, ensures that Guernsey funds are recognised as internationally accepted and well recognised vehicles for all kinds of fund-related activity.

Collaboration between the Guernsey government and the private sector also ensures that Guernsey laws keep pace with market evolution and demand. New products were introduced to the market last year to keep Guernsey at the forefront of the international funds market, including manager-led products (**MLPs**) and private investment funds (**PIFs**).

The growth in this area shows a strong correlation with the fund finance space where Appleby's Guernsey office continues to see steady growth year on year in the subscription credit facility market. Indeed, Appleby's Guernsey office continues to be a market leader in this area, representing the majority of the largest global banks on a variety of different financing structures.

Fund formation and finance

<u>Lending to Guernsey funds</u>

Guernsey private equity funds have typically been registered as limited partnerships under the Limited Partnerships (Guernsey) Law, 1995, as amended (**LP Law**). Though registered pursuant to the LP Law, a limited partnership is not generally a separate legal entity (although it can elect to have separate legal personality from its partners at the time of registration).

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A limited partnership reflects a formal legal arrangement between one or more general partners of the limited partnership and one or more limited partners of the partnership. A general partner of a Guernsey limited partnership (**LP**) is liable for all of the debts and obligations of an LP and is vested with certain duties and powers with respect to the business of the LP. On the other hand, limited partners contribute or agree to contribute specific sums to the capital of the LP only, and have no liability for any of the debts or liabilities of the LP beyond this amount so long as they refrain from taking part in its management. Any rights and obligations of the general partner and the limited partners are governed by the limited partnership agreement and any subscription agreements or side letters entered into by the limited partners, and are therefore contractual in nature. The LP's rights and property of every description, including any right to make capital calls and to receive the proceeds thereof, are held by the general partner in trust as an asset of the LP (and this remains the case even if an LP elects to have separate legal personality).

The typical security package

This contractual arrangement and ownership structure largely dictates the structure of the security package available to lenders offering subscription credit facilities to Guernsey vehicles. As previously mentioned, limited partners of an LP will usually commit in the partnership agreement and/or subscription agreement to fund investments or to repay fund expenses when called upon to do so by the general partner from time to time. It is this contractual obligation of a limited partner to make these capital contributions, to the extent that they have not already been called (**Uncalled Capital**), and the corresponding right of the general partner on behalf of a limited partnership to call for Uncalled Capital (**Capital Call Rights**) that is at the core of the typical subscription credit facility security package. Given that these rights are contractual in nature and will be governed by the laws of Guernsey, the appropriate form of security over such rights is an assignment of title in the form of a security interest agreement in accordance with section 1(6) of the Security Interests (Guernsey) Law, 1993, as amended (the **Security Law**).

As legal title to the assets of the LP ultimately vests in the general partner, the Capital Call Rights are exercisable by the general partner for the benefit of the LP. As such, the proper parties to any grant of security over the LP's assets (and in particular, the Capital Call Rights) must be the general partner as well as the limited partnership (acting through the general partner). The security package must be in strict compliance with the requirements of the Security Law and, ideally, should incorporate an express irrevocable power of attorney in favour of the secured party, entitling the secured party to exercise the general partner's Capital Call Rights following the occurrence of an event of default.

It should not be assumed that the assignment of Capital Call Rights is necessarily permitted under the limited partnership agreement governing the LP (although it is common enough that the requisite changes to an agreement to permit such security are fairly uncontroversial). The terms of the limited partnership agreement can have a fundamental effect on the structuring of the collateral package and must be reviewed in detail in order to ensure a number of key elements, including but not limited to:

- the ability of the LP to incur indebtedness and enter into the transaction;
- that security may be granted over (a) the Uncalled Capital, (b) the right to make and enforce capital calls, and (c) the related contributions; and
- that Uncalled Capital may be applied (when called) towards the secured obligations.

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Service of notice in respect of security over Capital Call Rights

In order to be effective and comply with the Security Law, any security over a contractual right must satisfy two limbs (the **Two Limbs**): firstly, the secured party must have title to the collateral assigned to it under a security interest agreement; and secondly, express notice in writing of that assignment must be served on the person from whom the assignor would have been able to claim the collateral (for example, in the case of Capital Call Rights, the limited partners). On this basis, the serving of notice under the Security Law is a matter not just of the perfection of the security; the service of notice is crucial to the creation of the security interest, and without it no security interest exists. Attention must therefore be given to the sometimes tricky issue of the service of notice on limited partners who may otherwise be unaware of the financing arrangements proposed for the LP in which they invest; funds are often reluctant to serve notice promptly following the signing of the security interest agreement, and it can be important to educate lenders and fund managers as to the implications of not doing so.

Where a security interest is granted over Guernsey Capital Call Rights, priority of the security interest over any competing security interest will therefore be determined in accordance with Guernsey law and, given that a valid security interest is only created once both of the Two Limbs have been satisfied, priority may not be established in accordance with the time of execution of the relevant security interest agreements. A delay in the delivery of the Notice will therefore open up the secured party to the possibility that a general partner, on behalf of the Guernsey LP, may (quite unintentionally) grant a competing security interest or an absolute assignment over Capital Call Rights to a subsequent assignee. If both security interest agreements have been executed, provided that notice of the second assignment is provided to the limited partners ahead of notice of the first assignment, the second assignee will rank for repayment ahead of the first assignee.

Limited partners are increasingly aware of subscription facilities and familiarity with the product means that there is now, generally, less resistance by Guernsey LPs to giving notice to limited partners. This has led to notices typically being circulated to the limited partners immediately upon execution of the security documents in order to ensure that security is created and priority is achieved at closing of the subscription credit facility.

Given the importance of actual delivery of the notice to the limited partners, evidence of the notice having been received also assumes some importance. In general, where the limited partners are not part of the same borrower group, it is unlikely that any form of acknowledgment of the notice will be received. It is increasingly common for Guernsey limited partnership agreements to build in provisions that specify the circumstances in which notices delivered in accordance with their terms are “deemed” to have been received by the limited partners. Where a limited partnership agreement contains such provisions, lenders can take some comfort in proof of delivery of any notice in accordance with the provisions of the partnership agreement (rather than proof of receipt by way of a signed acknowledgment by the limited partners, which is the ideal). In all cases, the recommendation would be that the general partner sign and deliver the notice to the limited partners in accordance with the provisions of the limited partnership agreement governing service of notices on the limited partners, with a copy delivered to the secured party. Where no such provisions are included regarding the service of notice and deemed delivery, it is important to obtain proof of delivery to limited partners (such as receipt of copies of courier delivery slips).

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We have also seen an increasing prevalence of limited partners, within the terms of the limited partnership agreement, appointing an agent specifically to receive notice of this nature on their behalf (and indeed, sometimes, to also acknowledge receipt of the notice on their behalf). Wording of this nature should be examined carefully to ensure compliance with the requirements of the Security Law.

In addition to facilitating the creation of a security interest, delivery of a Notice to a Guernsey limited partnership's limited partners of an assignment of Capital Call Rights has other distinct advantages. Two of the more important advantages of delivery of the Notice include preventing: (i) the limited partners from obtaining good discharge for their obligations to fund their Uncalled Capital in any manner other than as specifically indicated in the notice; and (ii) set-off arising after the date of service of such notice (on the basis of the common law principle that set-off works between the same parties in the same right).

Other elements of a typical security package

The typical security package will also include the grant of a security interest over a designated bank account under the control of the Lenders into which any capital call proceeds must be paid. Although the security interest agreement over Capital Call Rights in a Guernsey LP must be granted under a Guernsey law security interest agreement which complies with the requirements of the Security Law, security over such designated bank accounts should usually be governed by the law of the jurisdiction in which the account itself is situated. Whilst Guernsey is a popular choice for the accounts of both Guernsey and non-Guernsey private equity funds due to the well-established and regulated status of the jurisdiction, it is equally common for such accounts to be sited in the United Kingdom or United States and, in such instances, it would be usual for such security to be granted under a New York or English law governed security agreement. If the account is Guernsey situate, security should be taken in compliance with the requirements of the Security Law and take the form of a security interest agreement. Assuming that the secured party is not also the account bank, then notice is once again a key factor, and time should be factored in to deal with the requirements of individual account banks who maintain the accounts which are the subject of the security.

Less typical security elements

Other, less typical security packages may include security directly from the limited partners over their interests in the limited partnerships themselves and, particularly in relation to hybrid facilities, security is often taken over underlying assets of the fund. In Guernsey these might include shares in Guernsey registered subsidiary companies, units in Guernsey unit trusts, and/or contract rights arising under Guernsey law contracts. In respect of these asset types, security is taken by way of a Guernsey law security interest agreement and the formalities to finalise the creation of the security are as follows:

- Shares – notice of the assignment is given to the company whose shares are secured, possession is taken of the share certificates (together with blank stock transfer forms) and the register of members is annotated to reflect the security interest.
- Units – notice of the assignment is given to the trustee of the unit trust whose units are secured, possession is taken of the unit certificates (together with blank unit transfer forms) and the register of unit holders is annotated to reflect the security interest.
- Contract rights – notice of assignment is given to the contract counterparty and acknowledgment obtained.

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Registration requirements

With the exception of land located in the Bailiwick of Guernsey, vessels flagged in Guernsey and Guernsey registered aircraft, there are no registration steps required in Guernsey and there is no general register of security interests in Guernsey accessible to the public. There is similarly no statutory requirement that a Guernsey entity keeps a private register of security interests.

Key developments

The protection afforded to investors in funds proposed by the Alternative Investment Fund Managers Directive (**AIFMD**) has been at the forefront of the minds of the entire Guernsey funds industry, and has seen increased emphasis on the substance of both funds and fund managers, in particular.

Guernsey has worked hard to ensure that from the outset its regulatory infrastructure is suitable to enable the distribution of Guernsey-domiciled funds to both EU and Non-EU countries. In July 2016, the European Securities and Markets Authority announced its recommendation that Guernsey be included in the first round for the granting of third country passport for the purposes of AIFMD. Guernsey is still one of only five non-EU jurisdictions to be given such an assessment and the recommendation (subject to relevant approvals at an EU level) will enhance Guernsey's position as a gateway to the European funds market. This enviable position will only further strengthen Guernsey's dominance in the offshore market in the EMEA time zones and make Guernsey a first point of call for the purposes of structuring funds distributing to both EU and Non-EU markets.

The Guernsey government reacted to significant market demand with the introduction of a Guernsey limited liability partnership (**Guernsey LLP**) under the Limited Liability Partnerships (Guernsey) Law, 2013 (**LLP Law**), which came into force by commencement order on 13 May 2014. This has been a significant development for the jurisdiction as it provides for the formation of a new type of business vehicle that is a hybrid entity, merging certain characteristics of a Guernsey non-cellular company limited by shares and a Guernsey limited partnership.

Guernsey publicly stated its intent to participate in the OECD's Base Erosion and Profit Shifting (**BEPS**) Project as an Associate in March 2016 and remains committed to the collective aim to reach a globally fair and modern international tax system. Accordingly it has signed a Multilateral Agreement to exchange tax information. The Multilateral Competent Authority Agreement provides for automatic exchange of information in accordance with country-by-country reporting by large multinational enterprises. BEPS refers to tax planning strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low- or no-tax jurisdictions where there is little economic activity, resulting in little or no overall corporate tax being paid.

Manager Led Product (MLP)

In May 2016, the Guernsey Financial Services Commission (**GFSC**) launched the MLP. The MLP is aimed at alternative investment fund managers (**AIFMs**) seeking to market into one or more EU Member States under national private placement regimes.

Under the MLP regime, all regulatory standards are borne by the AIFM and, by virtue of the AIFM's sponsorship, no alternative investment fund or underlying licensee will have rules imposed on it. The MLP regime avoids duplicating regulatory requirements over several entities. Further, derogation requests acceptable to the host country will be considered by

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the GFSC. The GFSC will be able to register a fund and license an underlying licensee within 24 hours of notification.

The GFSC intends to extend Guernsey's suite of MLPs to include a similar offering for marketing outside the European Union.

Private Investment Fund (PIF)

In November 2016, the GFSC introduced a PIF regime which provides fund managers with greater flexibility and simplicity. The PIF, which was developed in response to market demand by the GFSC in consultation with the island's funds industry, recognises that certain investment funds are characterised by a relationship between management and investors that is closer than that of a typical agent. The PIF dispenses with the formal requirement for information particulars such as a prospectus in recognition of that relationship, significantly reducing the cost and processing time of launching of a fund.

The PIF, which can be either closed or open-ended, should contain no more than 50 legal or natural persons holding an economic interest in the fund. A key strength of the product is that, where an appropriate agent is acting for a wider group of stakeholders such as a discretionary investment manager or a trustee or manager of an occupational pension scheme, that agent may be considered as one investor. While there is a limit imposed on the number of investors in the PIF, no attempt has been made to limit the number of investors to whom the PIF might be marketed – a feature not available under comparable regimes.

The PIF is predicated on a close relationship between investors and the licensed manager, who will be responsible for providing warranties on the ability of the investors to assume loss. Under the new rules, both the PIF and its manager benefit from an application process that can be completed in one business day. The two processes may be completed in tandem by the GFSC, ensuring a short regulatory timescale.

The year ahead

2017 has continued the trend of making a mockery of any attempt to make accurate predictions about market developments. Political developments both in Europe and in the US continue to play out and it remains to be seen what effect they will have in the medium to long term. While some consensus and stability appears to have been achieved, there is still some way to go and Brexit negotiations have been far from smooth so far. The mid to long term effect on the UK and European markets remains far from predictable.

Being established in a non-EEA country, Guernsey funds can offer their investors separate regimes, depending on whether or not they wish to access EU investors. A choice exists between fully EU/EEA independent regimes, targeted "private placement regimes" with individual EU countries, or, once the AIFMD passport is granted, full access to EU member states under AIFMD. Some EU countries, such as Germany, have already indicated however that "private placement regimes" will be done away with once passporting rights are in place. Whether this comes about (and, if so, for which countries) remains to be seen.

The Guernsey market continues to see sophisticated lenders providing increasingly complex and tailored solutions to the funds market, with loans being made to the full cast of players in the funds market including funds, secondary funds (against their limited partnership interests, to finance the acquisition of limited partnership positions and release capital to investors), limited partners and general partners (to help finance GP and fund commitments). As the funds industry continues to flourish, so will the fund finance industry; the market shows all the signs of continuing to expand in 2018.

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Hong Kong

Fiona Cumming, Patrick Wong & Natalie Ashford
Allen & Overy

An overview of the Hong Kong fund landscape

When referring to "funds", a distinction must be drawn between public, open-ended funds and private, close-ended funds.

Over 700 public, open-ended funds were domiciled in Hong Kong as at 31 March 2017.[1] It is expected that this number will continue to grow as the Hong Kong government and regulatory authorities are introducing a number of initiatives in a drive to promote Hong Kong as a full-service international asset management centre and preferred fund domicile. One such initiative is the mutual recognition of public funds arrangements implemented by the Securities and Futures Commission (**SFC**), which allows for securities of public funds domiciled in Hong Kong to be offered directly to investors in the People's Republic of China (the **PRC**) and, most recently, in Switzerland and France, and *vice versa*. This regime provides Hong Kong funds with a direct route to PRC and European Union investor bases. In addition, the authorities are confident that Hong Kong's position in the international funds market will be further enhanced with the introduction of a new form of corporate entity, being the open-ended fund company, next year, which will enable funds to be established in corporate form (in addition to the existing unit trust form, which can give rise to cross-jurisdictional issues for those jurisdictions that do not recognise the concept of a trust). Time will tell whether these initiatives help to establish Hong Kong as a preferred public fund domicile in Asia or even globally.

The private fund space paints a rather different picture. While there are roughly 200 fund managers based in Hong Kong today, there are but a handful of private equity funds actually domiciled in Hong Kong.[2] This is largely due to uncertainties surrounding the tax treatment of limited partnerships in Hong Kong pursuant to its historic Limited Partnership Ordinance, which was introduced in 1912. The Hong Kong government and regulators have recognised a number of gaps in the legislative and regulatory framework applicable to private funds and are currently considering various proposals in an effort to close these gaps and promote Hong Kong as a more competitive centre for private funds and as a preferred fund domicile. As fund finance activity is very much concentrated in the private funds domain, the remainder of this article will focus more on the private fund market in Hong Kong and the proposals that are expected to propel Hong Kong into a prime position in the global funds market.

What is a "Hong Kong" fund and what is "Hong Kong" fund financing?

As noted above, it is rare for private funds to be domiciled in Hong Kong and so when a reference is made to a "Hong Kong" fund it is, to a large extent, referring to funds

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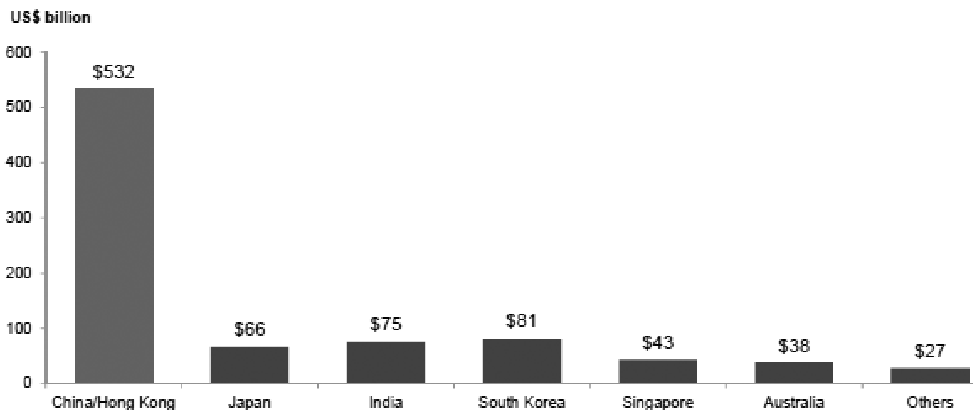
administered out of Hong Kong or managed by a fund manager based in Hong Kong. Similarly, we would classify a fund financing as a "Hong Kong" financing if it is provided by a lender operating from Hong Kong and/or the fund obtaining the financing is administered or managed out of Hong Kong. In practice, the reality is that Hong Kong fund financing typically involves various parties across a number of jurisdictions (especially as we see more financing provided on a club rather than on a bilateral basis).

The private equity funds market in Hong Kong and China

Hong Kong-managed funds account for roughly a quarter of all newly raised private equity capital in Asia and the investment managers generally operate on a regional basis, with most capital being raised from professional investors (including pension funds, insurance companies and sovereign wealth funds) based in the PRC, Australia, Singapore, India and Korea.[3] Therefore, in order to get a truly representative view of the Hong Kong funds market, the PRC and the Asia-Pacific region as a whole should also be considered.

The private equity funds market in Hong Kong, and in the wider Asia-Pacific region, may not be as established or as sophisticated as it is in the United States and Europe, but it is evolving. China is leading the way as the largest private equity centre in Asia, followed by Hong Kong in second place. As a combined force, private equity funds in China and Hong Kong raised commitments in excess of US$532 billion between 2006 and 2016, while all other countries in Asia combined raised only around 60% of this figure in the same period.[4] This is illustrated by the chart below, which clearly emphasises the dominance of China- and Hong Kong-based funds within the Asia-Pacific region.

Total funds raised by countries in Asia (2006 — 2016)



Source: China Private Equity/Venture Capital, 2016 Review and 2017 Outlook, PwC, 23 February 2017

This year (up until August), just over 50 funds have been closed by managers located in Greater China, raising US$16.2 billion. If the wider market is taken into account as well, funds focused on the Asia-Pacific region as a whole raised approximately US$70 billion over the last 12 months (to the end of June 2017). While this represents a downward trend in the region over the short term, being approximately 25% below the peak of US$93 billion that was raised in 2014, there are signs that the market will pick up again: a number of record-sized funds entered the Asia-Pacific market this year, including KKR Asia III, which closed at US$9.3 billion.[5,6]

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Factors affecting the market

The slight downward trend in fundraising activity that the Asia-Pacific region has experienced over the last few years is partly due to a stagnant exit environment. Where managers feel unable to divest their holdings, they are less likely to make new investments and are consequently less profitable and make fewer distributions to their investors. When not seeing significant return on their capital contributions, investors are deterred from committing further capital, which serves to exacerbate the cycle. Indeed, Asian-based fund managers have reported that it has become more difficult to source attractive investment opportunities over the past year and, for this reason, at the end of December 2016, they were holding a record US$144 billion of dry powder.[7]

The fundraising market in China, in particular, is further hampered by there being a limited number of managers performing at the highest level with a consistent track record and sector expertise, especially in the technology, healthcare and education sectors. This is especially detrimental in the current exit environment, where it is essential that fund managers are able to show that they have good management skills and an ability to negotiate favourable exit rights in order to attract investors.

We believe the PRC's further tightening of restrictions on outbound investment, as well as keeping Qualified Domestic Institutional Investor (**QDII**) and RMB Qualified Domestic Institutional Investor (**RQDII**) quotas closed over the last 12 months, may have also had an impact on the funds market. As there are limited channels through which onshore capital can be repatriated outside the PRC, it is not surprising to see a lot of private funds based in Asia (including those managed in Hong Kong) having an investor base which is dominated by offshore investors. Despite regulatory relaxations in recent years in the PRC, there are still limited opportunities for onshore investors to commit onshore capital directly to offshore private funds.

Fund formation in Hong Kong

Funds: Currently, the vast majority of Asia Pacific-focused funds are set up as limited partnerships in jurisdictions such as the Cayman Islands, where the limited partnership is considered tax-neutral and treated as a "flow-through" structure, which is particularly advantageous since investors are usually based internationally. As mentioned above, Hong Kong's existing Limited Partnership Ordinance does not create an attractive legal framework for private equity funds. In particular, it is not clear whether a limited partnership domiciled in Hong Kong would be transparent for tax purposes. However, since Hong Kong benefits from a wide network of double tax agreements, it is an ideal jurisdiction in which to establish fund domicile, and this has encouraged local regulators to consider introducing measures to improve the legal and regulatory framework in order to, amongst other things, clarify the tax treatment of limited partnerships. In order to provide a more attractive regime for funds, Hong Kong may continue to develop its network with key missing jurisdictions, such as Australia and India (where, as noted above, a significant number of investors in Hong Kong-managed funds are based).

However, updating the limited partnership law in isolation will not be enough. A wide range of legal and regulatory developments will be required in order to develop Hong Kong as a truly preferred fund domicile. Tax laws have recently been developed to provide that limited partnerships are exempt from Hong Kong profits tax but, in order to be on par with other jurisdictions, this needs to go one step further to provide that the sale or transfer of limited partnership interests would not be subject to stamp duty. In tandem, the authorities

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also need to consider confidentiality and other measures that may be required in order to protect investors as limited partners.

Investment managers: Any entity that holds responsibility for managing investments in Hong Kong must hold a Type 9 (asset management) licence with the SFC, regardless of whether the fund itself is incorporated onshore or offshore. It is intended that, with the development of the new limited partnership law, the partnerships themselves will be subject to the approval of the SFC, but would not be regulated by it. The SFC would continue to operate its supervisory role through the investment managers that are licensed to manage the funds. It will be interesting to see whether a new class of licence is developed by the SFC in parallel with a revised limited partnership law since, currently, the most relevant licence is that which is designed for publicly traded funds. The skills and experience required for managing a small, private fund are rather different to those required for managing a large portfolio of public securities, so it would be more appropriate for the SFC to consider a separate class of licence for the management of private equity funds.

It is worth noting that, in instances where the main commercial substance of a fund is located in another jurisdiction, the investment manager would most likely be domiciled in that jurisdiction and subject to any local regulatory requirements. In order to manage the Hong Kong aspects of that fund, the investment manager would then appoint an investment advisor in Hong Kong. Such advisor would be subject to the same licensing requirements as described above and would manage the local aspects of the fund only.

Investors: While fund investors in North America and Europe are mostly pension funds and foundations, Asian-based fund investors are predominantly corporates, banks and insurance companies. As private wealth increases across the Asia-Pacific region, an increasing number of high-net-worth individuals and family offices are also investing in funds.

A distinction should also be drawn between those investors that are committed to investing in the Asia-Pacific region as part of their long-term investment strategy and opportunistic investors that invest in the region only where they see real windows of opportunity that may afford positive returns. When the market is not at its peak, it is those opportunistic investors that may be most significantly deterred from investing in the region.

Hong Kong fund financing

Capital call (subscription) financing: Although currently not as prevalent as it is in the United States and Europe, subscription financing has become significantly more common in the Hong Kong market in recent years. Traditionally subscription financing was used as a bridging loan to allow investment managers to close deals in a tighter timeframe than would be possible by calling capital from investors (as amounts can often be drawn down under a subscription facility within a matter of days, while notice periods for calling capital from investors can extend into a number of weeks). Due to low interest rates, funds are now using subscription facilities more frequently and more extensively for longer-term borrowings than the original bridging financings they were intended for. In recent years, the subscription facility market has significantly increased in size as more funds are attracted by the flexibility and liquidity and lenders are attracted by strong credit profiles and historically low delinquency rates.

In Hong Kong, as is the case in the United States, Europe and Australia, security under a subscription facility is two-fold: firstly, an assignment of the general partner's right to make capital calls on the limited partners' unfunded capital commitments; and, secondly, a fixed charge over the collection account into which the proceeds of such capital calls are paid.

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The assignment interest can be a legal or equitable assignment but market practice in Hong Kong is generally to give notice of the assignment to the limited partners (and use reasonable endeavours to obtain an acknowledgment) in order to evidence a legal assignment (and in this respect, the law in Hong Kong relating to charges and assignments follows the same principles as English law).

As suggested above, the market indicates that there may be an increased appetite for fundraising in the Asia-Pacific region and, since the market for subscription facilities generally tracks that of fundraising, the prevalence of these facilities may increase in the next few years, particularly if the PRC relaxes its restrictions on outbound investment over time. With the proposed legal and regulatory developments in Hong Kong, it is hoped that much of this activity will be concentrated in Hong Kong, affording local investors a far broader access to funds, which will help to further encourage financing by local funds.

While international banks (many with a strong track record in fund financing in the United States, Europe and Australia) still dominate the market in Hong Kong, Chinese banks based in Hong Kong are also starting to become increasingly involved in subscription financings. Given their extensive network in China, they are much better placed than a lot of their offshore counterparts in assessing the credit of funds with a large Chinese investor base, and have a greater appetite for China-based risk.

Umbrella financing: A number of funds choose to set up as an umbrella fund: a single legal entity with a number of separate sub-funds that each operate as an individual fund. For investors, this provides the benefit of economies of scale and, for the investment manager, it is more efficient as the same terms and conditions tend to apply to each of the sub-funds and to the umbrella fund, reducing administrative time and costs. A subscription facility may be provided either to the umbrella or to any one or more of the sub-funds against the usual security package. While we have not yet seen any umbrella financings, it is becoming increasingly common in the Hong Kong market as a number of Asia-domiciled funds are choosing to establish themselves using umbrella structures.

General partner financing: Although not particularly common to date, we have seen an increasing number of enquiries in the last 12 months with regard to general partner financings, where financing is provided to the general partner of a fund in order to fund its own commitment. Under these facilities, security is taken by way of an assignment of all of the general partner's partnership interests in the fund (including, for example, its right to receive management fees, performance fees, carried interest and any other related income) in addition to a fixed charge over the relevant collection accounts. This structure is the same in Hong Kong as it is in the United States, Europe and Australia, where these types of financings are much more common in the respective markets.

Since the general partner does not have "skin in the game" under these financings, they are not popular among lenders or investors. However, the increasingly competitive lending landscape means that lenders are being forced to consider general partner financings in order to protect their relationships with funds.

Alternative models: As the Hong Kong market becomes increasingly sophisticated, both lenders and borrowers are beginning to ask more questions of alternative financing structures that may be more suited to their requirements. Mature funds, which have already called all or a significant portion of their investors' capital commitments, or funds that do not permit traditional subscription financing, may, for example, benefit from a net asset value-based (**NAV**) financing. Instead of being backed by the uncalled capital commitments of the fund's investors, which in such cases would not be operable, lenders are showing interest

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in NAV facilities that are backed by the underlying cashflow and distributions that flow up from the fund's underlying investments.

While NAV financings are becoming relatively common in the United States, market participants are only just beginning to explore this product in Hong Kong. An alternative option is the hybrid facility, which offers maximum flexibility to both lenders and borrower funds. These are particularly useful in financings with a long maturity, as they utilise a traditional subscription financing structure in the early stages and then switch to an NAV-based structure later in the life of the fund, after a certain proportion of commitments have been drawn from investors. This affords lenders recourse to both the undrawn commitments of the fund and the fund's underlying assets, while borrowers are presented with a more flexible solution that may suit their investment needs over time.

Other key developments

ILPA guidance: A subscription financing allows a fund to delay calling capital, which can boost its internal rate of return and artificially inflate the fund's performance. While many investors do favour subscription facilities due to the decreased number of capital calls, others are more hesitant because of the additional expenses, and this has led the Institutional Limited Partners Association (**ILPA**), following consultations with various interested parties, to issue best practice recommendations in respect of subscription financings in June 2017. Generally, these recommendations focused on increased transparency and disclosure to investors. In the Asia-Pacific region in particular, where investors may be less sophisticated and familiar with the product, the market view is that this guidance may lead to increased discussions and interest from investors, helping them to better understand subscription facilities, and in turn perhaps enabling them to better utilise the product. Over time, we are also tending to see new funds established with limited partnership agreements that are much more favourable to, and expressly permit, subscription financings and any applicable limits or restrictions.

Regulatory environment in China: Since summer 2016, the Asset Management Association of China (**AMAC**) has opened the private fund market up to foreign asset managers. Both Fidelity International and UBS Asset Management have been granted a private fund management licence by AMAC this year, which enables them to market funds to institutional and high-net-worth individuals in the PRC. As an increasing number of global asset managers obtain licences from AMAC, it will be interesting to see whether this significantly alters the fund landscape in Hong Kong, particularly as a large number of asset managers are based here.

Looking forwards

It is hoped that the introduction of new measures, such as the mutual recognition of funds, will help to encourage an increasing number of public funds to be domiciled in, and managed from, Hong Kong.

While Hong Kong will no doubt continue to be a key player in the private fund market in Asia, with a large number of global asset managers based here, the Limited Partnership Ordinance will need to be updated in order for funds to consider adopting Hong Kong as their place of domicile. The proposed legislative changes are by no means a quick fix and it will take the relevant authorities some time to thoroughly consider, and implement, an overhaul of the Limited Partnership Ordinance alongside complementary regulatory and tax positions.

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The changing regulatory environment in China provides an exciting backdrop for lenders, funds and investors in Hong Kong, all of whom are continuing to learn a great deal about the funds market. With investors becoming increasingly sophisticated and developing a greater understanding and appreciation of the available products, it is expected that the fund financing market in Hong Kong will begin to follow the growth and progression seen in the United States and Europe, with the rise of more complicated products and tailor-made solutions, such as NAV and hybrid financings.

* * *

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India

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Overview

India has seen significant investments from Alternative Investment Funds (AIFs) in the last year. As per the reports provided by SEBI, there has been a 78.5% growth in commitments, 113% growth in funds, and a 75% growth in investments made from September 2016 to September 2017. The quarter from July 2017 to September 2017 has seen a 21% growth in commitments, 28% growth in funds and a 10% growth in investments by AIFs.[1] As of September 2017, the foreign direct investment (FDI) inflows into India for the financial year 2017 have increased, in USD terms, by 17%. The total FDI inflow for the quarter ending September 2017 has been USD 19,047 million, of which the equity inflows amount to USD 14,946 million.[2]

In continuation of last year's trend, the Indian government and regulators continue to take steps to ease investments into India. One of the steps in this regard was doing away with the foreign investment promotion board – previously required for approvals for any FDI investments. In addition, for foreign investments, the Reserve Bank of India (RBI) (which is the Indian central bank) has revised the regulations dealing with foreign investments in India.

Fund formation and finance

The process of fund formation and financing has broadly been in line with what was done in the previous year. The fine-tuning of processes for this is ongoing. While we have seen interest in India, competition from other Asian countries for investments continues.

As in the year gone by, leverage / financing structures are prevalent in the Indian market. Most of them involve financing of offshore funds by utilising Indian assets as the collateral. These Indian assets could be in the form of listed shares, real estate, mutual fund units, etc. We have in our experience also seen offshore funds taking leverage against the Indian assets to repay the LPs, or even for dividend distribution to the LPs.

The SEBI has re-organised the debt limits for FPIs. Now, a sub-limit of INR 9.5 billion has been created exclusively for investments by long-term FPIs like Sovereign Wealth Funds (SWFs), Multilateral Agencies, Endowment Funds, Insurance Funds, Pension Funds, Foreign Central Banks etc. investing in the infrastructure sector. This sub-limit is proposed to be enhanced to INR 19 billion on 1st January 2018 – and will be available for on-tap investments. This makes it easier for the long-term FPIs (many of which are also LPs in other funds) to churn their investments across portfolios and create a mix of long-term and short-term investments as may be required.

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Key developments

The securities market regulator in India is the Securities and Exchange Board of India (SEBI). The SEBI has issued several amendments to the AIF regulations in the last year. These amendments are primarily to bring in liquidity and depth – for price discovery and price risk-management, within the markets. For example – Category III AIFs are now permitted to invest in commodity derivatives subject to certain conditions. The investment of the Category III AIF cannot be more than 10% of its investible funds in a single commodity.

In addition, and as a welcome step, these AIFs may borrow / engage in leverage for these trades. Investor consent is required for engaging in commodity trading and for leverage. AIF units can be listed on the stock exchanges in India. This is specific to close-ended AIFs which can list their units after the close of the fund or the scheme, with a minimum tradeable lot of INR 10 million. The process for listing of these units was provided by the stock exchanges during the year. The listing is a two-step process – providing for in-principle approval, and the actual listing and trading of the units. From the context of AIFs, the tax authorities in India brought some cheer regarding the levy of securities transaction tax (STT) on Category I and II AIFs, along with venture capital funds. They are now exempt from paying long-term capital gains if STT was paid at the time of acquisition of the listed shares of a company.

In addition to amendments to the AIF regulatory framework, foreign portfolio investors (FPI) are now permitted to invest in unlisted debt securities. This was previously not permitted by the SEBI. This enabling provision makes investments by funds offshore (registered as FPIs) much easier and makes available a group of companies for which, otherwise, extensive structuring options had to be considered for investment.

As part of the changes that have taken place in the past year, we have seen significant traction on the Insolvency and Bankruptcy Code, 2016 (IBC). The legislation is a ground-breaking law with the kind of results that it has been creating and has the potential to create, in and for Indian businesses / those with exposure to Indian businesses. It is also the first time in India that we have a legislation which provides for resolution of insolvency and bankruptcy. The development of the IBC and its implementation has created a spur within business and fund communities alike. The reason for this is the value that both the businesses and the funds see in entities which are undergoing, or may potentially undergo bankruptcy – resulting in a spurt in control deals, leveraged buy-outs and even trading of distressed loans. The IBC has and is likely to continue to give rise to new partnerships and strategic partners over time to come.

India has also had a major tax reform in 2017. Moving to a goods and services-based tax regime is a mammoth step in terms of India's perception to the world. This, along with the changes to the accounting standards, have together, aided India's progress and perception, resulting in a 34-place jump in the ease of doing business rankings as provided by the World Bank.

The year ahead

In the year ahead, we expect further development and structure to the regulatory landscape in terms of fund management and investments into India. Investments in India continue to be on an up-trend, especially in the context of capital expenditure and acquisition of stressed assets. With the number of funds being set up domestically and funds offshore having an interest in India given its regulatory improvements, we expect funds investing

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in entities which require a turnaround to enjoy increased interest and potentially, provide good returns. For these funds, the IBC has become a game changer. What will really determine whether the game is a good one, is its implementation and interpretation in the courts of law.

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Ireland

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Overview of the Irish funds industry

Overview of the Irish regulated funds market

Ireland is regarded as a key strategic location by the world's investment funds industry. Investment funds established in Ireland are sold in over 70 countries across Europe, the Americas, Asia, Africa and the Middle East. As of August 2017 there were 6,672 Irish domiciled funds with net assets of over €2.25 trillion. While the majority of these fund assets are held in UCITS,[1] Irish-domiciled AIFs[2] had in excess of €521 billion in net assets as of 2017 (representing significant growth in the size of alternative investment funds since last year and, in particular, since the introduction of AIFMD in 2013). The majority of the investment in these regulated investment funds comes from non-Irish institutional investors.

Regulatory framework

The Central Bank of Ireland ("Central Bank") is responsible for the authorisation and supervision of regulated financial service providers in Ireland, including regulated investment funds and investment managers. The powers delegated to the Central Bank are set out in the laws and regulations applicable to the relevant financial services sector. In addition, the Central Bank issues guidance in relation to various aspects of the authorisation and ongoing requirements applicable to financial service providers and investment fund products in Ireland.

Fund structures

Ireland as a domicile provides a variety of attractive fund structures, which can be broadly categorised as regulated by the Central Bank or unregulated.

There are four main types of regulated fund structure in Ireland: (i) variable capital investment companies ("Investment Companies"); (ii) Irish collective asset management vehicles (or "ICAVs"); (iii) unit trusts; and (iv) common contractual funds (or "CCFs"). Each of these regulated fund structures may be established as UCITS or as AIFs. An AIF may also be established as a regulated investment limited partnership (pursuant to the Investment Limited Partnership Act 1994). These structures may be organised in the form of umbrella schemes with segregated liability between compartments ("sub-funds"). The limited partnership established pursuant to the Limited Partnership Act, 1907 is the favoured structure for unregulated investment funds in Ireland.

In the 2017 1st Edition of this book we provided a detailed description of the above structures as well as information on the regulation of Irish funds established as either UCITS or AIFs. As such we do not propose to detail these structures again in this current Edition but instead to provide an update on certain regulatory and market developments affecting the Irish

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funds sector, with a particular focus on developments with a potential impact on fund finance arrangements.

Regulatory and market update

Brexit

Brexit remains the most significant market development impacting the financial services sector in Ireland and across the European Union ("EU"). Britain triggered the Article 50 mechanism to exit the EU on 29 March 2017 and, at the time of writing, over eight months later, it remains to be seen what form Brexit will take. With negotiations continuing on the "Brexit Bill", it would appear that either a hard Brexit (with no passporting rights) or a soft Brexit (with some form of third country equivalency rights) remain possible outcomes. Notwithstanding this uncertainty, UK-based financial services firms have been busily planning for business in a post-Brexit world, with some already having relocated activities to the remaining EU countries. Ireland and other EU countries have received and continue to receive more and more queries from UK-based financial service providers seeking to explore options to relocate some or all of their business, and Ireland is well-positioned to offer an EU solution for UK-based financial services firms.

To the backdrop of a potential raft of relocations by UK-based financial services firms, ESMA has published three sector-specific opinions to promote supervisory convergence in this area. Two of the opinions relate separately to investment management and investment firms and focus on how national regulators in the EU should deal with MiFID investment firms, UCITS management companies, self-managed investment companies and authorised AIFMs that are currently based in the UK and are looking to relocate to within the EU. The third opinion issued in July addresses the perceived regulatory and supervisory arbitrage risks arising from third country trading venues relocating to the EU and looking to outsource investment activities back to their jurisdictions of origin.

In September this year, the EU Commission published draft regulations proposing to give ESMA enhanced supervisory powers in relation to reviewing the delegation arrangements of investment management firms (such as MiFID firms, AIFM, and UCITS management companies). It is difficult not to link these proposals to Brexit and UK-based investment management firms looking to establish similar firms within the EU. At the time of writing, it would appear that the EU Commission's proposed regulations have upset a number of EU member states so it remains to be seen whether the proposals as presented by the EU Commission will be implemented as drafted, but it does seem unlikely at the time of writing.

UK-based lenders are an important source of finance for Irish investment funds. From a fund financing perspective it is important for Irish funds that whatever deal (or indeed no deal) scenario plays out, that Brexit does not impact on the ability of UK-based lenders to continue to provide finance to Irish investment funds and, on a broader basis, to investment funds established within the EU post-Brexit. While the solutions available to lenders post-Brexit will vary depending on their particular circumstances, there is a continuing trend towards lenders exploring the establishment of lending operations in one of the remaining EU countries. Ireland is well placed to benefit from this trend.

Loan origination funds

In the 2017 1st Edition we advised on some of the key features of the Irish loan origination fund (i.e. the loan originating qualifying investor alternative investment fund or "LO-QIAIF") which represents the first dedicated regulatory regime in the EU for loan origination funds. The Central Bank's rules for loan origination funds are set forth in a dedicated chapter

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of the Central Bank's AIF Rulebook. AIFMs that meet the specific conditions relating to LO-QIAIFs will be able to manage the new LO-QIAIF and market it within the EU using the AIFMD passport. The specific conditions applicable to LO-QIAIFs include the requirement that the LO-QIAIF: (i) be closed-ended; (ii) must not have gross assets of more than 200% of its net asset value; (iii) must achieve a diversification of its exposures to any one issuer or group to 25% of its assets within a time frame specified in its prospectus; (iv) does not lend to certain categories of borrower; and (v) that certain 'skin in the game' is maintained in respect of loans acquired from a bank under arrangements that involve the retention by the bank or an affiliate of an exposure correlated with the performance of the loan.

At the inception of this regime, the AIF Rulebook prohibited LO-QIAIFs from engaging in activities other than lending and directly related operations. However, in a welcome development, and following a number of submissions from industry, the Central Bank updated the AIF Rulebook in early 2017 to permit other investments linked to the loan origination strategy and, more specifically, debt and equity securities of entities or groups to which the LO-QIAIF lends or which are held for treasury, cash management or hedging purposes. This added flexibility has meant that the LO-QIAIF is now a much more practical and attractive product for managers and we have seen growth in the numbers of LO-QIAIFs established during the year (particularly in relation to the use of a LO-QIAIF as part of a blended credit allocation).

EU long-term investment funds

The EU regulation on long-term investment funds ("ELTIF") came into force on 9 December 2015 and was implemented into Irish law by the EU (European Long-term Investment Funds) Regulations ("ELTIF Regulations"). In the 2017 1st Edition we advised that the ELTIF has been designed with the intention of increasing the level of long-term investment in the European economy by facilitating investment in asset classes that are too illiquid to be served by existing fund structures. The fact that an ELTIF can be marketed on a passported basis to retail investors across the EU is a significant advantage over other types of AIFs. While the uptake on the establishment of these products has been slow, we have seen indications of interest from some managers and there is certainly potential for growth in this area.

Irish real estate funds (IREFs)

The Irish tax rules changed, with effect from 1 January 2017, to apply a new tax regime in respect of investment funds that invest in Irish real estate and related assets. In effect, where a regulated investment fund derives at least 25% of its value from certain Irish property assets (Irish real estate, shares in unquoted real estate companies, Irish REITs and certain debt securities issued by Irish securitisation companies), then the investment fund is considered to be an "Irish Real Estate Fund" (or "IREF"). An IREF may be required to impose a 20% withholding tax on a percentage of the distribution and redemption payments to investors (other than in respect of certain exempt classes of investors, most notably, Irish taxable investors). As a consequence of these changes many investment funds, assisted by their tax and legal advisers, investing in Irish property assets, had to re-examine their structuring and financing arrangements. As a result of the tax changes, the advantages in using a regulated fund structure to acquire Irish property assets has been somewhat eroded. As such it is possible that the use of Irish AIFs to purchase Irish property will decline going forward in favour of the use of non-regulated corporate structures.

Indeed, the new tax rules provided for two restructuring options which appeared to encourage such transactions. The first was a provision which exempted from stamp duty the transfer of

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the property rental business of an IREF to an Irish REIT (which are generally exempt from tax on rental income and gains), provided this was done before 31 December 2017. Further, transfers of land/business of an IREF to a non-regulated corporate structure prior to 1 July 2017 were also deemed exempt from stamp duty provided the transferee company issued shares to the shareholders in the IREF as consideration for the transfer.

Security update

In the 2017 1st Edition of this publication we referenced the typical security package(s) that we would most commonly see being used in Irish transactions. Before deciding on the final lending and security structure, it is of critical importance that the requisite due diligence is undertaken. In this update we focus on some issues which lenders should bear in mind in undertaking their due diligence for subscription facilities.

(a) *Power and authority to borrow and give security*

Subject to any leverage limits, as mentioned below, most non-UCITs funds will have broad powers, in their constitutional documents, to borrow and create security. For a subscription call facility, it is preferable that the constitutional documents, when describing the assets over which security can be taken, explicitly refer, for example, to "unfunded capital commitments". But even where they do not, the lender should be satisfied if the constitutional documents refer to the fund's ability to create security over all of its "assets", as the unfunded capital commitments will constitute an asset of the fund.

Borrowing and leverage limits

As referenced above, there are a variety of available fund structures in Ireland, ranging on the regulated side from Investment Companies, ICAVs, Unit Trusts and CCFs to Limited Partnerships on the unregulated side. The constitutional documents of each type of fund, while bearing similarities to each other, can be quite different and need to be carefully reviewed to establish who has the authority to borrow and provide security on behalf of the fund. Such authority should reflect the legal structure of the fund and should be set out in the relevant constitutional document. Typically, the following parties will have authority to borrow and provide security on behalf of a fund:

- **Investment Company**: The directors of the Investment Company.
- **ICAV**: The directors of the ICAV.
- **Unit Trust**: The Manager commonly has the power to borrow and frequently also has the power to create security, although this varies and sometimes requires execution by the Trustee.
- **CCFs**: As per Unit Trust above.
- **Limited Partnership**: The General Partner.

Regulated Irish funds may be established as umbrella funds with one or more sub-funds and segregated liability between sub-funds. Importantly, the sub-funds do not have a separate legal personality so the finance documents are typically entered into by the corporate entity itself in the case of a corporate fund such as an Investment Fund and ICAV; the Manager in the case of Unit Trusts and CCFs; and the General Partner in the case of the Limited Partnership. In each case, the relevant entity is acting for and on behalf of the relevant sub-fund and this should be reflected in the finance documents. Segregation of liability means that the assets of one sub-fund cannot be used to satisfy another sub-fund's liabilities or *vice*

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versa. This is achieved by statute in the case of Investment Companies and ICAVs, and by contract in the case of Unit Trusts, CCFs and Limited Partnerships. While statute implies the concept of segregated liability in every contract entered into by Investment Companies and ICAVs, it is customary practice to include segregated liability language into any finance document to which the Irish fund is a party, irrespective of its legal form.

(b) *The constitutional documents – Due diligence*

Irish funds may be open-ended, open-ended with limited liquidity, or closed-ended. In the context of a capital call facility (in the case of closed-ended funds or limited liquidity funds with a capital commitment structure), it is crucial to understand: (i) the subscription process, including who can make calls on investors; (ii) who determines the price at which units or shares are issued and by what means; (iii) when capital calls can be made on Investors; (iv) what an investor can be asked to fund; (v) the implications of an Investor not funding a capital call; and (vi) what account are subscription proceeds paid to?

(i) The subscription process, who can make calls?

The agreement between the fund and the investor in relation to subscription is typically enshrined in a subscription or capital call agreement. This tends to be a relatively short document, but must be read in conjunction with the constitutional documents. Most commonly it is the fund through its directors who will be authorised to make the calls on investors, although this is sometimes a role which is delegated by the directors to the Administrator. For entities such as a Unit Trust or a CCF, which are constituted by deed between the Manager and the Trustee/Depositary, it is usually the Manager who is authorised to make calls.

(ii) How and who determines the price at which units or shares are issued?

For Irish regulated funds it is not just the fund itself acting through its directors that has a role. Other service providers such as the Administrator of the fund also play a crucial role. The Administrator in an Irish regulated fund assumes, for example, the role of calculating the Net Asset Value ("NAV") of the fund and its units/shares. This calculation is crucial in determining the number of units/shares that will be issued to the investor in return for their subscription/capital call proceeds. Once the proceeds are received, the Administrator will then issue all of the relevant shares/units to each relevant investor. In Irish regulated funds, the constitutional documents commonly provide that physical unit/share certificates are not issued but rather the unit holder/shareholder register is evidence of ownership. Due to the important role played by the Administrator, it is common that an Administrator side/control letter is obtained as part of the security package.

(iii) When can calls be made on investors?

Calls are typically made on a Dealing Day, which will be a defined term in the constitutional documents. It is important to check this definition accommodates calls being made by the lender, if they need to, on a future enforcement. The definition of Investment Period is also relevant in this regard. Many constitutional documents only permit calls to be made during the Investment Period, subject to limited exceptions, for example where the call is made to satisfy sums due for an acquisition which has contracted but did not complete prior to the expiry of the Investment Period. As noted above, one of the key first steps in making a call is for

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the Administrator to determine the NAV and how many units/shares will be issued. The constitutional documents must be carefully reviewed to determine what events are specified, the occurrence of which gives the directors the right to suspend calculation of the NAV. The concept of suspension is an important safeguard for the fund to deal with, for example, *force majeure* market events which prevent the fund from valuing a substantial portion of the assets of the fund, or generally where it is deemed in the best interests of the investors in the fund. However, in practice, while the NAV is suspended, calls cannot be made. A suspension of the NAV where enforcement is necessary is not ideal!

(iv) What can an investor be asked to fund?

As you would expect, investor calls are primarily made to fund the acquisition of investments. Preferably the constitutional documents should also explicitly permit calls to be made to repay sums due to the lenders. Importantly, most Irish funds will operate on the basis that *pro rata* calls are made on investors. This may not be explicit in the constitutional documents, and sometimes may be reflected in an investor side letter.

(v) What are the implications of an investor not funding a subscription call?

The constitutional documents and/or the Subscription Agreement will usually provide for a period of time in which the investor must remit the call proceeds. If they are not received in that period, the documents will commonly provide that the fund may then issue a default notice and if the default is not remedied within any applicable remedy period, the fund will have the right to charge default interest and ultimately to realise the defaulting investors shares/units to meet the call. From a lender perspective, the constitutional documents need to be checked to determine if they contain "overcall" provisions. Such provisions permit the fund to call on the other investors to fund another investor's defaulted call, subject of course to the investors' maximum commitment not being exceeded. As noted above, this needs to be carefully considered in the context of any potential conflict with any "*pro rata*" call provisions in the constitutional documents, any side letter or the commercial practice of the particular fund. The constitutional documents should also be checked to determine if the investor has any right of set-off in respect of unpaid calls against amounts that may be owed by the fund to the investor.

(vi) What account are subscription proceeds paid to?

A key part of the security package for this type of facility is security over the Subscription Proceeds Account. There can be some variation between funds as regards how and in whose name their bank accounts are established. For example, it may be in the fund's name, which is the most straightforward position from a lender's perspective, but may also be in the Administrator's or the Depositary's name. The bank account mandates should also be checked to see who has signing rights. Appropriate control arrangements should also be considered, to include the above-referenced service providers, where necessary.

(c) *The Subscription Agreement, Investor Side Letters and Notice of Security*

As mentioned above, the typical Subscription Agreement is quite short but it is a crucial document. As part of the security package, security is taken over the fund's rights therein by way of security assignment. The Subscription Agreement and any side letters need to be checked to ensure there are no prohibitions or restrictions on

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such assignment. Upon execution of the security, an equitable assignment is created as a matter of Irish law. From a priority perspective, however, it is better to convert this to a legal assignment. There can be some reluctance on the part of the fund to have notices of assignments sent to investors and relevant acknowledgments obtained, particularly where there are a large number of investors. In this regard, some lenders will agree that notices are not served until a future Event of Default. One possible compromise between these two positions is that the relevant notice of creation of security is communicated in the next investor communication.

The year ahead

In the coming year, Brexit, whether a hard or softer version, and its consequences, will continue to loom large over the financial services sector (and beyond) throughout the EU. As the negotiations of Brexit have progressed and continue to progress over the coming year, Ireland, which has close strategic links with the UK, is watching developments closely, and will need to adapt and be ready for the likely outcome of these negotiations. From a fund financing perspective, it is important that UK-based lenders put appropriate arrangements in place to ensure that they maintain and can continue to grow their lending to Irish and other EU-based investment funds post-Brexit.

* * *

Endnotes

1. Established pursuant to the European Communities (Undertakings for Collective Investment in Transferable Securities) Regulations, as amended.
2. Alternative Investment Funds established pursuant to the EU (Alternative Investment Fund Managers) Regulations 2013.
3. AIF Rulebook, March 2017.

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Jersey

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Overview

An international financial centre (**IFC**) of choice for global investments into the UK and Europe, as of Q2 2017 (30 June) Jersey was home to approximately 1,141 funds with an aggregate of net assets under management of GBP 263.4 billion placed in 1,963 separate pools.[1] In comparison, figures as at Q3 2016 (30 September) showed a total of 1,125 funds with an aggregate of GBP 237.3 billion of assets under management, placed in 2,001 separate pools.

Apart from normal fluctuations typical in the funds market, these figures indicate that while the number of funds and pools has slightly diminished over these two quarters, assets under management have increased by GBP 25 billion. This trend is consistent with the wider market, and Jersey's fund-friendly regulatory approach, which helps to push investments and maintain solid investor confidence despite prolonged global economic and political uncertainty.[2]

There are many reasons for the continuing confidence in Jersey: as an IFC, the island has been economically and politically stable for decades and in 2017 Jersey was awarded "International Financial Centre 2017" at the Wealth Briefing European Awards 2017.[3] This award acknowledges the leading role Jersey has carved out for being close to the pulse of upcoming regulatory changes, such as the OECD's "Base Erosion and Profit Shifting" framework (**BEPS**) or the EU's "Alternative Investment Fund Managers Directive" (**AIFMD**), and steps it has taken in recent months to overhaul the private fund regime on the island.

While Jersey still ranks behind the big onshore fund jurisdictions such as Ireland, Luxembourg and Delaware and some of the offshore ones like the Cayman Islands[4] with regard to number of funds or assets under management, the island remains a very popular choice for real estate, hedge and private equity funds. Jersey has been commended for its proactive stance in adopting global compliance standards by the European Securities and Markets Authority (**ESMA**), the OECD, EU and the IMF as a well-regulated IFC. ESMA has confirmed on a number of occasions that there are no objections to Jersey being granted the AIFMD "passport",[5] allowing Jersey funds to conduct business in all EU member states, but, primarily as a result of Brexit, final approval is still awaited. This gilt-edged reputation becomes increasingly important to fund managers, promoters and investors, who wish to ensure that their fund is domiciled in a business-friendly jurisdiction, which not only protects and grows their assets, but also protects their reputation.

In addition, BEPS and AIFMD increased the importance of substance for funds and fund managers, with much more need to demonstrate an economic reality where the relevant expertise and people who manage the fund and hold the assets are based locally. This gives Jersey, with its 13,000-strong financial sector workforce (over 2,000 directly specialising

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in funds matters[6]) and well-developed local infrastructure, an edge over competitor jurisdictions who have adopted more of a brass-plate approach, and who may not be able to comply with substance requirements as readily as Jersey.

Notwithstanding Brexit's suppressing influence on activity generally, the weak pound has led to a significant increase in the number of market participants using Jersey as a base for rest-of-the-world transactions, particular those based in the US.

Fund formation and finance

Fund formation: More clarity for private funds in 2017

Jersey regularly revisits its existing regulatory toolbox in order to make sure that it can offer products which the financial services community needs to conduct international business effectively.

As a result, Jersey is continuing with its plans to introduce a manager-led fund product called the JRAIF (see para below, 'JRAIF') and the Jersey Financial Services Commission (**JFSC**) (the island's regulatory body) has simplified and completely overhauled the existing private fund and unregulated fund landscape.

The 'Jersey Private Fund Guide', published by the JFSC, sets out the eligibility criteria for a Jersey Private Fund (**JPF**). From April 2017, the JPF replaced all existing private and unregulated fund vehicles (including Very Private Funds, Private Placement Funds (**PPFs**) and COBO-only funds) none of which are now available for new funds. Existing funds may continue in their current form until the end of their natural life, or may apply to the JFSC to convert into a JPF.

The Jersey Private Fund Guide provides greater clarity on the authorisation process for a private fund in Jersey, specifically in relation to the eligibility conditions and regulatory approach needed, when a fund is offered to 50 or fewer investors. It introduces a fast-track 48-hour approval process for such funds and allows a JPF to be closed-ended or open-ended (subject to the 50 or fewer investor test).

Eligible investors include those who invest or commit no less than GBP 250,000 (or currency equivalent); holders of non-participating interests; holders of management/founder interests; and holders of interests giving an entitlement to performance fees for the management team. Direct investment by retail investors is prohibited and all investors must acknowledge in writing the receipt and acceptance of a prescribed investment warning. These new requirements form the basis of a universal "professional investor" definition which will be utilised across all Jersey funds and replace existing definitions, which vary slightly from regime to regime.

Taking security over fund assets

The fund structures most commonly used in Jersey are companies, limited partnerships or unit trusts. Depending on the vehicle used for the fund, the powers of the fund manager and the terms of the constitutional documents for the fund, it may be necessary to obtain prior consent from shareholders, partners, trustees or custodians before security can be granted over fund assets.

In some cases, a fund may be structured in such a way that granting security is prohibited or that only certain assets may be covered or certain types of security be given. However, it is usually possible to negotiate amendments to the articles of association, partnership agreement or trust instrument if all parties concerned deem it in the best interest for the proper performance of the fund that security should be granted.

Security is documented in a security interest agreement (**SIA**) and governed by the Security

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Interests (Jersey) Law 2017. Perfection requirements for a Jersey law-governed security depend on the security: documentary intangibles like negotiable instruments or bearer securities are perfected by possession; investment securities (including shares) or security over bank accounts is perfected by control over the relevant account or investment; or security interests in receivables are registered on the Security Interests Register (**SIR**). The most common form for security perfection is registration. Where possible, it is also best practice to perfect by means of control as this has preferential treatment in terms of priority. Perfection by control is usually obtained only in respect of bank account security in fund finance transactions, as it is not possible to perfect security over call rights by control and share, and unit security (where control is possible) is not common as a result of the heavy involvement required of the investors.

A registration fee of currently GBP 150 is payable for each security registered on SIR. No other stamp duties, taxes or registration fees are due in Jersey for the taking and registration of security. With regard to funds, lenders commonly take as transaction security:

Examples of security

Collateral	Market practice comment	Usual perfection method(*)
Call rights	Investors are usually notified of the security interest and asked to sign an acknowledgment of the notice. The acknowledgment acts as "estoppel" argument, but is not required to perfect the security interest.	SIR registration
Bank accounts	Notice and acknowledgment from the account bank are usually obtained. The account bank acknowledges that it will not agree to the creation of any other security interest in the accounts. In this context, a "bank account" could be a deposit account or a portfolio/securities account.	Control over bank account and/or SIR registration
Shares	Notices and acknowledgments are generally obtained. Share certificates and blank share transfer forms are delivered at completion.The entity granting security may be asked to annotate its register of members by inserting a notice that security has been granted over the shares.	SIR registration or, in the very rare case of bearer securities, possession
Units (for unit trust structures)	Notices and acknowledgments are generally obtained. Unit certificates and blank unit transfer forms are delivered at completion.	SIR registration
Contract rights regarding a custodian agreement	Notice is served on the custodian and acknowledgment obtained. This is important so that the custodian agrees to follow the instructions of the secured party as regards the underlying collateral. This is generally combined with a security over any relevant portfolio/security account.	Possession of agreement which assigns the contractual rights + possession of the custodian's acknowledgment

(*) *Perfection by taking control is usually achieved by:*

Perfection by taking control of a bank account is achieved by:

- the bank account being transferred into the name of the secured party;
- the secured party also being the account bank;
- the account bank agreeing in writing to the instructions of the secured party; or
- the assignment of the bank account to the secured party.

Perfection by taking control of a securities or custody account is achieved by:

- the account being transferred into the name of the secured party;

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- the secured party also being the intermediary; or
- the intermediary agreeing in writing to agree to the instructions of the secured party.

In relation to investment securities, perfection can be achieved by:

- the secured party being registered as the holder of such securities; or
- the secured party being in possession of the relevant instrument or certificate.

Lending to funds in Jersey

In general, there is no legal or regulatory impediment to lending to funds in Jersey. The fund manager and directors of the fund can agree limits and restrictions in the constitutional documents of the fund and the investment manager agreement, if they so choose. In particular, the ability of the fund manager to borrow additional sums or grant security over the fund's assets is an important commercial point to consider.

Under the previous private and unregulated funds regime (which still represents the vast majority of funds), there are no regulatory restrictions on borrowing for Very Private Funds, funds under the Private Placement Funds Regime, and Unregulated Funds. The same is also true for JPFs.

For Expert Funds, Listed Funds and Eligible Investor Funds, no legal restrictions are set in stone but the JFSC reserves the right to additional scrutiny if the fund is permitted to borrow money in excess of 200% of its net asset value.[7]

Unclassified Collective Investment Funds are regulated by the JFSC, which provides guidance on borrowing restrictions of the following fund types:[8]

Guidance on borrowing restrictions

Fund type	Limits on borrowing
General Securities Fund	Not more than 25% of the fund's total net asset value.
Fund of Funds	May borrow up to 10% of its total net asset value, but only on a temporary basis for the purpose of meeting redemption requests or defraying operating expenses.
Feeder Fund	May borrow up to 10% of its total net asset value, but only on a temporary basis for the purpose of meeting redemption requests or defraying operating expenses.
Money Market Fund	May borrow up to 10% of its total net asset value, but only on a temporary basis for the purpose of meeting redemption requests or defraying operating expenses.
Warrant Fund	May borrow up to 10% of its total net asset value, but only on a temporary basis for the purpose of meeting redemption requests or defraying operating expenses.
Real Property Fund	May borrow for the purpose of purchasing real property and for short-term purposes like defraying expenses or facilitate redemption. The maximum aggregate amount which may be borrowed is 35% of the total net asset value. Borrowing for the purpose of purchasing real property must not exceed 50% of the purchase price of the real property. For real property funds with a net asset value of less than GBP 5 million, and esp. during the early life of the fund, some relaxation from the above limits may be granted by the JFSC.
Futures and Options Fund	To be discussed with the JFSC.
Guaranteed Fund	To be discussed with the JFSC.
Leveraged Fund	To be discussed with the JFSC.

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Fund finance market – latest thoughts: Substance

In light of BEPS, AIFMD and the Panama Papers, the funds world (not only in IFCs) sees a continued focus on substance. In order to take advantage of appropriate tax benefits, regulatory exemptions or reduced compliance burdens, it is more and more important that funds and fund managers can demonstrate substance. This means that there is also more importance on what the economic reality of a corporate structure looks like, where fund managers, administrators and key decision-makers are based, where economic value is being created and to whom relevant staff report.

Questions of physical location become important:

- Where do senior personnel involved in the fund's management reside?
- Where is portfolio and risk management undertaken?
- Where are the meetings being held at which the decisions for day-to-day running of the business are made?

It is also worth looking closer at Article 82 AIFMD,[9] which aims to curb the use and abuse of letterbox entities: it is more important than ever for alternative investment fund managers to retain staff of sufficient experience, seniority and decision-making power to conduct the business of running the fund successfully. They should also provide their own oversight instead of only taking instructions from an onshore manager. Senior management functions should not be relinquished to other decision-makers, wherever they are based.

It is also vital that any amount of delegation the fund manager may deem appropriate is not so much that it could be argued the fund manager has "by a substantial margin" divested itself of the key functions which make it the fund manager. When delegating, the fund manager must also ensure that it does not lose "[…] *contractual rights to inquire, inspect, have access or give instructions to its delegates or the exercise of such rights becomes impossible in practice.*" (Article 82.1(c) AIFMD).

As a "substance" jurisdiction, Jersey's financial services and legal industry is very well developed and has the necessary manpower and expertise to show the required degrees of substance. Proactive legislation also ensures that where required, Jersey will insist on relevant personnel and business vehicles being based in Jersey while still remaining open for global flexibility and administrative ease wherever possible.

Key developments in the Jersey fund landscape

Loan-originating funds (LOF)

The popularity of LOFs (which offer to act as third-party lenders and provide alternative sources of capital) continues to grow with a number of jurisdictions introducing specific regulatory treatment to match demand. It is estimated that since 2010, the number of funds engaged in lending activities has risen steadily and looks to become about 20% to 30% of the lending market.[10]

In Jersey, provided that the JFSC is satisfied that the fund will not provide capital to people or other financial institutions, the regulatory treatment of LOFs is flexible but the JFSC will likely require that:

- the fund was established as an "Expert Fund" under the Jersey Funds Guide;
- it is a closed-ended fund;
- it does not lend to natural persons, its own management, depositaries or other investment funds;

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- it complies with the JFSC's Sound Business Practices Policy; and
- it includes in its offer document the appropriate risk warnings and complete details about its credit procedures, permitted activities and their risks, eligible borrowers, stress testing, liquidity, leverage, diversification and periodic investor reports.[11]

As each LOF is likely to be different, the JFSC will assess on a case-by-case basis.

Crypto-currency funds

Research suggests that crypto-currencies form an independent asset class with unique characteristics, making them particularly attractive for investors with an interest in the Fintech market.[12] A further example of Jersey funds' creativity when considering alternative asset classes is the successful world premiere listing of Jersey-based fund "Global Advisors Bitcoin Investment Fund plc" on the Channel Islands Securities Exchange,[13] a fund established with the blessing of the JFSC.

Virtual currencies like Bitcoin are still often poorly understood by the law and regulators and therefore met with varying degrees of scepticism or refusal of regulatory approval. Against this trend, Jersey regulators are keen to build on the island's strong reputation as a Fintech hub. This is well illustrated by its recent adoption of a specific regulatory regime for virtual currencies and those who provide virtual currency exchange services[14] while incorporating a turnover-based sandbox to ensure innovation in these key areas is not stifled.

Jersey continues to monitor and engage with regulatory developments in Australia, Canada, Germany, Hong Kong, the UK and the US, all countries which have decided to take a proactive approach to crypto-currencies and harness their economic potential.

JRAIF

In consideration of AIFMD and reacting to the demand for fund products which saw Luxembourg successfully take off with the Reserved Alternative Investment Fund (**RAIF**), Jersey reviewed its fund landscape and has taken steps to introduce the Jersey Registered Alternative Investment Fund (**JRAIF**) later in 2017/18, which is expected to provide investors with an impressive new vehicle, which can flourish even further once the AIFMD passport is granted.

Under AIFMD, the regulatory focus switched from regulation of the fund to regulation of the fund manager. However, this also introduced the risk of "double regulation", where a fund and its manager are both required to comply with regulatory demands, adding administrative cost, delay and complexity. As a non-EEA jurisdiction, Jersey is not as affected by this as e.g. Luxembourg or Ireland but, given Jersey's strong commercial links to EU member states, it is important to not only offer AIFMD-compliant regulatory regimes but also fund products that make the best out of that regime.

Being a manager-led product, the JRAIF is aimed at professional and sophisticated investors and will be supervised directly by the alternative investment fund manager, who in turn is authorised and supervised by the JFSC. Unlike in other fund structures, with the JRAIF the alternative fund manager is responsible for ensuring the JRAIF's compliance with the AIFMD. This also means that no JFSC approval, either prior to launching the fund or thereafter, will be required. The JRAIF will not be required to adhere to the code of practice for certified funds.

It is thought that the JRAIF provides a pragmatic compromise between appropriate regulatory supervision of financial vehicles and providing relief to investors, who are often stuck with the costs of dual regulation and compliance. After all, a fund is essentially a pooling vehicle and if that vehicle has been set up and is managed by an appropriately regulated and supervised fund manager, there is little need to add additional regulatory

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requirements to the vehicle itself. Furthermore, it should not be forgotten that not only the fund manager is regulated but the fund's and fund managers' lawyers, bankers, accountants, custodians and administrators are also regulated persons.

The year ahead: A glimpse into the future of Jersey funds for 2018/19

If 2016 and 2017 showed us anything, it was how tough it is to make any accurate predictions about politics, trade, regulatory matters or market developments.

However, a few points may influence fund activity further:

Firstly, as a non-EEA country, Jersey funds can offer their investors separate regimes, depending on whether they wish to access EU capital or not. A choice exists between fully EU/EEA independent regimes, targeted "private placement regimes" with individual EU countries, or, once the AIFMD passport is granted, full access to EU member states under AIFMD. However, some EU countries like Germany have already indicated that "private placement regimes" will have to go once passporting rights are in place.[15] If this comes to pass (and for which countries) remains to be seen.

Secondly, Jersey became a BEPS Associate on 19 June 2016 and committed to country-by-country reporting standards. Legislation on country-by-country reporting for BEPS came into force on 21 December 2016.[16] Jersey has also recently signed the OECD Multilateral Convention on the prevention of BEPS, alongside more than 60 jurisdictions, which will allow Jersey to strengthen its tax treaty network.[17] This is a further indicator that Jersey remains committed to BEPS' and AIFMD's substance requirements. Funds in Jersey (if they aren't already) will increasingly have to be mindful of where their key decision-makers are located, risk-management takes place, assets are held and employees and management reside. It is also thought that Jersey as a reputable "substance jurisdiction" will become increasingly attractive to investors who wish to access the EU markets using the benefits of offshore vehicles and expertise without needing to worry about regulatory or reputational concerns onshore.

Thirdly, President Donald Trump made statements to the effect that he supports further de-regulation of the US funds market, in particular by repealing or heavily amending the Dodd-Frank Act and the Volcker Rule.[18] Since such statements, the Treasury Department has released a report recommending a reworking of such rules that were put in place after the financial crash of 2008. This would lead to many advisers of private funds no longer being required to register with the Security and Exchange Commission. It is unclear whether deregulation in the US would have a tangible competition effect on funds in jurisdictions like Jersey, which comply with higher regulatory and compliance standards than President Trump favours. But as IFCs like Jersey are very much global businesses, any such development deserves to be carefully monitored.

Lastly, Brexit: while Jersey is neither part of Great Britain nor an EU member state, it enjoys close links with both.[19] From a funds perspective, the close working relationship between Jersey's financial sector and the major players in the City of London is important. Any substantial disadvantage the UK's finance industry may suffer would require Jersey to adopt appropriate protective measures, including a further strengthening of its ties with the Middle East, Asia and key EU member states like Germany, Italy and France as well as the US. The fund landscape may also be somewhat re-shaped if more financial services businesses move from London into Luxembourg, Dublin, Frankfurt or Paris.

Media coverage of Britain's preparation for Brexit is extensive but unfortunately, neither the conduct of the British media nor the British government allows for a reasoned and well-

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grounded opinion at present. It is very much in Jersey's interests that the Brexit negotiations deliver a beneficial outcome for all parties concerned.

* * *

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James Gaudin is a partner within the Corporate department and leads the structured finance team in Jersey. He specialises in all areas of offshore corporate, finance and restructuring work.

His extensive experience covers banking and asset finance, real estate investment structures, public and private debt and equity issues, securitisations, repackagings and initial public offerings, as well as structures involving Jersey limited partnerships and unit trusts. More recently, James has advised on some of the largest corporate restructurings to have occurred in the Jersey market. He also advises banks and other global financial institutions in relation to the Jersey elements of complex cross-border insolvencies.

Prior to joining Appleby in August 2010, he spent six years in the capital markets and structured finance team at a Jersey-based offshore firm, before joining another major offshore firm where he was a group partner and head of corporate in Jersey. Before returning to Jersey, James worked with Hemmington-Scott in London for four years, latterly as Head of Treasury and Banking.

James was recognised in 2017 by *The IFLR1000* as highly regarded in the areas of finance and corporate. Clients told *The IFLR1000* that James is "first class", "very good" and "really helpful and commercial". James has also appeared in *The Legal 500* UK 2016 recommended lawyer list. He has been commended by *The Legal 500* for his "practical advice", "availability" and "excellent responses".

James has contributed to numerous publications, and regularly presents to conferences, seminars and clients. He also participates in numerous industry steering and consultation groups.

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Paul Worsnop is an Associate in the Corporate department in Jersey and works closely with James Gaudin, servicing both fund managers and lenders in connection with high-value, secured and unsecured, capital call facilities. In the past 12 months, he has advised in relation to over €5bn of finance provided to funds established in Jersey.

Paul joined Appleby in June 2016 from a leading international law firm and has an active practice in general funds advice and corporate and real estate finance.

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Luxembourg

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Overview

Luxembourg has developed into the second-largest fund centre in the world, with €3,957bn of assets under management.[1] This volume has been driven mainly by Luxembourg's success in positioning itself as the leading jurisdiction for undertakings for collective investment in transferable securities (**UCITS**). In recent years, a second pillar of funds has been developing markedly, namely investment funds focusing on so-called alternative asset classes, including private equity, real estate/infrastructure and debt, dedicated to a sophisticated and/or institutional/professional investor base.

Concurrently with the surge in the alternative investment funds market, Luxembourg has seen a significant development in fund finance activity, supported by the possibility of implementing efficient security packages in the context of credit facilities for funds. The recent years have been particularly active as regards fund finance transactions in Luxembourg, with positive growth and strong credit performance. While capital call subscription credit facilities and bridge facilities are still used and continue their steady growth, permanent leverage facilities have become increasingly popular.

Fund formation and finance

Legal overview – fund formation

When selecting Luxembourg as their hub for setting up their investment fund, initiators generally opt for either a non-regulated ordinary commercial company (**SOPARFI**) or one of the following (regulated and non-regulated) alternative investment fund (**AIF**) regimes:

- an investment company in risk capital (**SICAR**), based on the law of 15 June 2004, as amended, on the risk capital investment company (**SICAR Law**) (the SICAR is a vehicle specifically dedicated to private equity and venture capital investments, whether diversified or not);
- a specialised investment fund (**SIF**), based on the law of 13 February 2007, as amended, on specialised investment funds (**SIF Law**);
- a reserved alternative investment fund (**RAIF**), based on the law of 23 July 2016 on reserved alternative investment funds (**RAIF Law**); or
- an undertaking for collective investment (**UCI**), based on Part II of the law of 17 December 2010, as amended, on undertakings for collective investment (**Part II UCI**) – given the declining popularity of Part II UCIs with fund initiators (in light of the flexibility of the other available alternative investment fund regimes), this article will not cover any particular aspects related to funds formed as Part II UCIs.

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On the basis of Directive 2011/61/EU of the European Parliament and the European Council of 8 June 2011 on alternative investment fund managers (**AIFMD**), implemented in Luxembourg by the law of 12 July 2013 on alternative investment fund managers (**AIFM Law**), whose impact on financing transactions taking place within the framework of investment funds will be discussed below, an AIF is defined as a collective investment undertaking, or its compartments: (i) which raises capital from a number of investors; (ii) with a view to investing it in accordance with a defined investment policy for the benefit of those investors; and (iii) which is not covered by EU Directive 2009/65/EC on UCITS.

While the RAIF is an AIF within the meaning of the AIFM Law by virtue of the RAIF Law (and must accordingly appoint an authorised alternative investment fund manager (**AIFM**) as well as a depositary), the SICAR and the SIF are deemed to be AIFs (and required to appoint an AIFM), unless they qualify for one of the exemptions under the AIFM Law.

It is important to note that any unregulated SOPARFI will be considered as an AIF if it fulfils all the above criteria, thereby triggering the application of the AIFM Law, including the obligation to appoint an AIFM and a depository in respect of the assets held by the SOPARFI (except if such SOPARFI is managed by an Exempted AIFM (as defined below)). This is even more relevant, as Luxembourg has taken advantage of the AIFM Law to modernise the existing Luxembourg corporate and limited partnership forms and introduce a new special limited partnership without separate legal personality, thereby setting the stage for the use of Luxembourg unregulated limited partnerships as fund vehicles.

Insofar as the AIFM Law applies, an AIFM may freely market the AIFs it manages to professional investors (within the meaning of EU Directive 2004/39/EC, as amended (**MiFID**)) in the European Union.

Leverage under the AIFMD and the AIFM Law

While non-regulated SOPARFIs, SICARs, SIFs and RAIFs are not subject to any legally imposed limits with regard to leverage, insofar as those vehicles qualify as AIFs and are considered as leveraged, the AIFM Law may nevertheless need to be taken into consideration.

- *Meaning of leverage*

The AIFM Law defines leverage as any method by which the AIFM increases the exposure of an AIF it manages, whether through borrowing of cash or securities, leverage embedded in derivative positions, or by any other means.

The AIFMD gives the European Commission the power to adopt delegated acts to specify the methods of leverage as defined in the AIFMD, including any financial and/or legal structures involving third parties controlled by the relevant AIF when those structures are specifically set up to directly or indirectly create leverage at the level of the AIF. It is important to note, in particular for private equity and venture capital funds, that leverage existing at the level of a portfolio company is not intended to be included when referring to those financial or legal structures.[2] The Commission has also used its powers under the AIFMD to clarify that borrowing arrangements entered into by an AIF are excluded from the leverage calculations if they are (i) temporary in nature, and (ii) fully covered by capital commitments by investors (i.e. a contractual commitment by an investor to provide the AIF with an agreed amount of investment on demand by the AIFM).[3] The Commission's Level 2 Regulations give details of the method to be used by AIFMs to calculate leverage in respect of the AIFs they manage.

- *Impact of leverage under the AIFMD and the AIFM Law*

Any leverage at the AIF level may affect whether or not the AIF must appoint an authorised AIFM and a depositary.[4] Under the AIFM Law, any vehicle qualifying as an AIF must

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appoint an AIFM, but a lighter regime applies to AIFMs managing: (i) AIFs whose total assets under management (**AuM**), including any assets acquired through use of leverage, do not exceed a threshold of €100m; or (ii) AIFs whose total AuM do not exceed a threshold of €500m which are unleveraged and have no redemption rights exercisable during five years following the date of the initial investment in each AIF (each a *de minimis* exemption).

AIFMs qualifying for a *de minimis* exemption (the **Exempted AIFMs**) must nonetheless register with the relevant supervisory authority of their home Member State (the **Regulator**). When registering, Exempted AIFMs must identify the AIFs they manage and provide the Regulator with information on their investment strategies. Once registered, Exempted AIFMs must regularly (at least annually) provide the Regulator with information on the main instruments in which they are trading, the principal exposures and the most important concentrations of the AIFs they manage, in order to enable the Regulator to monitor systemic risks effectively. If Exempted AIFMs cease to qualify for the *de minimis* exemption, they must notify the Regulator accordingly and apply for a full authorisation.

The AIFM Law also requires AIFMs to set a maximum level of leverage which they may employ on behalf of each AIF they manage, as well as the extent of the right to re-use collateral, or guarantees which could be granted under the leverage arrangement.

For each AIF they manage which is not an unleveraged closed-ended AIF, AIFMs must employ an appropriate liquidity management system and adopt procedures which enable them to monitor the AIF's liquidity risk and ensure that the liquidity profile of the investments of the AIF complies with its underlying obligations. They must regularly conduct stress tests, under normal and exceptional liquidity conditions, which enable them to assess the AIFs' liquidity risk, and monitor that risk accordingly.

The AIFM concerned must provide investors with disclosures in respect of the AIF in which they intend to invest, including, but not limited to, a description of the circumstances in which the AIF may use leverage, the types and sources of leverage permitted and the associated risks, any restrictions on the use of leverage and any collateral and asset re-use arrangements, and the maximum level of leverage which the AIFM is entitled to employ on behalf of the AIF. In addition, AIFMs managing EU AIFs employing leverage or marketing AIFs employing leverage in the EU must disclose, on a regular basis for each such AIF: (i) any changes to the maximum level of leverage which the AIFM may employ on behalf of the AIF, plus any right to the re-use of collateral or any guarantee granted under the leveraging arrangement; and (ii) the total amount of leverage employed by that AIF.

In addition to the disclosures to be made, AIFMs must also provide the competent authorities of their home Member State with information in respect of the AIFs they manage. In this context, AIFs employing leverage on a substantial basis must make available information on the overall level of leverage employed by each AIF they manage, a break-down between leverage arising from borrowing of cash or securities and leverage embedded in financial derivatives, and the extent to which the AIFs' assets have been re-used under leveraging arrangements. This information includes the identity of the five largest sources of borrowed cash or securities for each of the AIFs managed by the AIFM, and the amounts of leverage received from each of those sources for each AIF. For non-EU AIFMs, the reporting obligations referred to in this paragraph are limited to EU AIFs which they manage and non-EU AIFs which they market in the EU.

Structuring the security package

Credit facilities relating to funds are typically secured by the unfunded capital commitments of the funds' investors. These facilities are subject to a borrowing base determined by the value

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of the pledged/assigned investors' commitments satisfying certain eligibility requirements. Investors' commitments relating to Luxembourg funds may be structured in different ways and they may take the form of equity capital commitments (i.e. to make equity contributions to the fund) and/or debt capital commitments (i.e. to provide debt financing to or to subscribe for debt instruments issued by the fund).

The security package typically comprises: (i) a pledge by the fund of the rights in and to the unfunded capital commitments of the investors and the claims against the investors in relation to those commitments; and (ii) a pledge over the bank account into which investors are required to pay their contributions. However, other forms of security interests may be envisaged (notably pledges over shares in intermediary vehicles). The fund's underlying investments are not usually part of the security package, although in some facilities, certain investments may be added to the borrowing base.

Luxembourg law typically governs the security interests granted by the borrowing fund over the rights in and to the investors' unfunded capital commitments and any claims against the investors in relation to such commitments. The relevant security interest is in the form of a financial collateral arrangement governed by the Luxembourg law of 5 August 2005 on financial collateral arrangements, as amended (the **Collateral Law**). According to the Collateral Law, security over claims against the investors may be created by way of a pledge or an assignment for security purposes. Pledges are the most common security interests over investors' commitments in relation to Luxembourg funds. The pledge/assignment agreement must be evidenced in writing, and the relevant security interest agreement must be executed by the fund (as pledgor or assignor), the fund's general partner and the security taker. If the AIFM is empowered to make capital calls and/or enter into borrowing and security interest arrangements on behalf of the fund, it must be added as party to the security interest agreement.

According to Luxembourg conflict of law rules, the courts in Luxembourg will generally apply the *lex loci rei sitae* or *lex situs* (the law of the place where the asset subject to the security interest is situated) in the case of creation, perfection and enforcement of security interest over the asset. Thus, Luxembourg law will apply in relation to the creation, perfection and enforcement of security interests over assets which are located or deemed to be located in Luxembourg or governed by Luxembourg law. Claims (*créances*) governed by Luxembourg law or owed by a debtor located in Luxembourg, or accounts opened with banks located in Luxembourg, will be considered as located in Luxembourg and fall within the scope of the Collateral Law.

Concerning claims against investors which are subject to security interests, certain conflict of laws rules must be taken into consideration when structuring the security package. According to article 14 of Regulation (EC) N° 593/2008 of the European Parliament and of the Council of 17 June 2008 on the law applicable to contractual obligations (**Rome I Regulation**): (i) the relationship between the security provider and the security taker is governed by the law applicable to the contract between the security provider and the security taker under the Rome I Regulation; and (ii) the law governing the pledged/assigned claim will determine its assignability, the relationship between the security taker and the debtor, the conditions under which the pledge or assignment may be invoked against the debtor, and whether the debtor's obligations have been discharged. Because the fund documentation and subscription agreements are typically governed by Luxembourg law, that law will apply to such matters. Since the Rome I Regulation does not provide explicitly for any conflict of law rules concerning the enforceability of and possibility to invoke a pledge/

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assignment over claims against third parties, some Luxembourg legal practitioners consider that a pledge over, or assignment of, claims would become invocable *vis-à-vis* third parties other than the debtor if the legal formalities applicable in the debtor's jurisdiction are duly complied with. In addition, according to the Regulation (EU) of the European Parliament and the Council No. 2015/848 of 20 May 2015 on insolvency proceedings (recast), claims against a third party (other than claims in relation to cash held in bank accounts) will be considered situated in the EU Member State within the territory of which the third party required to meet the claims has the centre of its main interests (**COMI**).

Given that investors in Luxembourg funds are generally located in different jurisdictions outside Luxembourg, the lenders and the security takers will need to take the above considerations into account when structuring the security package.

The Collateral Law allows a security interest to be created over present and future claims, provided that they are identified or identifiable at the time of entry into the security interest agreement. It is common practice for the security provider to provide the security taker periodically with an updated list of the investors' commitments.

Under Luxembourg law, pledges/assignments for security purposes which are not notified to or accepted by the investors are fully recognised and enforceable. However, the debtor of a pledged/assigned claim may be validly discharged from its obligation *vis-à-vis* the security provider if it had no knowledge of the pledge/assignment in favour of the security taker. It is therefore usual for lenders to require security interests granted by the fund to be notified to and accepted by the investors, in order to ensure that the investors act in accordance with the security taker's instructions and pay the unfunded commitments to the pledged accounts if the security interest is enforced. Another reason for such notifications, acceptances and investors' letters is the requirement for the investors to waive any transferability restrictions which may be applicable to the pledged/assigned claims, and any defences, right of retention or set-off and counterclaim the investors may have with regard to the pledged/assigned claims. According to the Collateral Law: (i) a debtor of a claim provided as financial collateral may waive its rights of set-off in writing or a legally equivalent manner, as well as any other exceptions *vis-à-vis* the creditor of the claim provided as collateral and *vis-à-vis* persons to whom the creditor assigned or pledged such claim as collateral; and (ii) the waiver is valid between the parties and enforceable against third parties.

Given the above and to pre-empt any difficulties with the investors, it becomes usual to include "bankable" financing provisions in advance in the fund documentation (notably the partnership agreements and the subscription arrangements), such as investors' acceptance of the possibility for the fund and its general partner to borrow and pledge the unfunded capital commitments, the security taker's right to initiate and enforce capital calls, waivers of defences to funding, and other provisions allowing the security taker to give instructions to the investors upon the occurrence of an event of default, etc. In addition, it is important to ensure that the investors' commitments are structured as obligations to pay rather than obligations to subscribe for interests/shares.

Concerning the right of the fund to make capital calls and enforce the obligations of the investors to contribute capital, it should be considered that such right is an ancillary right to the pledged/assigned claim (*droit lié à la créance gagée/transférée*), and as a result the security taker may be entitled to exercise that right in accordance with the provisions of the security interest agreement. This view is supported by the Collateral Law, which provides that the pledge/assignment of a claim implies the right for the security taker to exercise the rights of the security provider linked to the pledged/assigned claim. Without prejudice to

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and independently of the above, Luxembourg security interest agreements provide for a power of attorney granted by the borrowing fund and its general partner in favour of the security taker to make the capital calls, send funding notices and require the investors to make payments into the pledged accounts, it being understood that this power of attorney may be subject to certain limitations arising under Luxembourg law.

The Collateral Law allows the enforcement of a security interest over claims upon the occurrence of an event of default (freely determined by the parties) without prior notice (*mise en demeure*). Subject to the terms of the fund documents and certain Luxembourg regulatory requirements, in respect of pledges, the security taker (as pledgee) may, *inter alia*: (i) serve a funding notice on the investors, requesting payment into the pledged accounts; (ii) request direct payment from the investors; (iii) appropriate the pledged claims (at a value determined using the valuation method agreed upon by the parties); (iv) sell the pledged claims by way of a private sale (at arm's length conditions) or a public sale; or (v) request a court to attribute the pledged claims. Concerning assignments for security purposes, in the event of the security provider's failure to perform the relevant financial obligations, the security taker (as assignee) is discharged from its obligations to re-transfer the assigned claims up to the amount of the secured obligations.

The security interest over the bank accounts (held in Luxembourg) into which investors are required to fund their contributions may be created by way of a pledge in accordance with the Collateral Law. The pledge agreement must be evidenced in writing and perfected in accordance with Luxembourg law. In practice, as a result of their general terms and conditions, Luxembourg account banks have a first-ranking pledge over such accounts. Provided the terms and conditions do not prohibit pledges, the pledge will become valid and enforceable against the account bank and third parties, once the existence of the pledge has been notified to and accepted by that bank.

Involvement of depositaries in fund finance transactions

The implementation of the AIFMD in Luxembourg through the AIFM Law has broadened the involvement of the depositaries in Luxembourg fund structures. Before the AIFMD, the appointment of a depositary was only mandatory in respect of Luxembourg regulated funds, including SICARs and SIFs. The AIFM Law and the RAIF Law have extended the requirement for appointing a depositary to: (i) non-regulated SOPARFIs qualifying as AIFs (except if they are managed by an Exempted AIFM); and (ii) RAIFs.

The increased use of Luxembourg as the jurisdiction of choice within the EU for the setting-up of AIFs means that in the context of fund finance transactions, it is essential to have a clear understanding of the duties of the depositaries, and of the interactions between their duties and the rights of the lenders. The duties of a depositary of a Luxembourg fund may generally be described as covering: (i) safekeeping and supervision of the assets; (ii) day-to-day administration of the assets; and (iii) control over the transactions of the fund (including compliance with investment policies and monitoring of the cash flows). With the ultimate goal being increased investor protection, the exact scope of a depositary's duties depends on whether the AIF concerned is subject to the SICAR Law, the SIF Law, the RAIF Law and/or the AIFM Law.

- *Depositary's duties in respect of SICARs and SIFs*

The depositary of a fund organised as a SICAR or a SIF is entrusted with the supervision of the fund's assets. This implies that the depositary must always know how the fund's assets of the fund have been invested, and where and how they are available. However, this does not prevent the physical safekeeping of the fund's assets by third parties designated by the

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fund, with the approval of the depositary. When carrying out its duties, the depositary must act independently and solely in the interest of the fund's investors. Entrusting some or all the assets in its custody to a third party does not affect the depositary's liability.

- *Depositary's duties in respect of AIFs*

With the implementation of AIFMD, the initial role of depositaries was supplemented by additional overview obligations relating to: (i) the valuation of assets; (ii) the subscription and redemption of shares or units; (iii) carrying out the AIFM's instructions; (iv) the timely settlement of transactions; and (v) distribution of the AIF's income. Depositaries are now also required, in addition to the custody/safekeeping of assets of the relevant AIF, to monitor and reconcile the AIF's cash flows by obtaining a full overview of its cash positions and cash movements. These duties apply to any depositary appointed in respect of an AIF, whether it is organised as a SICAR, a SIF, a RAIF or any non-regulated SOPARFI qualifying as an AIF (except for a SOPARFI managed by an Exempted AIFM).

The depositary must in general ensure that the AIF's cash flows are properly monitored, and ensure in particular that all payments made by or on behalf of investors upon the subscription of units or shares in the AIF have been received, and that all the AIF's cash has been booked in cash accounts opened in its name, the name of the AIFM acting on behalf of the AIF, or the name of the depositary acting on behalf of the AIF as an entity referred to in points (a), (b) and (c) of Article 18(1) of Directive 2006/73/EC (implementing MiFID as regards organisational requirements and operating conditions for investment firms), or another entity of the same nature, in the relevant market where cash accounts are required, provided that entity is subject to effective prudential regulation and supervision which have the same effect as EU law and are effectively enforced and in accordance with the principles set out in Article 16 of Directive 2006/73/EC.

The assets of the AIF or the AIFM acting on its behalf must be entrusted to the depositary for safe-keeping, taking particularly into account the following elements: the depositary must: (i) hold as custodian all financial instruments that can be registered in a financial instruments account opened in the depositary's books, and all financial instruments that can be physically delivered to the depositary; and (ii) verify that the AIF or AIFM acting on behalf of the AIF is the owner of those assets, and maintain a record of the assets which it is satisfied are owned by the AIF or the AIFM acting on behalf of the AIF.

If a financial instrument in its keeping is lost, the depositary must return an identical type of financial instrument or the corresponding amount to the AIF or the AIFM acting on behalf of the AIF without undue delay. The depositary is not liable if it can prove that the loss is due to external events beyond its reasonable control, whose consequences would have been unavoidable despite all reasonable efforts to the contrary. The depositary is also liable to the AIF or its investors, for any other losses they suffer as a result of the depositary's negligent or deliberate failure to fulfil its obligations under the AIFMD correctly.

- *Interactions between the duties of the depositary and the rights of the lenders and the security takers*

Owing to the responsibilities imposed on depositaries of Luxembourg-based funds, their potential exposure to liability has increased, meaning that they will seek to limit their risks and secure additional protection in depositary agreements. It is important for the borrowing fund, the lenders and the security takers to verify whether the provisions of the depositary agreements and the duties of the depositary might have an impact on the financing transaction and the effectiveness of the security package. The exact scope of such contractual protection should be analysed on a case-by-case basis, as each depositary may

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have its own requirements. It may cover both assets and accounts held in custody by the depositary and any other assets owned by the borrowing fund. In practice, the depositary agreements usually provide for: (i) a right of information; (ii) a right of prior consent; and/or (iii) a right of pledge over the assets of the fund.

The right of information usually provides that the depositary must be informed in advance of any transaction in respect of the fund or its assets (in particular, borrowings and any transaction involving a transfer of rights/ownership of the fund's assets, such as the granting or enforcement of security interests). The right of prior consent obliges the fund to obtain the depositary's consent before entering into borrowing arrangements and granting security interests over the fund's assets. Both these rights aim to ensure that the depositary obtains sufficient information on transactions affecting the fund's assets which it has to monitor or supervise, and is able to block transactions which may violate the fund documentation or the applicable laws and regulations. Any fund which entered into a financing transaction that breached the depositary agreement would expose itself to contractual liability. From a lender's perspective, the depositary may also challenge the validity of the financing arrangements and the security interests and the enforceability of such security interests, and bring claims against lenders who acted despite being aware of the breach of contract. It is therefore usual for lenders to require an acceptance letter from the depositary in relation to the financing transaction and the security package.

The depositary arrangements often provide for a pledge over all or part of the fund's assets of the fund in favour of the depositary. As long as that pledge remains in place, the fund will not be able to grant a first-ranking pledge over the same assets for the purpose of a financing transaction. A waiver of the pledge granted in favour of the depositary will be required in order to conclude the new security interest agreement validly and perfect the pledge it creates. Without such a waiver, the pledge granted by the fund in favour of the lenders may either rank as junior to the pledge granted in favour of the depositary, or even be considered as not validly created.

When the lenders and/or security takers exercise their rights under the security interests, they must take the duties of the depositaries into consideration. The security interest agreements would typically allow them to make capital calls on the investors upon the occurrence of an event of default. Special attention must be paid to situations where lenders and/or security takers require the investors' contributions to be paid into an account, which is not opened in the name of the fund, the AIFM acting on behalf of the fund or the depositary acting on behalf of the AIF, in each case in accordance with the AIFM Law. In such situations, the exercise of the lenders' and/or the security takers' rights may potentially conflict with the duty of the depositary to monitor the fund's cash flows and supervise its assets for the purpose of the AIFM Law.

Outlook

A significant driver for the success of Luxembourg as a European hub for the structuring of AIFs, in particular over the past few years, has been the success of the modernisation of the Luxembourg partnership regime and its increasing use by fund managers, with a view to allowing the distribution of the funds they manage to EU-based investors. There is no reason to doubt that this trend, which has even been accelerated due to the uncertainties as to the outcome of the Brexit negotiations, will continue and sustain a growing demand from fund managers for financing solutions.

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Endnotes

1. As at July 2017.
2. According to Recital 78 of the AIFMD.
3. Commission Delegated Regulation (EU) No 231/2013 of 19 December 2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (the **Level 2 Regulations**).
4. SIFs, SICARs and RAIFs are obliged to appoint depositaries in any event on the basis of the SIF, SICAR and RAIF Laws, respectively.

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Mauritius

Malcolm Moller
Appleby

Overview

Mauritius has a diversified economy, politically stable and business-friendly environment and is undoubtedly well positioned to act as an investment and trading bridge between Africa and Asia. In fact, in recent years, global business in Mauritius has experienced a positive trend, mainly for inbound investment into Africa and India. Over the years, Mauritius has equally built an active investment relationship with India, and Africa particularly with the conclusion of the double taxation treaty between Mauritius and India (**Treaty**) and other African member states of the African Union. Mauritius has been providing more and more foreign direct investment into India and Africa.

Global funds (that is, investment funds and their intermediaries) in Mauritius are regulated by the Financial Services Commission (**Commission**). The Commission has, since 2001, developed a very flexible set of guidelines as well as consolidated regulatory and supervisory framework for the regulation of such global funds, namely the Securities Act 2005 (**Securities Act**), the Securities (Licensing) Rules 2007 (**Securities Licensing Rules**), the Financial Services Act 2007 (**FSA 2007**) and the Securities (Collective Investment Schemes and Closed-end Funds) Regulations 2008 (**Securities Regulations 2008**). As a result, the funds market in Mauritius currently, and as at 31st August 2016, holds around 972[1] active global funds, as compared to 958[2] active global funds licensed with the Commission at 31st December 2015. Notwithstanding the amendments made to the Treaty, we expect further positive growth as 2017 comes to a close given that the uncertainties of Treaty amendments are now behind us. This projected positive growth will be fuelled by another strong year for fundraising, a rise in dry powder levels and an increase in the unrealised value of portfolio assets.

However, this projected growth is not without its concerns; the fundraising market is more competitive than ever and dry powder levels continue to increase and put further stress on finding attractive entry prices for assets. Fundraising should remain strong due to investor demand for African and Indian assets, but the challenge of identifying the best investment opportunities in a competitive market remains for limited partners (**LPs**). General partners (**GPs**) will be excited by the prospect of fundraising in the year ahead, given the liquidity within the investor community, but less established fund managers face difficulties in attracting investor capital and meeting the demands of an increasingly sophisticated community.

Fund formation and finance

Global funds – Overview

The present regulatory framework enables global funds to be structured as companies incorporated under the Companies Act, 2001 (**Companies Act**), as limited partnerships

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which came into force pursuant to the Limited Partnership Act 2011, or licensed as companies or partnerships holding category 1 Global Business Licences (**GBL 1**) under the FSA 2007.

The Mauritian Limited Partnership (**LP**) combines features of both a company and a partnership. It can have separate legal personality just like a company, while at the same time enabling some partners, known as limited partners, to contribute and participate in the returns of the LP without being engaged in its day-to-day management. The general partner is responsible for managing the business and affairs of the limited partnership and is personally liable for the debts of the partnership.

The regulatory and supervisory framework for global funds is in line with international principles and practices as laid down by the International Organisation of Securities Commissions (**IOSCO**). Intermediaries ensure the proper functioning of investment funds and hence protect the best interests of investors. All global funds are therefore subject to ongoing reporting obligations, as imposed by the Commission under the Securities Act and the FSA 2007. Reporting obligations include submission of Audited Financial Statements and Quarterly Statutory Returns (Interim Financial Statements) in accordance with the FSA 2007.

As in recent years, despite numerous headwinds, fund finance markets continued their outpaced growth in the first half of 2017, building upon and continuing a market trend in place since at least 2010. Similarly, fund finance performance remained pristine, and no loan losses or write-downs from last year have become public. Other than the infrequent dust-up that has occurred between an investor and a general partner/investment manager, we are still not aware of any substantial case law relevant to fund finance in 2017. Also, as indicated above, we expect further positive growth in 2018.

Fund financing

As the private funds sector grows and matures in Mauritius, financing solutions are increasingly required by funds and fund managers. The need for finance can vary, from equity bridge or capital call facilities used to assist liquidity and speed of execution for private equity funds, to more esoteric products used by hedge funds in addition to their prime brokerage agreements, such as NAV-based margin loans to provide liquidity or leverage, and equity or fund-linked derivative solutions. Consistent with prior quarters, capital call subscription credit facilities continued their positive momentum in 2017 and had an outstanding year as an asset class.

In fact, we still have not been consulted on a single facility payment event of default in the first half of 2017. Also, as more investors look to limit their investments to a smaller group of preferred sponsors, sponsors are also diversifying their product offerings. We have, for instance, noticed a trend involving a number of sponsors leveraging their existing investor relationships by creating funds focused on sectors in which they have not traditionally participated (i.e., buyout shops creating direct-lending funds). In addition to the very positive credit performance, the asset class seemed to enjoy significant year-over-year growth in the Mauritius fund industry. Below we set forth our views on the state of the fund finance facility market and the current trends likely to be relevant in 2017. While the fund finance market in Mauritius currently lacks an industry-accepted data collecting and reporting resource, making it difficult to accurately estimate the exact size of the market, we remain confident based on our experiences, as well as anecdotal reports from multiple facility lenders, that the fund facility market expanded materially from 2010 to 2017. The positive growth for private funds was driven by a confluence of factors, the more so as investors have become increasingly comfortable with the global funds structures.

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<u>General security structure for Mauritius transactions</u>

Historically, funds have predominantly been incorporated as corporate structures. Some companies may have more than one class of shares, which denote various fee structures and/or limitations on the types of investments some shareholders can make. There may also exist multiple series within each class of shares. To widen its array of financial products, Mauritius introduced its Limited Partnership Act 2011, adding a new dimension to the international investment community. This investment vehicle enables Global Funds to be structured as partnerships in Mauritius, reducing the need for complex master-feeder structures and ensuring tax-efficient structures.

Mauritius has become a central hub for foreign direct investment into India and Africa due to its network of double taxation avoidance agreements and investment protection and promotion agreements with various African countries. However, while investors have been able to form Global Business Companies for foreign direct investment, the more rigid structure of companies means they are not always perfectly suited for these investment projects. For example, for funds structured as a Mauritius corporation, a shareholders' agreement governs the relationship with the shareholders rather than a partnership agreement. Shareholders' obligation to pay in capital contributions is contingent upon the issuance of further shares, and a corporation's ability to issue shares is generally not delegable under Mauritius Law, thus limiting the ability to make capital calls on investors in an event of default under the fund financing facility.

Security for the fund finance consists of: (a) a security assignment by the fund of the capital commitments, right to make capital calls, right to receive and enforce the foregoing and the account into which the capital commitments are to be funded; and (b) a charge on the bulk of its other assets including its accounts, investments compensation from various of its assets including bonds, guarantees, negotiable instruments and the like. The security package relating to the capital calls is tailored in order to account for specifics of Mauritius law and the structure of the fund as a corporation (rather than a limited partnership, as most funds in Mauritius are structured as corporations). In particular, various rights in respect of the fund are vested in the board of directors and cannot be easily delegated. Mauritius law requires that shares be issued in exchange for capital calls.

So while one would have a pledge over the security provided above, the ability for a lender to make a capital call on its own would be complicated by the foregoing. In a worst-case scenario, the preferred enforcement mechanism would have the lender appoint a receiver (and if necessary, a liquidator), as each have statutory authority to make capital calls and issue shares in order to satisfy creditors to whom such security is pledged. Indeed, after an event of default, a lender is entitled to appoint a receiver under the Insolvency Act of 2009. Security documents, such as fixed and floating charge documents, would need to provide that if a receiver were appointed, it would have full management powers to the exclusion of the board of directors. Under the Insolvency Act of 2009, the receiver would have the power to make calls of unfunded capital to the extent such assets are included in the charge granted to a lender and issue shares.

It is also recommended that a liquidator be appointed in order to avoid certain issues relating to set-off of claims by shareholders against the called capital (described further below). The liquidator would also be permitted to call capital. For example, various contract law defences may be waived in Mauritius by contract in the situation where the fund is not in insolvency (including non-performance by the fund). In the US, such language was cited in the *Iridium* line of cases. Generally, such language is sought for three reasons: (a) to waive

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contract law defences such as lack of consideration, mutual mistake, impracticability, etc.; (b) to prevent the LPs from claiming that they may set off amounts owed to them by the fund against what is due to the lender; and (c) claims that an issuance of shares or some other action by the fund is required as a condition for payment of capital contributions.

We recommend that such language be included in this transaction, since in the event of insolvency of the fund, the language may prove helpful and could avoid other defences raised by shareholders that their commitment to contribute capital is a "financial accommodation" or otherwise avoidable under insolvency laws. Such ability to waive in advance the right to raise the defence above, and other defences by contract, could be inserted in the contract (presumably by amendment to the shareholders' agreement or by an investor letter); however, general waivers are not effective, so specific waivers would be required as to each of the possible defences.

Moreover, such contractual waivers would not be effective in a number of circumstances, including rights to set-off pursuant to Insolvency Act of 2009. By statute, under the Insolvency Act of 2009, while a receiver is in place, principles of contractual, legal and equitable set-off apply which would permit set-off by shareholders, and such set-off is available to the extent that claims have been incurred prior to the commencement of the liquidation (subject to other limitations). To avoid such risk, we normally recommend the initiation of winding-up by a lender by appointment of a liquidator, as such appointment would crystallise the liability of shareholders as a statutory liability which cannot be set off against amounts owing to the shareholder.

Key developments

Protocol amending the Treaty

The changes brought under the Protocol have indeed not affected the current business environment, thanks to the transitional period, and the impact of the Protocol on investments into India, and the growth of Private Equity Funds in Mauritius, continues to be estimated to be a minimal one that is unlikely to make a significant dent.

Fund financing

The following four key trends continue to dominate the market, even in the first half of 2017: (i) the general maturation of the fund financing product and market; (ii) the continuing expansion of fund financing into various fund asset classes, and particularly, private equity; (iii) fund structural evolution, largely responsive to the challenging fundraising environment and investor demands; and (iv) an entrepreneurial approach among funds to identify new investor bases and new sources of capital commitments. We think these trends will continue to have a material impact on the fund financing market in 2017 and beyond.

The year ahead

As 2017 is coming to a close, it continues the generally steady growth in the global funds finance market, with investors continuing to reap the benefit of hefty distributions at record rates and Mauritius further enhancing itself as a fund domicile as well as a preferred jurisdiction for setting up global funds targeting investment opportunities in India and Africa. Notwithstanding concerns around the terms of the Protocol, Mauritius remains committed to developing and maintaining conditions, supported by responsible asset protection laws and robust anti-money laundering laws, which are conducive to attracting international business not only in India, but equally to other jurisdictions such as China

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and Africa. The changes brought under the Protocol are not expected to affect the current business environment.

Further, multiple regional US lenders continue their efforts to keep up with the growth of their funds clients by expanding beyond their historical geographies and middle-market fund roots. Most of the regional lenders continue to increase their facility maximum-hold positions to levels comparable to those offered by the money centre lenders, at least for certain preferred funds in Mauritius, thereby making substantial progress in increasing their relevance in the greater facility market in 2017. As their facility structures and underwriting parameters often differ from a traditional facility, they are also altering the competitive landscape in fund financing in Mauritius. Correspondingly, variations in facility structure dictate the syndication strategy and prospects for a particular facility, adding additional complexity to a transaction.

We remain cautiously optimistic for a robust fund finance market in 2018 and we further expect the number of facilities consummated to continue to grow at a solid clip, as fundraising improves, the product further penetrates the private equity market, and a greater number of existing facilities get refinanced.

* * *

Endnotes

1. Commission website: www.fscmauritius.org/media-publications/statistics-and-surveys/statistics/global-business.aspx.
2. Commission website: www.fscmauritius.org/media-publications/statistics-and-surveys/statistics/global-business.aspx.

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Netherlands

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Overview

Historically speaking, the Netherlands has been a gateway (both literally and figuratively speaking) to the financial and investment world; not only spearheading the establishment of the first company in worldwide history to issue securities to the public, but also making major contributions to the way the world does modern (transnational) banking and finance. The Netherlands has remained a major location in both fields. The Netherlands is widely recognised as a leading international financial centre and has a mature investment funds industry with an attractive investment environment due to, amongst others, flexible corporate legislation, interesting tax structuring options and an extensive network of bilateral investment treaties and tax treaties. We expect that the Dutch government's recently announced plans to withdraw the Dutch dividend withholding tax in its entirety, and to lower corporate income tax rates, will further contribute to the Netherlands' position as a jurisdiction of choice.

In terms of both fundraising and invested capital, 2016 has been the most successful year for the Netherlands since 2008, with 2017 expected to exceed these numbers.[1] Based on annual research conducted by the *Nederlandse Vereniging van Participatiemaatschappijen* (the Dutch Association of Private Equity Firms) and PWC,[2] in 2016 alone Dutch private equity firms have raised around €2.4 billion in new funds, of which approximately €725 million in new funds have been raised by Dutch venture capitalists, a record number stimulated by, amongst others, attractive seed capital regulations issued and local development funds established by the Dutch government. In 2016, 176 Dutch private equity or venture capital firms managed approximately €20.9 billion (committed capital) in 343 funds, and over €3.7 billion has been invested by national and international private equity and venture capital firms in approximately 365 Dutch companies. As a consequence of growing numbers for fundraising and private equity and venture capital investments in the Netherlands, the Dutch fund finance practice also enjoys increased attention, which we do not expect to decline in 2018.

Another development adding to the increased importance of the Netherlands as an international financial centre is the potential migration of several financial institutions as a result of Brexit. Several firms are currently shifting their focus away from London towards mainland Europe, and in particular, the Netherlands as an often-mentioned candidate. A shift towards the Netherlands would likely increase the amount of funds established in, and amount of financing structured through, the Netherlands.

In view of the aforementioned increasing relevance of the Dutch fund formation and fund financing market, this chapter seeks to provide further background on the following

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relevant aspects: (a) fund formation and the most commonly used Dutch fund vehicles; (b) certain regulatory aspects of fund formation and fund financing; and (c) the structuring of the security package.

Fund formation

Dutch alternative investment funds (**AIF**)[3] may be structured in various ways, both as corporate and contractual entities. Corporate entities have legal personality, enabling them to hold legal title to assets, and which are governed by mandatory law, whereas contractual entities lack such legal personality and are unable to hold legal title, but enjoy the benefit of contractual freedom. The most frequently used corporate investment vehicles are the private limited liability company (*besloten vennootschap met beperkte aansprakelijkheid*) and the cooperative (*coöperatie*). Contractual investment vehicles are most commonly established in the form of a limited partnership (*commanditaire vennootschap*) or a mutual fund (*besloten fonds voor gemene rekening*). The ultimate selection strongly depends on the outcome of relevant tax and legal structuring analyses.

Regardless of whether a contractual or legal entity is selected, an AIF incorporated in the Netherlands should take into account that the European Alternative Investment Fund Managers Directive 2011/61/EU (the **AIFMD**) is applicable and has been implemented in the Dutch Act on Financial Supervision (*Wet op het financieel toezicht*, the **AFS**). Consequently, the AIFMD and all rules and regulations promulgated thereunder (including Delegated Regulation (EU) 231/2013, the **Delegated Regulation**) have to be complied with in the Netherlands by any alternative fund manager (an **AIFM**), unless an AIFM can benefit from exemptions (such as, *inter alia*, AIFMs managing AIFs below the Threshold (as defined below)).

In the event that a Dutch-authorised AIFM establishes a contractual investment vehicle as AIF, under the AFS it is required to also establish a single-purpose corporate entity to hold the assets of one or more of such AIFs set up by the licensed AIFM (as is further set out below).

<u>Asset owning SPV holding the assets of contractual AIFs managed by a Dutch AIFM</u>

In the event that a Dutch-authorised AIFM contemplates using a contractual investment vehicle as an AIF, the legal title (*juridische eigendom*) to the assets of such AIF should be held by an entity whose single purpose is to hold the assets of one or more AIFs. In practice, Dutch AIFMs use a Dutch foundation (*stichting*) for this purpose. A Dutch foundation does qualify as a legal entity but is not limited by shares and hence can operate as a bankruptcy remote vehicle.

In addition, Dutch law provides that the assets of a certain AIF further form a separate estate serving solely to satisfy claims arising from: (a) liabilities related to the management, custody and ownership of the legal title of the assets of such AIF and which, pursuant to the information as referred to in article 4:37m sub 1 AFS, may be charged to the estate of such AIF (*i.e.* the information set forth in article 23 AIFMD); and (b) the investors of such AIF.

In practice, this arrangement is implemented into the governing documents of the respective AIF (for instance, the limited partnership agreement), which provides that the foundation shall hold the legal title of the assets of an AIF for the risk and account of such AIF. In order to enable the AIFM to deal with the assets of an AIF, the governing documents shall likely also include an unconditional and irrevocable power of attorney to the AIFM to enter into any and all acts on behalf of such foundation acting as an asset-owning SPV.

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The above requirement also applies if a Dutch AIFM manages a non-Dutch AIF that qualifies as a contractual investment vehicle. Consequently, a Dutch foundation may also hold legal title of the assets of an AIF where the AIF itself is, for instance, a Scottish limited partnership.

Regulation of fund raising and fund managers

Authorisation

Following the implementation of the AIFMD in the Netherlands, the management or marketing of AIFs in the Netherlands by 'large' AIFMs, *i.e.*, managers which, directly or indirectly, manage portfolios of AIFs whose assets under management amount to €500 million or more, or – when open-ended or leveraged – €100 million or more (together, the **Threshold**) or more, triggers an authorisation requirement in the Netherlands, subject to certain exemptions and grandfathering rules. A manager is deemed to manage an AIF in the Netherlands if it is established in the Netherlands, or if the AIF managed by it is established in the Netherlands.

Dutch AIFMs that fall below the Threshold may manage and market their AIFs without Dutch authorisation in the Netherlands, provided that:

(a) the AIF's units or shares (e.g. LP interests) are exclusively offered to professional investors within the meaning of the AFS (e.g. banks, insurers, pension funds, brokers, AIFMs, AIFs or qualifying large corporates); or

(b) the AIF's units or shares are offered to fewer than 150 persons; or have a nominal value of, or are offered for a consideration payable per investor of, at least €100,000, provided that a banner or selling legend as to the AIFM's unregulated status (in a predefined size and layout) is printed on the AIF's offering documents; and

(c) in each case, the relevant AIFM is registered with the Dutch competent authority, the Dutch Financial Markets Authority (*Autoriteit financiële markten* or **AFM**). The aim of said registration is to ensure that the AFM can assess whether or not the sub-Threshold regime is legitimately relied upon, and to effectively monitor any build-up of systemic risks. Such Dutch AIFMs are required to disclose to the Dutch Central Bank (*De Nederlandsche Bank*), amongst others, information on the main instruments in which the AIFs are trading, the principal exposures and the most important concentration of the AIFs managed.

Dutch AIFMs that do not require authorisation for managing and marketing their AIFs in the Netherlands may voluntarily apply for authorisation, provided such AIFM complies with all applicable AIFMD requirements (as implemented into Dutch law). Not many Dutch AIFMs have chosen to apply for authorisation voluntarily.

Finally, considering that AIFs making private equity investments are not excluded from the scope of the venture capital regulation (Regulation 345/2013/EC or **EuVECA**), EU-based managers of (EU) AIFs that comply with the conditions of EuVECA, may benefit from a passport as introduced therein for the marketing of units or shares to potential investors that are or may, on request, be treated as professional clients (within the meaning of Directive 2004/39/EG (MiFID)), or to investors investing at least €100,000, provided that they have confirmed their awareness of the risks associated with their investment.

Fund financing

With increasing availability of capital for investments and demands for high returns by investors, the need for financing solutions by Dutch AIFMs and Dutch AIFs is expected to

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experience a similar upturn. Depending on the type of AIF and type of investor, the need for financing can vary from the more traditional capital call facilities to assist in providing liquidity and expediting the making of investments, to credit facilities based on e.g. net asset value of investments to provide leverage or liquidity for the AIF. There is very limited data publicly available on the use of the various types of fund financing in the market, which makes it difficult to assess the size of the fund financing market in the Netherlands. In our experience, traditional capital call facilities continue to be the main type of financing selected by AIFMs and increasingly, AIFMs require the possibility to take out this type of financing and the creation of security by the fund on its assets and receivables (as discussed below) to be explicitly included in the relevant fund documentation.

An important consequence of incurring leverage at the level of a Dutch AIF is that, depending on the details of the financing, the relevant AIFM managing such AIF may be required to obtain authorisation in the Netherlands, as further discussed below.

Leverage calculation at the level of the AIF

Whether or not an AIF incurs leverage may affect the relevant AIFM's regulatory status (*i.e.* may lead to a lower Threshold to be applied for purposes of determining whether authorisation is required in the Netherlands). Additionally, if AIFMs deploy leverage, the AIFMD (and rules and regulations promulgated thereunder) pose additional obligations on an AIFM. Consequently, incurring leverage may affect an AIFM.

The term 'leverage' is defined by the AIFMD as any method by which an AIFM increases the exposure of an AIF it manages, whether through borrowing of cash or securities, or leverage embedded in derivative positions, or by any other means.

The Delegated Regulation sets out two mandatory methods for calculating and reporting leverage, referred to as the "Gross Method" and the "Commitment Method".[4] The Gross Method requires the absolute value of all positions to be calculated, converting derivatives into positions in the underlying assets without taking account of netting and hedging arrangements. The Commitment Method allows a few types of derivatives not to be converted into underlying asset positions and taking into account a limited range of netting and hedging arrangements.

In addition, the Delegated Regulation provides that AIFMs, when calculating exposure, should 'look through' corporate structures. Therefore, exposure which is included in any financial and/or legal structures involving third parties controlled by the relevant AIF, where those structures are specifically set up to directly or indirectly increase the exposure at the level of the AIF, should be included.

However, for AIFs whose core investment policy is to acquire control of non-listed companies or issuers, AIFMs should not include in the calculation any leverage that exists at the level of those non-listed companies and issuers, provided that the relevant AIF does not have to bear potential losses beyond its capital share in the respective company or issuer.

On the other hand, borrowing arrangements entered into by the AIF are excluded under any of the abovementioned methods if these:

(a) are temporary in nature; and
(b) are fully covered by 'capital commitments' from investors (*i.e.* the contractual commitment of an investor to provide the AIF with an agreed amount of investment on demand by the AIFM).

Revolving credit facilities should not be considered as being temporary in nature.

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Structuring the security package

Credit facilities to be granted to AIFs can be secured in a variety of ways. For example, security could be granted over the assets in which an AIF would (indirectly) invest in, depending on the type of assets and the way the AIF is structured. Typically, credit facilities granted to AIFs would be secured by providing security in the form of a right of pledge over the receivables or contractual rights that the investors owe to the AIF arising out of the members' agreement or limited partnership agreement, such as the right to make drawdowns from the capital commitments. Pursuant to Dutch law, security over receivables can be established by way of a disclosed right of pledge, or by way of an undisclosed right of pledge.

A disclosed right of pledge is created by way of a security agreement and is perfected by notifying the relevant debtors of the secured receivables. An undisclosed right of pledge is created either by way of a notarial deed or by way of a security agreement that is registered with the Dutch tax authorities for date-stamping purposes. As an undisclosed right of pledge only covers present receivables and future receivables arising from legal relationships existing at the time of creation of such undisclosed right of pledge, it is required to periodically file with the Dutch tax authorities supplemental security agreements to also secure present and future receivables resulting from legal relationships that have arisen in the interim.

Choosing one form of pledge over the other strongly depends on whether it is commercially desirable to disclose the right of pledge to the relevant investors, and whether an undisclosed right of pledge is acceptable to the beneficiary of the right of pledge.

With respect to creating an undisclosed right of pledge over capital commitments in particular, in Dutch case law it has been decided that if a receivable is dependent on a creditor's declaration of will (*wilsverklaring*), the receivable will only come into existence after such declaration has been made. It could be argued that the right to make drawdowns from the capital commitments is only considered to be a receivable and that the relevant legal relationship only comes into existence after a capital call notice has been issued, in which case an undisclosed right of pledge created prior to the issuance of such capital call notice would not cover this receivable, nor any future receivables arising from the relevant legal relationship with the investor. To overcome this potential problem, a provision could be included in the fund documentation stating that the parties acknowledge and agree that the right to make drawdowns from the capital commitments constitutes an existing and unconditional claim. However, there is no statutory law or case law confirming that such a provision would work to avoid any of the aforementioned issues. Therefore, in practice, the investors are requested to grant to the general partner a direct independent right to issue call capital notices. If such direct agreement is not (commercially) feasible, the general partner could grant a power of attorney to the pledgee to issue, in certain default situations, a capital call notice to the investors, and the investors are requested to acknowledge this right of the pledgee. However, as a power of attorney is cancelled in bankruptcy of the entity that has granted the power of attorney, the latter option is less favourable to the pledgee.

A downside to an undisclosed right of pledge is that the pledgee may only collect a receivable after the debtor has been notified of such right of pledge. Until a notification has been made, the pledgor remains authorised to collect payments and, upon bankruptcy of the pledgor, the bankruptcy trustee becomes authorised to do so. After bankruptcy of the pledgor, payments made to the pledgor prior to notification will form a part of the bankruptcy estate of the pledgor. The pledgee will have a priority right over these payments, but it will have to share

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in the bankruptcy expenses, which can be significant. Both the pledgor and pledgee may notify the debtors. However, the pledgee may only notify the debtors if the pledgor has failed to (properly) perform its obligations covered in the applicable security agreement.

Another element to take into consideration when structuring the security over the AIF's assets is that assignability/transferability or "pledgeability" of receivables and contractual rights may be prohibited in the contract creating such receivables or rights. Depending on the wording of the relevant provision of the contract, the prohibition could have an effect *in rem*, in which case creating a right of pledge over such receivable or right will be impossible. However, we often see that fund documentation caters for the possibility to assign, transfer or encumber any right to make drawdowns from the capital commitments or other receivables of the AIF.

The year ahead

As emphasised, 2016 and 2017 have been interesting and important years for the Dutch fund formation and fund financing markets. With current national and international political developments confirming and strengthening the Netherlands' position as a mature and well-equipped jurisdiction for funds and investments, we expect that 2018 will be another important year for the Dutch private equity and venture capital markets.

* * *

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* * *

Endnotes

1. Publication of research is pending.
2. A summarised report of their findings can be consulted on the website of the NVP, http://www.nvp.nl/pagina/ondernemend%20vermogen/ (this information was accurate on the date of this publication).
3. We note that this chapter does not focus on collective investment undertakings that require authorisation pursuant to Article 5 of Directive 2009/65/EC (UCITS).
4. Annexes to the Delegated Regulation set out methods of increasing the exposure of the AIF, conversion methodologies for some standard types of derivatives and duration netting rules.

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Scotland

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Overview

Scotland has a long history of innovation in the financial sector, from the 17th and 18th century banks that are still with us, the insurers and the fund managers, to cutting-edge fintech. The funds sector remains very strong and is closely integrated with the rest of the UK market and worldwide, and has shared fully in the recent opportunities and challenges in those markets.

Scotland has played a strong role in investment innovation over this long history in, for example, development of the investment trust and other corporate investment vehicles and in the use of partnerships as investment vehicles. In particular, Scottish limited partnerships have become a significant element in investment structures in the UK and worldwide, and the reasons for this are outlined below, along with some recent and prospective developments.

Fund formation and finance

Scottish limited partnerships are useful to the funds market for a number of reasons. These are, principally, their stability as longstanding mainstream business entities from a G8 state, their flexible and non-bureaucratic nature, their tax transparency in various jurisdictions, and their separate legal personality from their partners.

Save for the separate legal personality of Scottish partnerships, Scottish and English partnerships are much the same and are very common business entities widely used in all sectors and established under a relatively simple and stable code set out in the UK Partnership Act 1890. A partnership can be formed as a limited partnership by filing details of its general and limited partners, their capital commitments, the nature of the partnership business and a few further details with the UK Companies Registrar, who then issues a certificate of registration. On registration, the UK Limited Partnerships Act 1907 then overlays limitation of limited partners' liability on the1890 Act code, linking limited liability to limits on limited partners' active participation in a partnership's business, and limiting liability to capital commitments. Ongoing filings then relate largely to changes to details originally filed.

Partnership agreements are not filed and there are relatively few restrictions as to their form and content, though applying Scots law and court jurisdiction are important elements in establishing that a partnership is Scottish – as is ensuring that as many further connections as practicable exist with Scotland, particularly at the outset.

Flexibility in partnership agreements means that limited partners can provide most of their contributions by way of debt rather than capital if they wish and that complex structures for contribution, investment and distribution can be set up and changed much as partners wish. Management by general partners is similarly flexible, provided limited partners do

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not participate actively in management, and a general partner can readily delegate most operational functions to external managers.

Separate personality of a Scottish limited partnership means that it can hold investments directly in its own name (including land), borrow directly or issue guarantees in its own name, or be a general or limited partner in another partnership. Scottish limited partnerships are accordingly popular feeder fund vehicles into other funds, or play other roles in complex fund structures.

Consequently, when a fund wishes to borrow, a Scottish limited partnership can participate in an active and flexible manner in that borrowing by virtue of its separate personality. For term borrowing to leverage investment, a Scottish limited partnership can accordingly act as borrower or guarantor in its own name and grant security over its assets for such borrowing or guarantees, or as third party security. Limited and general partners can also grant security over their interests in the Scottish limited partnership. Similarly, when bridge lending is provided to a fund pending drawdown of investor commitments, a Scottish limited partnership can itself grant security over those commitments as part of that lending structure, whether those commitments are capital commitments or debt commitments embedded in its partnership agreement.

There are two basic types of security interest in Scots law – fixed securities and floating charges. Floating charges create security over all or a category of assets owned from time to time by a chargor and provide a slightly lower level of protection to a secured creditor than fixed securities. Floating charges are flexible and easy to constitute but unfortunately can only be granted by incorporated companies and not by conventional partnerships. Scottish limited partnerships cannot, therefore, grant floating charges over investments or other assets held by them and must, therefore, use fixed securities relevant to the asset in question.

When granting fixed security over commitments to it from limited partners under its partnership agreement, a Scottish limited partnership is required to assign its rights to those commitments in security to the lender or a security trustee, and give notice of that assignment (the Scottish term being *assignation*) to the limited partners. A degree of control over the rights assigned and/or their proceeds must also be provided to the assignee. The flexibility inherent in a Scottish partnership agreement can facilitate this process by clarifying and separating payment, drawdown and other supporting rights to be assigned, confirming their assignability and severability, eliminating internal set-off rights and easing notice procedures by authorising general partners to receive notice for multiple limited partners. Various methods are used to establish assignee control of rights assigned, ranging from fully blocked proceeds accounts to countersigned drawdown notices and a series of variants to suit the administrative requirements of the various parties involved.

Security granted by partners over interests in Scottish limited partnerships is also effected by assignment in security of rights under the relevant partnership agreement. Notice is then given to the partnership itself and (depending on the rights assigned) other relevant partners, and control over rights assigned taken by the assignee. If all of a partner's rights under a partnership agreement are assigned, the assignee will, however, become a partner in place of the assigning partner. While this may not be too problematic when assigning the interests of a limited partner, this change is normally required to be publicised in the Edinburgh Gazette and by advising the Companies Registrar. While it is less common to do so, when assigning the rights of a general partner under a partnership agreement, the liability of a general partner for all partnership debts, and its management responsibilities as a general partner, need to be borne in mind.

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Again, the flexibility of a Scottish partnership agreement can facilitate security assignments of rights by partners so that only certain separated defined rights (for example, rights to receive distributions) are assigned, cleanly and conveniently and without the assignee becoming a partner.

Partners that are incorporated companies can also grant floating charges over the whole or parts of their interests in Scottish limited partnerships in a relatively straightforward manner, and without risking the security holder becoming a partner prior to enforcement of the charge.

In situations in which parties wish to have more complex matching of funding to tranches or other categories of commitment, investment or distribution by and to partners and partnerships, this can also be facilitated in Scottish partnership agreements. Relevant classifications can be embedded in the partnership agreement and the relevant rights tracked through in a severable manner. Such severable rights can then be assigned in security or (as applicable) charged separately to fit in with funding, security and operating requirements. Additionally, it is possible to set up "cascading" security structures under which commitments to a feeder fund or other rights may be assigned down to a main fund and then on to a lender rather than being assigned direct.

Developments

Brexit & Scottish independence. Uncertainty continues in Scotland, as in the rest of the UK, regarding the consequences of the decision in the UK referendum in June 2016 to leave the European Union. While market activity has continued since then, driven largely by normal market factors, there has been increasing analysis and contingency planning going on throughout the industry as discussions continue between the UK government and EU negotiators. Depending on the nature of funds, investors and investments, this has included analysis of existing and possible future legal and regulatory frameworks, of the activities that currently are and may be regulated or unregulated in different EU jurisdictions, of possible application of EU equivalence rules providing market access from non-member states, of possible negotiated arrangements and of options for migration of operations or parts of operations from the UK to different ongoing EU states with differing existing funds industries and capabilities. As negotiations progress and likely outcomes clarify on final and transitional arrangements, planning will clarify accordingly, although there is some concern that lead times may require actions to be taken by some market participants at an earlier stage.

There are, however, few "Brexit" issues arising in the funds context that are distinctively Scottish. Following the Brexit referendum result, with the majority in Scotland favouring remaining in the EU, the devolved Scottish government sought continuing membership by the UK of the EU Single Market and, failing that, a Single Market arrangement for Scotland itself if the UK as a whole were not to remain in the Single Market. At the time of writing, it appears that continued formal Single Market membership by the UK is unlikely and that an analogous arrangement for Scotland alone is unlikely. Continuing conventional EU passporting for UK regulated entities or some similar Scottish EU "gateway" is accordingly unlikely, although negotiation of special equivalence of some sort for UK regulation obviously remains possible.

There has also been controversy in Scotland about the manner in which the UK legislation introduced to the UK parliament to deal with Brexit was drafted to provide the UK government, rather than the Scottish parliament or government, with power to adjust

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EU laws imported into UK law where the subject matter of those laws would otherwise normally fall within the sphere of the devolved competence of the Scottish parliament. It is not clear at the time of writing how this, or the similar constitutional controversy regarding the balance of UK parliament and UK government powers, will be resolved, although as most of the laws relevant to funds will fall within powers previously retained by the UK parliament rather than those devolved to the Scottish parliament, distinctively Scottish issues are again relatively unlikely to arise.

Following the "remain" vote in Scotland in the EU referendum, there was an increase in support for Scottish independence in opinion polls and the Scottish National Party, in power in the devolved Scottish government, has since been planning for a second referendum on Scottish independence from the UK, on the basis that the changing relationship with the EU and the differing vote in Scotland from the UK as a whole justifies a further independence referendum. This in turn has led to arguments that an independent Scotland might remain in or rejoin the EU and provide a good EU gateway for financial and other businesses in England or currently accessing the EU through the UK. However, polling support for Scottish independence has since dropped to below that obtained in the referendum in 2014 in which independence was rejected. When coupled with larger polls against holding another referendum in the short term and reduced votes for the Scottish National Party in intervening Scottish and UK elections, it is now thought unlikely that a second Scottish independence referendum is likely to take place before the UK has left the EU.

Private fund limited partnerships. As indicated above, limited partners in a limited partnership lose their limited liability when they participate in managing the partnership. There have been concerns for some time about the extent to which limited partners may become involved in the management processes of funds partnerships without running this risk. In April 2017 a "white list" of activities in which limited partners in Scottish and English limited partnerships may become involved without risking their limited liability was introduced by the Legislative Reform (Private Fund Limited Partnerships) Order 2017, including taking part in decisions approving managers' actions in acquiring or disposing of investments. To benefit from this more specific protection, a limited partnership is required to be a collective investment scheme under the UK Financial Services and Markets Act 2000 and elect to register as a "private fund limited partnership" with the Companies Registrar. An existing or new limited partnership may so register.

In addition, partners in private fund limited partnerships are not obliged to make capital contributions and capital may be withdrawn (in both cases, not previously possible due to statutory restrictions), and capital information does not require to be filed with the Companies Registrar. This increases funding flexibility for funds, and limited partner funding through capital rather than debt may become more common for UK limited partnerships, as is the case with investment vehicles in many other jurisdictions.

Trading and securing full limited partnership interests in private fund limited partnerships is now also more straightforward than for corresponding interests in other limited partnerships, as assignments of such interests in private fund limited partnerships do not require to be advertised in the official London or Edinburgh Gazette as they do for other partnerships.

People with significant control regime. In parallel with the relaxation of some administrative requirements for private fund limited partnerships from April 2017, the regime for registering "people with significant control" of UK companies has been extended to apply to Scottish limited partnerships (including private fund limited partnerships) and certain other Scottish partnerships. The regime has not, however, been extended to English partnerships as they

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do not have separate legal personality – the criterion of the EU 4th Money Laundering Directive under which this extension of the "PSC" regime took place. This reform should also go some way to addressing some recent use of Scottish limited partnerships as vehicles for international fraud.

Under the new PSC regime, the details of those having direct or indirect control of a Scottish limited partnership require to be registered with the Companies Registrar and if a partner or other relevant entity does not comply with notices from the partnership to provide relevant information, the partnership can issue a "restrictions notice" to that party, restricting dealings with its partnership interests. While the details of the PSC regime are complex, as they are designed to address avoidance of its application, in most circumstances general partners and managers of a Scottish limited partnership (or, possibly, holding entities) will require to go on its PSC register, but limited partners holding less than 25% of the partnership will not normally require to go on the register and holders of security over commitments will not require to be registered. The previous general requirements for registering details of all partners with the Companies Registrar continue to apply for Scottish as for English limited partnerships.

While some adjustment to the new PSC regime will be required, it is thought unlikely to lead to significant extra administration and is not thought likely to increase risks to lenders or security taken on subscription facilities significantly where Scottish limited partnerships are involved. In addition, the application of the PSC regime should increase the prudential standing of Scottish limited partnerships.

Security interest reform. The Scottish Law Commission's report on moveable transactions was published in December 2017. This project arose from practical problems in transferring and constituting fixed security under Scots law over moveable property, such as claims and financial instruments. The reform proposals contained in the previous consultations on this project were generally well received and it is likely that there will be support for taking forward the legislation to be proposed in the report. There is therefore a reasonable prospect that some of the slightly restrictive rules around giving notice of assignments, and assignee control of assigned rights mentioned above, may be relaxed to some extent within the next few years. While the Scottish Law Commission has not been looking at the restrictions mentioned above on partnerships granting floating charges, it is possible that the Scottish government will be open to relaxing this restriction, for limited partnerships at least, when considering implementation of the Scottish Law Commission's proposals in the related field of fixed security.

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Singapore

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Overview

The fund finance market in Asia-Pacific has grown significantly in the past few years, and 19 June 2017 marked the launch of the 1st Asia-Pacific Fund Finance Symposium (the **"Asia-Pacific Symposium"**) organised by the Fund Finance Association in Hong Kong. The Asia-Pacific Symposium attracted a strong turnout from market participants including banks, law firms and sponsors from across the region. The success of the Asia-Pacific Symposium sets a very positive tone to the outlook for the fund finance market in Asia.

In 2016, over 700 infrastructure investments and 400 venture capital investments were made in China alone. This can be attributed principally to the promulgation of China's One Belt, One Road Initiative which is sweeping through the region. The Belt and Road Initiative is expected to bridge the 'infrastructure gap' in less developed countries and accelerate economic growth across the Asia Pacific area and Central and Eastern Europe. The proposed size and scale of the investments under the Belt and Road Initiative is impressive. It is estimated that China will spend roughly $150bn a year in the 68 countries that have signed up to the initiative. The scale of such investments is likely to turbocharge the number and amount of renminbi and infrastructure-related financings within Asia.

Background – Singapore as a vibrant fund management centre

Strong growth and activity in the funds sector often acts as a good backdrop for the continued development of a fund finance market. It is encouraging that Singapore's assets under management (**"AUM"**) in 2016 have continued to grow and grew by 7% to S$2.7 trillion – which is in-line with global trends. Over the last five years, Singapore's AUM has expanded at a 15% compound annual growth rate (**"CAGR"**). This growth was supported by sustained net fund inflows and broad-based improvements in market valuations. Rather notably, a large portion of the total AUM was sourced from outside Singapore – particularly from Asia-Pacific, North America and Europe. The diverse sources of funds show that Singapore's reputation as a hub for regional and international investors is growing.

Looking back, the inaugural Singapore chapter of *Global Legal Insights – Fund Finance* 1st Edition (2017) noted that the use of Singapore-domiciled fund entities for fund-raising was to be regarded as a relatively recent trend. It is significant that the Asia-Pacific Symposium highlighted Singaporean structures as growing in popularity. This shows that Singapore has strengthened its reputation as an asset management hub.

This growth can be attributed to some of the following factors:

1. Strong tax incentives

The Singapore Government has put in place several tax treaties and incentives for fund

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managers to attract them to operate in Singapore. This is important for a business entity because it is generally liable to tax in a jurisdiction where its activities have created a taxable presence. Due to the varied sources of its funds and investment destinations, a fund manager is likely to have taxable activities in a number of jurisdictions. The tax impact of doing business between Singapore and these other jurisdictions is therefore an important consideration for a fund manager. In this respect, Singapore is an attractive destination from a tax perspective – it currently has more than 82 tax treaties with various countries, especially those in the Asia Pacific region. A tax treaty (more specifically, a double tax agreement) between Singapore and another jurisdiction serves to prevent double taxation of income earned in one jurisdiction by a resident of the other jurisdiction. This means that through the provisions of the tax treaty, a fund manager can benefit from the elimination of double taxation between Singapore and the respective treaty country.

A fund manager is generally incentivised to base its activities in Singapore as a Singapore tax-resident fund has access to several tax-exemption schemes. For example, under an offshore fund regime, an offshore fund managed by a Singapore-based fund manager may be exempt from tax on income from designated investments. Such exemptions are also given under a Singapore-resident fund scheme to fund managers to encourage them to base their fund vehicles in Singapore. Separately, Singapore-based or offshore funds may enjoy tax exemptions for income and gains on designated investments made by the fund under an enhanced-tier fund scheme.

In view of the above, it is therefore unsurprising that outside of the traditional offshore funds jurisdictions (such as the Cayman Islands), Singapore is now regarded as one of the most attractive tax regimes for funds and fund managers.

2. Robust regulatory regime

Singapore is also deemed to be a jurisdiction with a transparent and robust regulatory regime for fund management companies. It has an enhanced regulatory regime which requires fund management companies to meet certain enhanced business conduct and capital requirements. These include rules requiring independent custody and valuation of investor assets. If the type and size of investments managed by the fund management companies exceed certain thresholds, it will have to put in place an adequate risk management framework and be required to undergo independent annual audits by external auditors.

A strong regulatory regime increases the administrative burden on a fund manager. However, it also reinforces the high level of professional duty of care that fund managers owe to their investors. In the longer run, such a regime will help strengthen Singapore's reputation as a trusted fund management jurisdiction.

Potential for growth for fund finance market

In view of the above, it is not surprising that the performance of Asia-Pacific fundraisings, in terms of both the number of funds and the average quantum raised, has been robust over the past five years. Prequin estimates that since 2011, average fund sizes in Asia have increased by 23% to US$320m in 2016, with fund raisings in H1 2017 dominated by private equity funds (82%). However, notwithstanding the growth highlighted above, less than 50% of Asian funds have implemented a capital call facility at the outset. These statistics show that there is a huge potential for growth in the fund finance market within the Asia region.

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Fund formation and finance

Basics of fund finance – Singapore

Singapore is an ideal vantage point for the fund finance market as the market is widely accessible to participants in the industry. The basic concepts of credit and security relating to the structure of a fund finance facility do not differ substantially from those which originate from more developed markets in the US and Europe. A capital call facility is currently the most widely available fund finance product.

What is a capital call facility?

A capital call facility, also known as funds subscription finance or equity bridge finance, is a form of short-term financing provided to a fund. Such financings are typically structured as revolving facilities secured on the investors' undrawn commitments. The duration of the facility may be several years (typically not longer than three years, and often a shorter period). However, as limited partnership agreements typically restrict any borrowing beyond a year, each loan made by the fund must be repaid within a year of its drawing to comply with the limited partnership agreement. A common agreement is that each loan may be outstanding for no longer than six months. This allows the fund to call on its investors semi-annually and also provides comfort to the bank that there will not be too long of a gap between calls on investors.

These capital call facilities originate from the funds markets in the US and Europe where the facilities are commonly used to bridge the gap between when an investment is made by the fund and when capital contributions are received from investors to finance that investment. Loans are repaid with capital contributions once received from investors.

In Asia, such facilities were historically popular with real estate funds. However, as the market in Asia evolved, these facilities became more prevalent in a broad range of specialty funds and sponsors including infrastructure, private debt and other specialty private equity funds. In this respect, asset-backed facilities – where the financing is provided against the asset value of the fund – are now not uncommon. More recently, hybrid structures (which are a combination of a capital call facility and an asset-backed facility) have also begun to emerge.

Governing law

The governing law for Asian facilities varies, often depending on the identity of the banks, funds and investors. However, the use of US and English law-governed documents appears to be most prevalent. English law is a popular choice for governing law in this region. This is because freedom of contract is widely regarded as a key principle upheld by the English courts. The principle emphasises the importance of upholding the parties' commercial bargain.

However, many have wondered what the impact of Brexit on English law loan documentation will be. Whilst the situation should be closely monitored as Brexit unfolds, it is unlikely to result in significant changes to loan documents at this stage.

Security package

An important feature of a capital call facility is the security package. Most capital call facilities in Asia-Pacific are provided on a secured basis. The security package for Asian funds financings is similar to those in European and North American facilities and typically consists of an assignment of call rights and account security.

The governing law of a security document will typically follow the law of the jurisdiction

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in which the secured asset is deemed to be located (the *lex situs*). In most cases, Singapore law will be used if the call rights are documented under a subscription agreement and limited partnership agreement governed by Singapore law and/or if there is a bank account located in Singapore. Fortunately, the principles of Singapore law on credit and security follow their equivalents under English law closely. However, despite the similarities, it is important to liaise with Singapore counsel as there are key practical requirements specific to Singapore law which the parties will need to fulfil to perfect the security.

Formalities

As a general principle, under Singapore law a legal assignment must be in writing, signed by the assignor, absolute and notified in writing to any persons against whom the assignor could enforce the assigned rights. If any of these formalities are not complied with, it is an equitable assignment. An equitable assignment is less desirable from an assignee's perspective as the assignee can usually only bring an action against the contract counterparty in its own name if it has a legal assignment. With an equitable assignment, the assignee will usually be required to join in proceedings with the assignor. This may be problematic if the assignor is no longer available or interested in participating.

Registration

In addition, a registrable charge created by a Singapore company has to be registered under section 131 of the Companies Act (cap 50, 2006 Rev Ed) (the Companies Act) with the Accounting and Corporate Regulatory Authority of Singapore (**"ACRA"**) within 30 days from the date the instrument of charge was created. A registrable charge that is not registered within the time limit is void against the liquidator and other creditors of the company.

Priority

Similar to other common law jurisdictions, the rules determining the priority of charges under Singapore law are fairly complex. However, under general common law and equitable principles, the relevant time for determining priority between charges is the time of creation of the charges. A prior equitable charge will be defeated by a subsequent *bona fide* legal chargee for value who had no actual or constructive notice of the prior charge.

Key developments

Regulatory developments

As the fund finance market is still not well developed in Singapore, it is important to keep an eye on significant regulatory changes which may affect the asset management industry. It is likely that these regulatory changes may impact the development of the fund finance market. Below are a few of the key regulatory changes.

1. **New proposed corporate legal structure for funds**

   Earlier this year, the Monetary Authority of Singapore (**"MAS"**) announced a public consultation on the proposed introduction of a new corporate legal structure known as the Singapore Variable Capital Company (**"S-VACC"**). The use of the S-VACC as a corporate vehicle is intended to enable asset managers domiciled in Singapore to enjoy more flexibility and to save on costs.

   Currently the most commonly used corporate structures for funds are business private limited companies, trusts and limited partnerships. At present, restrictions on the return of capital to shareholders have meant that companies incorporated under the Companies Act are not widely utilised as a form of corporate vehicle for funds in Singapore.

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In contrast, the S-VACC as a corporate vehicle for funds is more advantageous as it gives investors the ability to freely invest in and out of the structure. Unlike a company incorporated under the Companies Act, an S-VACC can vary its capital without significant restrictions and its capital will always be equal to its net assets. Such a feature provides flexibility in the distribution and reduction of capital of the S-VACC as a company – and is just one of several other attractive features of the proposed S-VACC structure.

2. Simplify approvals and requirements for venture capital funds

In Singapore, the venture capital and private equity sector AUM has grown at a CAGR of 28% over the past five years to reach S$157 billion. It is generally recognised that the venture capital and private equity ecosystem plays an important role in supporting entrepreneurship and innovation. As part of its broader efforts in stimulating growth in the industry, the MAS is working on a number of initiatives including one to simplify the authorisation process and regulatory framework for managers of venture capital funds (**"VC managers"**).

Currently, VC managers are subject to the same regulatory framework as other fund managers. However, there is a general view that VC investors are typically highly sophisticated. Therefore MAS intends to simplify the admission requirements and authorisation process for VC managers based on what it regards as a lower risk of business and market conduct issues associated with VC managers.

As the above proposed regulatory changes relating to the S-VACC and VC managers are currently at a consultation stage, it is premature to determine how this will impact the fund finance market. However, such regulatory changes will generally be well received as they improve Singapore's reputation as a competitive asset management hub in the region.

3. Financial accountability

In a bid to enhance its reputation as an ideal destination for banking and asset management, Singapore has made concerted efforts in improving the transparency and accountability of its financial system.

At an international level, the Ministry of Finance announced on 20 January 2016 that Singapore had signed up to the Convention on Mutual Administrative Assistance in Tax Matters (the **"Convention"**). This is an international agreement for bilateral tax cooperation among the Convention's signatories to combat cross-border tax offences. So far, 92 jurisdictions, including all G20 countries, most OECD countries and major financial centres such as Singapore, Switzerland and Luxembourg, have signed the Convention. Ratifying the Convention will expand Singapore's network of partners for exchange of information on request across various jurisdictions and prevent regulatory arbitrage between countries. This forms part of various measures which Singapore has adopted over the years to combat cross-border tax evasion.

One of the more significant pieces of corporate legislation which the Singapore Parliament passed this year is the Companies (Amendment) Act 2017 on 10 March 2017. The rationale of this latest legislative amendment is to ensure that Singapore's corporate regulatory regime adheres to the high standard of transparency. The amendments include the requirement on Singapore companies, limited liability partnerships and branches of foreign corporations to maintain a new register of controllers. Separately, there is a new requirement for nominee directors to disclose their nominee status and

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nominators to their companies. The objective of these measures is to ensure that the ownership and the control of these Singapore corporate entities are transparent – thereby reducing the opportunities for these entities to be misused for illicit purposes.

The year ahead

Looking ahead, there are a lot of reasons to be optimistic about the fund finance market in Singapore. The asset management industry has continued with its upward growth trajectory this year. Locally, the Singapore Government has made concerted efforts to implement measures to boost the asset management industry. Therefore whilst fund finance facilities are still not very widely utilised by fund managers, there is potential for growth.

2016 was a year marked by unexpected events such as Brexit and the outcome of the US presidential election. Fortunately the focus in 2017 appears to be more on the need to strengthen the liquidity risk management in funds. These are encouraging signs for the fund finance market. The increased emphasis on strengthening liquidity, and the current low interest rate environment, is likely to stimulate greater interest by the Asian funds to access the fund finance market. This may be in respect of its traditional purpose as a subscription facility but perhaps, in the future, more widely as a means to manage the overall cash of the fund on an ongoing basis.

* * *

Endnotes

1. Data based on figures presented by Prequin at the Fund Finance Association 1st Asia Pacific Fund Finance Symposium.
2. Article on "What is China's belt and road initiative?" published by *The Economist*, 15 May 2017, by J.P., Beijing.
3. Information and data from 2016 *Singapore Asset Management Survey, Singapore – Global City, World of Opportunities* published by the Monetary Authority of Singapore (**"MAS"**).
4. Cayman structures are still widely regarded as the most well-established fund structures for Asia-Pacific fund managers.
5. Data based on the Inland Revenue Authority of Singapore website – https://www.iras.gov.sg/irashome/Quick-Links/International-Tax/.
6. Data based on figures presented by Prequin at the Fund Finance Association 1st Asia Pacific Fund Finance Symposium.
7. An absolute assignment of a *chose in action* (ie. like the call rights documented under a subscription agreement) by way of security is typically registered as a charge over book debt under section 131(3)(f) of the Companies Act.
8. See Consultation Paper on the Proposed Framework for Singapore Variable Capital Companies dated March 2017 published by the MAS.
9. Refer to the Consultation Paper on the Proposed Framework for Singapore Variable Capital Companies dated March 2017 published by the MAS for a full list of the proposed features of a S-VACC.
10. Information and data from 2016 *Singapore Asset Management Survey, Singapore – Global City, World of Opportunities* published by the MAS.

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11. See Consultation Paper on the *Proposed Regulatory Regime for Managers of Venture Capital Funds* dated February 2017 published by the MAS.
12. In Singapore, the MAS announced its intention to introduce a set of guidelines for liquidity risk management for fund managers. See speech by Mr Lim Cheng Khai, Director, MAS, at the Investment Management Association of Singapore's 4th Regulatory/Legal Roundup Forum on 10 February 2017.

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Spain

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Overview[1]

For the last few years, the venture capital and private equity industry in Spain has been growing but 2017 has been a spectacular year for the industry in Spain. Latest data available regarding the first nine months of 2017 from *Asociación Española de Capital, Crecimiento e Inversión* (the Spanish private equity and venture capital association) (**"ASCRI"**) through the new European EDC platform show that total investment volume reached €4,380.4m in 575 investments, which is a 102.9% increase with respect to the same period in 2016. The historical record in Spain is 2007 with €4,425m; such historical record may be beaten by the end of 2017.

Highlights of the 2017 venture capital and private equity industry in Spain are:

(a) a significant number of deals with investments higher than €100m in equity (11 transactions until October 2017), mainly performed by international funds which have been very active in the Spanish market representing 71% of total investment volume;

(b) a strong performance of the middle market (deals with investments in equity from €10m to €100m), mainly performed by national funds which have also been remarkably active (42 transactions amounting to €1,248m);

(c) domestic private equity firms raised €1,283m in new funds. One of the continuing important drivers behind this is the Fond-ICO (*the public fund (fund of funds) created by the Spanish Government in order to promote the creation of privately managed venture capital funds which invest in Spanish companies and indirectly in the Spanish business sector*) which drove new fundraising with its eighth call in May 2017, allocating funds to two growth capital funds, three venture capital funds and three incubators. Fond-ICO's commitment to the funds prior to this call was €1,264m. Fond-ICO launched its ninth call in July 2017 and is expected to proceed with its tenth in early 2018; and

(d) divestment volume remained very high: €2,365m (at price cost) in 161 transactions (40% by "Trade Sale", 27% by "IPO" and 21.4% by "Secondary Buyout").

By the development stage, buyouts stood out with an investment volume of €2,831.4m in 42 transactions, driven by the closing of megadeals. This represented 64.6% of total investments made during this period. Growth capital received 77 investments totalling €342.4m. Venture capital received €401m in a total of 445 investments and accounted for 77% of the total number of transactions. Including both venture capital and private equity, the sectors with the highest investment volume during the first nine months of the year were: Consumer Goods (27%); Leisure (19%); Transportation (16%); and Financial Services (14.5%). By number of investments, the best-performing sectors were IT (40.7%), Consumer Goods (9%) and Healthcare (7.5%).

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From a legal standpoint, there have not been significant updates since the Act 22/2014, dated 12 November 2014, regulating venture capital entities, other closed-ended investment entities and closed-ended investment entities' management companies (hereinafter, the "**Private Equity Act**"), which implemented the AIFM Directive in Spain [Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010 Text with EEA relevance], was enacted in Spain. The Private Equity Act has played and continues to play an important role in enhancing the venture capital and closed-ended investment entities' access to financing in Spain, as explained in more detail below.

Fund formation and finance

The emergence of fund finance

One of the mainstream topics in the Spanish funds industry during the last year has been the emergence of fund finance in Spain.

The Private Equity Act indirectly created the necessary legal framework to allow funds to accede to fund financing by allowing the assets of a private equity entity to be charged. In this sense, section 93.d) of the Private Equity Act contemplates that funds can pledge their assets provided that this does not result in a breach of their bylaws or limited partnership agreements. Article 15.4 of AIFMD (which is implemented by section 62.4 of the Private Equity Act) also sets forth the possibility of charging assets of private equity entities. The Private Equity Act addresses a point that the previous legislation did not tackle: the formal recognition that the assets of a private equity entity are chargeable, even in the case of private equity funds (*fondos de capital-riesgo*) which under Spanish law do not have their own legal personality (i.e. the Private Equity Act recognizes the possibility of charging the assets not only for private equity companies or *sociedades de capital-riesgo* but also for private equity funds – *fondos de capital-riesgo*).

During the last years, an increasing number of Spanish private equity houses have, in the wake of fund finance emerging as a product in Spain, expressly included in their bylaws (*estatutos sociales*) or limited partnership agreements (*reglamentos de gestión*) an ability for them to make the assets of their investment vehicles chargeable. One can argue this trend stems only from the aforementioned change brought about by the Private Equity Act, or is the outcome of importing a trend from the United States and the United Kingdom or – why not raise it – is the result of the favourable curve of interest rates or a type of financing that fits better the current needs of the managers of private equity funds; but it is rather likely to be a combination of all of the above.

We have referred above to the fact that private equity houses (and, generally speaking, fund managers) can elect for the possibility of charging the assets of their vehicles. It is worth noting that this assertion is extendable to all the investment vehicles promoted by Spanish fund managers, irrespective of the nationality of the investment vehicle.

On the other hand, the largest Spanish financial institutions have kicked off their internal analysis process to reach the necessary approvals from their internal committees to start participating / increase their participation in fund financing transactions.

Financing and collateral structure

As regards the financing structure for fund financing transactions, the pattern followed in most of the transactions closed in the Spanish market as of today has been the following: a

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committed revolving credit facility – *subscription facility* – governed by Spanish or English law, granted by a foreign fund or credit institution (mainly, based in the United States or the United Kingdom) to an investment vehicle and collateral governed by Spanish law, limited or related to: (i) a pledge over the credit rights resulting in favour of the investment vehicle from the obligations of the investment vehicle's equity investors to make future contributions of previously subscribed capital to the investment vehicle – *unfunded capital commitments* – (the **"UCC Pledge"**); and (ii) a pledge over the credit rights from the bank account where the capital contributions of the investment vehicle's equity investors have to be made – *deposit account*.

It is worth pointing out that the reason for using English law in the subscription facility is that the entities financing this product are based in the United States or the United Kingdom, and they are more familiar with English law than with Spanish law, rather than any limitation under Spanish law that exists for this type of transaction. We anticipate that as with the French market, as fund finance products become more commonplace and better understood in Spain, we will see a move to at least some of these facilities being documented under Spanish law. As Spain is, however, a relatively nascent market still for fund finance, to date the fund financings that have been done in Spain are either solely or principally LP-backed facilities, and we have not yet many other types of fund finance products in Spain.

In addition to the aforementioned collateral, it is essential for the lenders in a fund financing to obtain from the fund an irrevocable power of attorney that allows them to call down and receive the undrawn investors' commitments in the event of a default under the subscription facility. Such irrevocable power of attorney has to comply with the requirements provided under Spanish law, such as the requirement that powers of attorney need to be granted in a public deed before a Spanish notary public by a duly empowered representative of the fund.

In light of the above, several aspects must be borne in mind in relation with the abovementioned pledges:

(a) *The necessity to notify:* Pledges require delivery of the possession (except in the case of pledges stated to be without delivery of the possession) under Spanish law. The existence of pledges over receivables was traditionally controversial under Spanish law but was finally recognised and accepted by the Supreme Court. The delivery of the possession that is required by section 1,863 of the Spanish Civil Code is obtained by serving notice to the relevant counterparties of the receivable (in this case, the unitholders and the credit institution which holds the bank account to be pledged pursuant to the bank account pledge referred to above).

    While an acknowledgment of the counterparty of the receivable is not legally required for Spanish perfection purposes, it is nonetheless something which is requested in fund financings to provide the lender with additional comfort and certainty in a potential enforcement of the pledge scenario.

(b) *Sensitivity of the notice:* The notification to the investors is a document that perfects the pledge but, at the same time, it is a document addressed to all the investors of the private equity entity. As a consequence, the notification must be drafted in a way that perfects the security without jeopardising the commercial relationship with the unitholders.

(c) *Transfer of interests:* Private equity entities often permit the transfer of the units or the shares, as the case may be, by their investors in certain circumstances and subject to certain conditions. This transferability should not be limited by the subscription facility but, at the same time, the security package must be drafted in such a way that

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any future acquirer is notified of the pledge, because without this any such investor can freely discharge its obligations against the fund without regard to the lender's security provided the contribution is effected on a *bona fide* basis. In order to facilitate this: (i) the notification will contain a statement that the existing investor will notify any transferee investor of the existence of the pledge; and (ii) the pledge will include an entitlement of the lender to update the list of investors in the document, as well as the entitlement of the lender (and corresponding duty of the borrower) to carry out as many steps as necessary in order to maintain the security (and this will include, without limitation, the serving of notice on investors acquiring shares or units from existing investors).

(d) *New closings:* Private equity vehicles in Spain, as elsewhere in the global private markets, are characterised by sequential closings, such that new investors acquire shares or units (as applicable) at different stages. The security package in a fund financing must include an obligation on the pledgor to update the pledge in order to capture all the prospective commitments. This will entail the issuance of new notices to the incoming investors for the purpose of perfecting the pledge.

Specific documentation issues

The rationale for Spanish fund managers employing these types of facilities is the same as for other regions, i.e., enhancement of returns, reduction of administration involved in issuing multiple capital call notices to investors, and the certainty of speed and execution brought about by fast access to capital provided by the credit facility in carrying out transactions.

By and large, limited partnership agreements for Spanish funds contain the same provisions as one would expect to see in limited partnership agreements in more familiar jurisdictions and, in particular, shortfall provisions and remedies in the event of a default by an investor in funding its commitment. Usually limited partnership agreements deal with defaulting investors by, firstly imposing a penalty to be paid by the defaulting investor together with its commitment within a period of time (between 15 days to a month) and, secondly in the case the defaulting investor does not attend to payment of the penalty and its commitment in the relevant period, by either: (a) selling the units or the shares, as the case may be, of the defaulting investor to a third investor; or (b) the investment vehicle acquiring the units or shares of the defaulting investor and then redeeming such units or shares.

Defaulting investors not attending to their payment obligations do have an impact on the UCC Pledge. The investment vehicle would still hold a credit right against the defaulting investor arising from its unattended obligation to provide its commitment and such a credit right would still be pledged under the UCC Pledge; however, in practice if an investor has defaulted in its obligations, presumably it will not attend to its future obligations (the penalty to be paid together with its defaulted commitment referred above) either, so the UCC Pledge is weakened because the credit right pledged thereunder is unlikely to be paid. In addition, the secured parties would not have a direct action against the defaulting investor; only the investment vehicle (as holder of the pledged credit right) would. And, as explained above, limited partnership agreements rather than regulating further actions of the fund against the defaulting investor, usually provide for: (a) selling the shares or units of the defaulting investor to a third party; or (b) redeeming such unit or shares. In both cases, the credit right against the defaulting investor would cease to exist and, as a consequence, so would the UCC Pledge over such credit right.

In that scenario, remedies for the secured parties will depend on whether the units or shares are (a) sold or (b) redeemed.

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If (a) the units are sold by the fund to a third party (incoming investor), the fund would hold credit rights against such incoming investor over its unfunded capital commitments equivalent to the credit rights initially held by the fund against the defaulting investor. Such credit rights could be captured under the original UCC Pledge provided the relevant incoming investor is notified of the UCC Pledge using the mechanisms provided thereunder. This scenario would be equivalent to a transfer of the shares made by the investors analysed above (see *(c) transfer of interest*) even if, in this case, the transfer of the shares is not made by the investors but by the fund itself. As a consequence, the secured parties should not be affected by a sale of the units or shares of the defaulting investor to a new incoming investor because the credit rights of the fund against the incoming investor would still be pledged in favour of the secured parties.

On the contrary, if (b) the units or shares of the defaulting investor are redeemed by the fund, the pledged credit rights (as credit rights of the fund against the defaulting investor) would be extinguished rather than replaced by the credit rights against an incoming investor, even if the fund would still hold a credit right against the defaulting investor for not attending to its payment obligations (the penalty). The UCC Pledge would cease to exist in respect of the extinguished credit right and would only capture the penalty, but presumably the amount of the penalty should be lower than the credit rights arising from the shares or units redeemed, so the position of the secured parties is weaker in a redemption scenario.

Key developments

As previously mentioned, it is now possible for a private equity fund manager to charge its assets in accordance with section 93.d) of the Private Equity Act. These entities do not have legal personality according to Spanish law and therefore could not charge their assets before the enactment of the Private Equity Act. This has been essential in the emergence and development of fund finance. Having overcome the obstacle of permitting private equity fund managers to charge their assets, it is now time to deal with a new obstacle, which is the impact on the UCC Pledge of redeeming the units or shares of the defaulting investor. There are currently discussions in the Spanish market around this scenario in order to provide a suitable solution for the secured lenders but, for the time being, this is a risk that secured lenders need to assess.

It is also worth noting as regards private equity funds (but not private equity companies), that the possibility of these funds being declared bankrupt according to Spanish law is questionable, due to the fact that they lack legal personality, and section 1 of Act 22/2003, dated July 9 and as amended (the "**Spanish Bankruptcy Act**") sets forth that the declaration of bankruptcy can be ruled only in respect or persons or legal entities with legal personality – which would not comprise private equity funds.

Lastly, we would like to specify that this fund finance analysis: (i) is applicable to both private equity companies (*sociedades de capital-riesgo*) and private equity funds (*fondos de capital-riesgo*), even when we use the expression "fund finance" informally; and (ii) is also applicable, with respect to most of its contents, to closed-ended entities (*entidades de inversión colectiva de tipo cerrado*).

The year ahead

The forthcoming year is expected to be active in terms of economic growth (both the International Monetary Fund and the Bank of Spain forecast a 2.5% growth in GDP) which, in our view, should reflect continued growth in the private equity industry and therefore

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continued growth in fund finance. The general consensus in the private equity industry in Spain is that 2018 will continue the 2017 growth trend given the large amount of capital raised last year. In addition, given the ECB has not yet shown any immediate intention on increasing the interest rate in the Eurozone and the existing legal framework in Spain, it seems that fund financing is becoming, or may become, a proper alternative in the Spanish market to LBO financing, taking into account the advantages that this type of financing offers to fund managers.

However, as with many countries in the EU, there is still a significant element of uncertainty arising from Brexit. We have referred to the fact that financiers from the United Kingdom and United States are very active in this sector, and it is not yet clear how the negotiations in respect of Brexit will develop. In addition to uncertainty arising from Brexit, in Spain recent events in connection with the political situation of Catalonia make it difficult to predict whether international investors will keep being attracted to Spain or will pause their investments until there is more certainty on the Catalonia issue. Time will tell.

* * *

Endnote

1. Source: ASCRI.

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2017 in Review – Records, Recommendations and Responses

While 2017 was a record-breaking year for private capital funds, it was also a year that featured a robust dialogue concerning the shape and scope of leverage applied to these funds. Fundraising for private equity funds surpassed or approached previous records, including with respect to the most capital raised in a calendar year and the launching of the largest private equity fund. Subscription line financings and other financing activity supporting these funds remained at historically high levels. At the same time, in 2017, market participants engaged in an active and, at times, public discussion of fund financing. Some groups, most notably the Institutional Limited Partners Association ("ILPA"), recommended certain improvements to funds and their subscription line financing providers for the benefit of investors. The commentary and recommendations spurred responses from other participants in the fund finance industry, including, most notably, the Fund Finance Association ("FFA"). A wide variety of commentators, including private investors, fund advisory firms, accounting firms, law firms and the mainstream media also contributed to the dialogue.

This article will address recent market trends in the private capital markets, including in the fund finance industry, as well as the public discourse surrounding subscription line credit facilities. It will then address other market and legal developments of note for fund financings, and will conclude with a brief outlook for the year ahead.

State of the market in 2017

Recordbreaking fundraising

According to industry reports, 2017 was arguably the most successful fundraising year for private capital markets. This success continued the consistent growth that the market has enjoyed since 2013: between 2013 and 2016, aggregate fundraising increased by approximately $50 billion each year. In 2016, fundraising for the private capital markets totaled $728 billion and surpassed the previous high of $708 billion from 2008. A strong fourth quarter in 2017 contributed to a fundraising total of $754 billion for the entire calendar year, which established a new record for the private capital markets, as measured by market data providers.[1]

In addition to the aggregate fundraising figures, there were several funds that established new highs for funds of their type in 2017. Internationally, the SoftBank Vision Fund, currently

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at $93 billion in capital commitments, is the largest private capital fund ever raised. In the United States, Apollo Investment Fund IX raised $24.7 billion in capital commitments and is the largest private equity fund ever. Venture capital, secondaries, growth and natural resources also closed funds that ranked among the five largest for such asset classes. The average size of a private capital fund closed in 2017 was $570 million, which surpassed the previous high in 2008 of $475 million. In addition, there is evidence that there are more new entrants into the market than in previous years, which may contribute to further growth in the coming years.[2]

Market research indicates that investors continue to report satisfaction with their investments generally across the asset classes, including private equity, private debt, venture capital, real estate and infrastructure. With the exception of hedge funds and natural resources, investors also report that they plan to increase their allocation in their existing asset classes, both in the next 12 months and in the longer term.[3]

Fund finance

The market for subscription line facilities and other financing products that leverage private capital funds is closely linked to the fundraising and successful closings of those funds. As such, the fund finance space has benefited from the sustained rise of both in the past few years. In parallel, the proportion of private capital funds utilising subscription line facilities as part of their fund capital structure has also increased in the recent past. Although there are no published reports on the aggregate amount of lender commitments under subscription line facilities, anecdotal evidence from market participants indicates that 2017 was another successful year for the fund finance space, with some estimating several hundred billion dollars of committed facilities. In addition, consistent with previous years, no significant defaults under subscription line facilities were reported by lenders or their counsel. The growth and stability with respect to fund-level leverage further supports the proposition that, in the United States, subscription line facilities and other leverage products occupy a key function in the capital structure for private capital funds.

Against the backdrop of continued fundraising success for private capital funds and investors subscribing to these funds, subscription line facilities have become a prominent topic of public discussion and press coverage.

The public discussion of subscription line facilities

Among numerous pieces contributed by various market participants, the June 2017 release by ILPA entitled, "*Subscription Lines of Credit and Alignment of Interests: Consideration and Best Practices for Limited and General Partners*" (the "ILPA Guidelines") and the response by the FFA, "*FFA Analysis and Recommendations on the ILPA Guidelines for Subscription Credit Facilities*" (the "FFA Analysis") were two of the more prominent contributions to the discussion.[4]

While there are many nuanced viewpoints articulated, in general, the discussion can be characterized as reflecting two differing counter-positions. One position contends that subscription line facilities may be used by funds to artificially increase the internal rate of return ("IRR") of a leveraged fund, in particular in the first few years of a fund's life, and that the interest and fees relating to the facilities (ultimately shouldered by investors) present a greater cost than the benefits they provide. It also alleges that subscription facilities may increase the probability of sudden capital calls (to repay defaulted lines), which, in extreme instances, could present a liquidity risk. The countervailing position contends that the difference in IRR (between a leverage fund and an unleveraged fund) over the course

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of the life of a fund is very small and that investors understand the economic impact of the facilities. In addition, it asserts that the pricing of subscription facilities is very favorable, and the facilities are an essential tool for funds from an operational and financial viewpoint (for example, to have capital deployable for investments within a very short time period, provide access to letters of credit and foreign currencies and ease the administrative burden of making multiple capital calls to investors). Additionally, the increased risks to investors presented by a fund employing a subscription line facility are remote (and the perceived liquidity risk is not created by the presence of the facility in and of itself), and the use of such facilities by funds has become standard in the market and is generally expected by investors.

ILPA guidelines

ILPA is a trade organisation representing the interests of institutional investors in private equity funds. The ILPA Guidelines briefly mention the administrative benefits of subscription line facilities for an investor, including smoothing cash flows and limiting the number of capital calls to which an investor has to respond.

The main focus of the ILPA Guidelines is the potential lack of alignment of interests between a fund and its investors with respect to subscription line facilities and where, in the view of ILPA, the differing interests may be detrimental to investors. In addition, the ILPA Guidelines discuss the possibility of inadequate visibility into investors' total exposure that may be attributable to subscription line financings. The ILPA Guidelines also identify the increased IRR of a leveraged fund in its first few years as a result of a subscription line facility, as compared to an unleveraged fund, and the effects this could have on investor perceptions of fund performance, as well as the possibility that the fund's general partner may potentially collect carried interest earlier in a leveraged fund than in an unleveraged fund with the same financial results. The ILPA Guidelines conclude by offering nine enumerated recommendations for funds and their general partners to ensure that "the use of lines of credit should accrue to the benefit of the LP."

Fund Finance Association analysis and response

The most substantive response to the ILPA Guidelines thus far has been the FFA Analysis. The FFA Analysis acknowledges the ILPA Guidelines as a constructive and productive attempt to present an analysis of the benefits and detriments of subscription line facilities, but also emphasises that ILPA should resist advocating a "one-size-fits-all" approach with respect to subscription line facilities. Specifically, the FFA Analysis responds to each of the categories of recommendations included in the ILPA Guidelines.

Increased disclosure

The FFA Analysis identifies various recommendations from the ILPA Guidelines that encourage greater transparency by funds in their communications with investors. These steps concerning transparency and disclosure from the ILPA Guidelines include: quarterly reporting to investors concerning a fund's financings, including the amounts outstanding, the use of proceeds, the number of days outstanding of each draw, the net IRR (calculated both with and without the subscription line facility), the terms of the financing and the costs of the financing to a fund; discussing the financing with the limited partner advisory committee; timely reporting to investors concerning investments, even if no capital has been called; generally reporting a fund's policies as to financings and the impact of financings on the sponsor's track record (including with respect to IRR) in the investors' diligence materials; and disclosure of detailed terms of the subscription line facility that would be of concern to an investor, such as the assets being collateralised, documentation requirements

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imposed on investors and terms that may influence the financial obligations of investors (e.g., cross-default provisions, facilities that are payable on demand).

Although the FFA supports the overall recommendation of robust disclosure to investors, the FFA Analysis stresses that the "vast majority" of funds already satisfy this standard of disclosure. The FFA Analysis adds that lenders under subscription line facilities often require much of the detailed disclosure discussed in the ILPA Guidelines with respect to the obligations of the investors *vis-à-vis* the subscription line facility. The FFA Analysis also notes that most investors are sophisticated and educated about the mechanics of a subscription line credit facility. Also noted, both in the FFA Analysis, as well as in other sources (such as in the Private Equity International piece, which quotes a fund manager stating that his investors are pressuring him to enter into subscription line facilities for his funds), is that many investors expect and welcome subscription line facilities, because of the benefits to investors with respect to cash flow and capital calls. In general, the FFA Analysis agrees that increased disclosure is better for all parties, but the precise nature of the disclosure, given the unique circumstances of any single credit facility, is best left to discussions between a fund and its investors. Commentators, including law firms, expect the trend towards increased disclosure to investors of their fund financings to continue in 2018, especially in light of the general agreement among all market participants as to the benefits of communication between funds and their investors.

Specific limitations on subscription line facilities

The FFA Analysis also discusses the ILPA Guidelines' recommendation concerning specific thresholds for subscription line facilities: (i) the maximum leverage should not exceed a certain percentage of all uncalled capital, from 15-25%; (ii) amounts borrowed should not remain outstanding for greater than 180 days; and (iii) there should be a maximum period of time for which such lines can be utilised; and other specific terms, such as: (1) ensuring that advance rates are based on uncalled capital; (2) ensuring that subscription line facilities are secured only by the uncalled capital commitments of investors, and not invested assets of a fund; (3) ensuring a maturity after a definitive time period and not payable on demand; and (4) allowing investors to cap their interest expense payable. The FFA Analysis states that these recommendations are too rigid to be applied to all subscription line facilities across all asset classes of funds, and suggests that a more nuanced approach, which would consider the unique circumstances of each fund, is advisable.

In particular, the FFA Analysis notes the ILPA Guidelines' recommendations do not account for a fund's individual investment strategy, availability of investment-level financing or fund-specific timing considerations. The FFA Analysis identifies different types of funds, based upon asset class or size, that may have divergent strategies with respect to leverage. For example, certain funds, such as credit funds, may use a subscription line facility to provide bridge financing until the funds are able to enter into a fund-level asset-based credit facility, secured by the loans held by such funds (and such asset-based facilities are rarely available in the early life cycle of such funds before they reach a level of portfolio diversification). Other funds, such as commercial real estate funds, use subscription line facilities as less expensive leverage, in lieu of specific mortgage financings, until the real estate properties can achieve a credit profile that maximises the terms of the property-specific permanent financing. If the ILPA Guidelines' recommendation requiring "clean-downs" (i.e., requiring loans to be repaid within 180 days) were to be strictly followed, many funds would lose the true benefits of the subscription line facilities, which would ultimately be to the detriment of investors.

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The FFA Analysis also notes that, with respect to the increased IRR in the first few years of a fund with a subscription line facility, the concern may be overstated because studies show that the effect on IRR over the life of a fund is fairly minimal.[5] Additionally, the FFA Analysis clarifies the differences between subscription facilities and other types of fund-level financing: while the latter forms of leverage are based upon the net asset value ("NAV") of a fund's underlying investments, traditional subscription facilities are based on the amount of investors' uncalled capital. To be sure, hybrid facilities, which include both capital commitment-based and NAV-based borrowing bases and collateral pools, are gaining increased popularity in the marketplace. However, many commentators draw a distinction between subscription line facilities and NAV facilities (including hybrids) and indicate that such facilities should not be subject to the same analysis as subscription line facilities, because the parameters of the former are typically addressed by investors and fund managers through a separate set of criteria.

The FFA Analysis includes helpful refinements of ILPA Guidelines' specific recommendations, such as: (i) that clean-downs should be considered after a fund has completed all fundraising to avoid frequent rebalancing between investor closings; (ii) that clean-downs should not be applied to all facility uses (for example, letters of credit, which are almost always required to be posted for a longer period of time, should be carved out); (iii) that restrictions on indebtedness should only apply to debt for borrowed money and not to guarantees or other credit enhancements issued by a fund in support of investments; (iv) that the post-investment-period needs of funds should be considered in determining the length of the term of facilities; and (v) that, most importantly, all funds have different investment objectives, asset classes and investor bases, so that imposing the ILPA Guidelines' recommendations (for example, that they be repaid within 180 days) universally might defeat their intended purpose. It should be noted that in some cases, either investors or lenders have historically required a clean-down of borrowings under subscription facilities within even a shorter period of time. Interestingly, some commentators have observed that in certain cases, the ILPA Guidelines now serve as an opportunity for extending these periods to the recommended 180 days.

Liquidity risk

The FFA Analysis further responds to the ILPA Guidelines' concern that the facilities could create a wave of capital calls that could affect investors' ability to fund capital calls. The FFA, referencing conversations with investors and noting the size of the secondaries market (which has grown exponentially over the last decade) as a source of liquidity, believes that investors are not concerned as to the risk of their inability to meet capital calls as a result of fund-level credit facilities. The FFA Analysis also notes that the investor funding default rate has historically been near a statistical 0%, even during the financial crisis.

The FFA and some commentators have noted that, although in practice, the facilities result in many fewer capital calls to investors, they neither release the investor from a capital commitment (because its capital is committed and must remain available on relatively short notice, as it can be called by a fund at any time) nor do they increase the investor's funding obligations (because a lender can never call more than the amount committed). Therefore, a subscription facility itself does not create any additional legal obligations on investors that could result in further funding risk than an investor has already assumed by virtue of subscribing to a fund and committing to fund capital calls.

Based on the number of participants in the discussion and the frequency with which they contribute to it, we expect that a lively debate concerning the merits of subscription line facilities will continue for the foreseeable future.

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Market developments: Investor letters

For more than a decade, direct privity between the subscription line facility lender and investors has not been required under typical market terms for diversified commingled funds. Such privity would generally be established by the relevant investor delivering an "investor letter" to the lender, pursuant to which the investor acknowledges the pledge by the fund of such investor's capital commitments and confirms its obligation to make capital contributions when called, including with respect to capital calls made in connection with a financing or when such capital calls are made by a lender.

Investor letters are an administrative burden to a fund: they present additional and separate documentation requested from investors (in addition to the regular subscription documents relating to the fund) and may disrupt the planned investor communications from the fund. Additionally, if all investors were expected to deliver investor letters, it would likely generate a negotiation process with each investor, and require significant time and resources, as well as added cost. Further, because each investor may have its own requirements and appetite for negotiation, the process could yield different versions of investor letters being delivered to the lender, which could contribute to inconsistent treatment of otherwise similarly situated investors in the borrowing base and create uncertainty for funds as to expected borrowing capacity.

As a result of these and other factors, investor letters are no longer standard in the United States for funds with a diversified limited partner base. Limited partnership agreements or the equivalent constituent fund documents have become more standardised with respect to the fundamental financing provisions that were traditionally contained in investor letters, especially as many fund sponsors launch second, third or later generation funds, often to repeat investors, with both a subscription line facility and a specific group of relationship lenders in mind. Fund sponsors and investors alike have pushed for the elimination of investor letters across the board and this approach has largely been accepted by lenders, as the appropriate protections are included in limited partnership agreements.

However, there are exceptions to this general rule. For instance, some fund sponsors who are new entrants into the subscription line facility market have historically agreed to request investor letters, if required by a lender. Even established, large fund sponsors may agree to investor letters in certain limited circumstances, including when a fund is comprised of one or a few large institutional investors, or when an investor is an affiliate of the sponsor (because the uncertainty of whether an investor letter can be obtained from an affiliate is significantly lower compared to a third party investor).

Market observers noted some interesting developments during the past year that suggest further refinement to the practice of providing investor letters. One such example is that investors affiliated with fund sponsors who historically had been delivering investor letters negotiated to eliminate such requirement. Another development was that large institutional investors utilizing separately managed accounts, or "funds-of-one", delivered very limited investor letters that provided lenders with little more than a confirmation of the investor's capital commitment. On the other hand, because of the rising popularity of these vehicles, investor letters in the more traditional and fulsome scope have not completely disappeared and are still utilized in that particular segment of the market. In 2018, we expect investor letters to continue to be very rare for funds with diversified investor bases, and investors who do deliver investor letters will continue to further negotiate for limited representations and covenants.[6]

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Market developments: LIBOR retirement and potential replacement approaches

In July 2017, the United Kingdom's Financial Conduct Authority, which regulates the London Interbank Offered Rate ("LIBOR"), announced that LIBOR would be retired by the end of 2021. The announcement reverberated across the international capital markets, as LIBOR serves as the interest rate benchmark for more than $300 trillion in loans and derivatives. While a number of other benchmarks have been suggested as replacements for LIBOR, as of year-end, no other interest rate has been widely accepted as a new standard interest rate.

Determining a replacement interest rate for LIBOR will have practical consequences for the fund finance space. LIBOR-based loans are very common in fund financings and there are a number of fund finance facilities that have terms of four years or longer, especially when giving effect to extension periods. As a result, there will be an increasing number of facilities in 2018 and beyond that will need to address a replacement interest rate for LIBOR-based loans.

There are certain trends developing in the broader financial markets with respect to the language in credit facilities that address a replacement rate for LIBOR. One approach is to permit any of the administrative agent, the borrower or lenders representing a majority in interest of commitments or outstanding loans, to recommend that LIBOR should no longer be used as the interest rate standard. In addition, credit facilities may provide that the replacement interest rate should be determined jointly by the administrative agent and the borrower, giving due consideration to any existing interest rate conventions for similarly situated loans. Accordingly, if such a replacement interest rate is provided for, no lender vote would be required and any potential disruption to the operation of the credit facility will be minimized (although in some cases, lenders constituting required majority have a right to disapprove such a rate). We anticipate that in 2018, the market practice will continue to evolve and LIBOR concepts and provisions will continue to be negotiated, as market participants of all shapes and sizes further reflect on the interest rate landscape and potential benchmarks.

Market developments: Tax reform

On December 20, 2017, the United States Congress passed H.R. 1, known as the "Tax Cuts and Jobs Act," which was signed into law on December 22, 2017 (the "New Tax Law"). The New Tax Law includes significant changes to the taxation of business entities. In particular, it places significant limits on the deductibility of interest expense, which, under certain circumstances, may make it less attractive for a borrower to issue debt. These limitations could affect funds and, indirectly, their investors and may also impact lenders, including subscription facility lenders. Although the New Tax Law has been enacted, only limited guidance has been issued to date and some uncertainty remains, including as a result of the need to implement Treasury Regulations and/or technical corrections. It is currently unclear if and when any further guidance will be forthcoming, and future regulatory guidance and legislation may significantly affect the impact of the New Tax Law.

Legal developments: The Hague Securities Convention

On April 1, 2017, the Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary (the "Convention") came into effect in the United States (after similarly being ratified by Switzerland and Mauritius). The Convention has a potential effect on the choice of law rules regarding certain issues in respect of securities held with an intermediary, including the perfection and priority of a security interest in such

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securities. Because of its impact on the perfection of liens over securities accounts (and, as a result, account control agreements), the Convention has received a significant amount of attention from practitioners in the fund finance space.

Securities accounts in fund financings

The collateral supporting a subscription line financing generally includes both a pledge of the uncalled capital commitments of the fund's investors, the associated rights of the fund or its managing entity to call such capital commitments, and a pledge of the fund's bank accounts into which capital calls are funded by investors. In connection with the pledge of a fund's applicable bank accounts, the fund, the administrative agent on behalf of the lenders as secured parties and the depositary bank (or securities intermediary, as the case may be) enter into an account control agreement. An account control agreement serves to perfect, under the UCC, the secured parties' security interest in the bank accounts (in that, with respect to perfection of a securities account, control has priority over filing a financing statement and, with respect to a deposit account, control is the only avenue to perfection).

In addition, an account control agreement governs the control of the pledged accounts both prior to an event of default under the underlying credit facility and subsequent to an event of default, in connection with which the administrative agent may deliver a notice of exclusive control over the accounts to the depositary bank (or securities intermediary). The accounts into which investor capital contributions are paid may be securities accounts (although investors are funding cash into the accounts, a fund may purchase liquid securities with the cash and hold such securities in that account, in order to generate return on the cash pending deployment by the fund). Because the securities account may hold non-U.S. securities or because a fund, the secured party and the securities intermediary may have differing jurisdictions, the Convention, which governs securities accounts but not deposit accounts, may be an important consideration with respect to determining perfection.

Scope of the Hague Convention: Choice of law rules

The main purpose of the Convention is to update the choice of law rules governing the holding, transfer and pledging of securities in light of certain technological developments in the securities market over the past few decades.

In the United States, Article 9 of the Uniform Commercial Code (the "UCC") governs the attachment and perfection of a security interest in securities. Article 2 of the Convention provides that the Convention determines the law applicable to, among other issues, the priority and perfection of a security interest in securities held with an intermediary (the "Convention Issues"). As a treaty, therefore, the Convention determines the applicable law in lieu of the UCC choice of law rules on these issues. It has no effect on the underlying substantive law, and the UCC still governs attachment generally, and the priority and perfection of security interest in securities that are directly held. In the United States, the Convention applies in all transactions involving even a minor foreign element, and whether or not such foreign element is of a nation that has adopted the Convention.[7]

Choice of law rules: Practical applications

The Convention provides that the law applicable to the Convention Issues is the law expressly agreed in the account agreement (i.e., the agreement between the account holder and the securities intermediary that governs their rights and duties in relation to the securities in the securities account) as either (i) the law governing all Convention Issues, or (ii) the law governing the account agreement. The rule also requires the securities intermediary to have an office in the United States that is engaged in the business of maintaining securities accounts.[8]

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From a practitioners' perspective, the Convention Issues can be addressed by ensuring that the account agreement is clear as to the jurisdiction of the laws applicable to the issues specified in Article 2(1) of the Convention. This can be accomplished in a number of ways, such as incorporating within the securities account control agreement an amendment to the account agreement to provide for the proper jurisdiction in the account agreement. Additionally, because the transition rules of the Convention are not clear with respect to account agreements and account control agreements entered into prior to April 1, 2017, some parties have amended their agreements to expressly provide for the desired law to apply to all Convention Issues, thus unambiguously applying the rule from the Convention, as recommended by the American Bar Association's Section on Business Law.[9]

Furthermore, in the United States, a security interest in securities can be perfected by either control or filing a financing statement, and while perfection by control has priority over perfection by filing, many lenders nevertheless choose to perfect by both methods. In light of the fact that the Convention could yield a result different from the UCC with respect to choice of law that would dictate where to file the relevant financing statement, parties may elect to file it under the laws of both jurisdictions in certain situations.

We anticipate that as the proper concepts and provisions concerning the Convention are incorporated into account agreements and, as necessary, account control agreements, issues regarding implementation of the Convention will continue to become less common.

Conclusion

The year of 2017 brought many notable developments and, overall, was a successful year for fundraising and fund financing. We expect that 2018 should continue on a positive note, based on macro-economic environment and investor confidence, among other reasons, although it will be interesting to see how the effects of the tax reform and the continued LIBOR replacement discussions and activities, among other developments, will be absorbed by the market generally. We also believe that a dynamic discussion concerning subscription line facilities will continue but, with public dialogue as a background, investors will continue to invest in funds employing leverage.

At the same time, we expect that the commentary concerning subscription line facilities will serve as a good reminder to keep open lines of communication between lenders, fund sponsors and investors, including about the subscription line facilities. Increased communication will contribute positively to the development of the fund financing market and allow for improved utilization of subscription facilities – in the mutual best interest of all constituencies.

* * *

Endnotes

1. *Preqin Q4 2017 Fundraising Update*.
2. *Preqin Q2 2017 Fundraising Update*; *Preqin Q4 2017 Fundraising Update*.
3. *Preqin Investor Outlook: Alternative Assets H2 2017*.
4. These are in addition to pieces by law firms, fund managers, fund advisory firms, accounting firms, international newspapers and media companies and trade publications. See, e.g., "Subscribing to Change", Thomas Duffel (PERE/PEI), Albert Tan (Haynes and Boone LLP), David Wasserman (Sumitomo Mitsui Banking Corporation), Kenneth Chiu

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(Gaw Capital Partners) and Jan Sysel (Fried, Frank, Harris, Shriver & Jacobson LLP), *Roundtable hosted by Private Equity Real Estate*, June 22, 2017; "The Subscription Line is Fine," Ellen Gibson McGinnis and Timothy E. Powers (Haynes and Boone LLP), May 8, 2017; "Subscription Credit Facilities: Misperceptions Remain Aplenty," Michael Mascia (Cadwalader, Wickersham & Taft LLP), December 7, 2017; "Lines in the Sand," Howard Marks (Oaktree Capital), April 18, 2017; "ILPA's Mistake – Credit Line Guidance," Matt Lowe (Langham Hall), July 31, 2017; "Sub-line Facilities: End of the Road?," Julia Keppe (PwC), November 15, 2017; "Private Equity's Dirty Finance Secret," *Financial Times*, Chris Flood, July 27, 2017; "Buyout Firms Are Magically -- and Legally -- Pumping Up Returns," *Bloomberg*, David Carey, April 13, 2017; and "The Dividing Lines of Fund Finance," *Private Equity International*, November 23, 2017.

5. "Lines of Credit and Their Impact on IRR", Cobalt for General Partners, 2017.
6. For further reading on investor letters, please see in this volume, "One size does not fit all: Subscription facilities as a global financing tool for investment funds of various types", Jan Sysel, Jons F. Lehmann & Sabreena Khalid.
7. A foreign element includes the place of business or incorporation of the account holder, the intermediary, the parties or the issuer of the underlying securities, and does not depend on whether or not such foreign element is related to the dispute on hand or is considered material by the chosen forum.
8. Convention art. 1(1)(e); Convention art. 4(1).
9. Presentation from the Business Law Section of the American Bar Association; March 15, 2017; "The Hague Securities Convention Becomes Effective," April 1, 2017; "What You Need to Know Now," p. 21.

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