Global Legal Insights

Fund Finance

2017

First Edition

Contributing Editor:
Michael C. Mascia

global legal group

FUND FINANCE association

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Published by Global Legal Group

GLOBAL LEGAL INSIGHTS – FUND FINANCE

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We are extremely grateful for all contributions to this edition.
Special thanks are reserved for Michael C. Mascia for all his assistance.

Published by Global Legal Group Ltd.
59 Tanner Street, London SE1 3PL, United Kingdom
Tel: +44 207 367 0720 / URL: www.glgroup.co.uk

ISBN 978-1-911367-36-9
ISSN 2399-1887

Printed and bound by CPI Group (UK) Ltd, Croydon, CR0 4YY
February 2017

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PREFACE

We are pleased to present the first edition of *Global Legal Insights – Fund Finance*. And I am pleased to serve as the contributing editor.

This book is designed to provide law firms, financial institutions, funds and investors with a comprehensive insight into the legal trends and developments in the greater fund finance markets across all the active jurisdictions. It includes 14 product-oriented chapters, which are designed to provide a comprehensive look at specific topics and product evolutions, and then follows with 17 jurisdiction updates.

In producing this edition, we have gathered the views and opinions of leading practitioners from around the world. The participating authors were asked to provide their personal views on the most important trends and recent developments in the subscription credit facility and related fund finance markets in their respective jurisdiction. We are thrilled with the quality of the submissions and greatly appreciate all the authors for their contributions.

We encourage you to provide any comments you may have to improve future editions of this book.

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 effort in establishing and publishing the inaugural edition of *Global Legal Insights – Fund Finance*. They have brought together the preeminent law firms across the globe, providing a virtually worldwide Fund Finance legal and market update in a single volume. The FFA were pleased to contribute to the publication and hope you find the first edition enlightening 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 7th Annual Global Fund Finance Symposium on March 14, 2017 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 the date and expanded venue for the 3rd Annual European Fund Finance Conference, which will take place on October 11, 2017, 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

Overview

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. As discussed in previous chapters in this book, 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 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.

Some lenders structure these facilities as a loan facility, others as a note purchase facility not too dissimilar to a securitisation structure.

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.

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 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. 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 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 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.

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 made by the fund. If its investor commitments are fully drawn, the fund may have a 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.

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 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.

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 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 the 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, 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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Leon Stephenson is a partner in Reed Smith's Financial Industry Group and the European Head of Funds Financing. Leon and his team work with banks, other financial institutional lenders, General Partners and Limited Partners of funds on specialist financing transactions with private equity, real estate, credit and other funds. Reed Smith has one of the market leading fund finance practices acting for lenders and funds in the European, US, Asian and Middle Eastern markets. Leon has particular specialist knowledge of capital call facilities, NAV, Asset-Backed and Hybrid facilities, co-investment and GP/Manager support facilities and other types of liquidity facilities provided to funds. He represents a large proportion of the banks specialising in fund finance in the UK and Europe.

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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 lenders 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 all 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.

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

The organisational 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.

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

The organisational and management documents of the various parties are among the most fundamental and important documents to review in connection with a capital call facility. These documents include: the limited partnership agreement or other operating agreement of each fund (referred to here as the LPA); the organisational documents of the general partner and other obligors, such as qualified borrowers (the Obligor Organisational 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 Organisational 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 capital call facility are derived from the provisions of the LPA, and lenders and their counsel must review and understand the provisions of the LPA. As the private equity capital call 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 private equity capital call credit facility. Older LPA iterations, however, may either be silent on some of those items or, worse still, expressly prohibit these rights or remedies.

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. 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 expressly allow the fund (or the related general partner) to call capital to repay borrowings, to pledge the unfunded capital 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 assignment, the fund should confirm with counsel that counsel will give a clean legal opinion on these issues or, in the alternative, that an amendment of 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. Of course,

if the LPA expressly prohibits the assignment of the right of the fund and the general partner, the prohibition will need to be amended.

- **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 credit facility carved out from that prohibition, so that they are third-party beneficiaries of the LPA. In the alternative, they should seek to have a carve-out from the provisions of the LPA governing, at a minimum, 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. While a general partner typically assigns to the lenders the general partner's rights under the LPA (and the lenders step into the shoes of the general partner upon a default to exercise those rights), it is also useful to provide that the lenders are express third-party beneficiaries of the LPA, so that the lenders may enforce the provisions of the LPA separately and apart from the rights given by the general partner.
- **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 investment period should determine 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 and 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. In those situations, many lenders find comfort if the definition of fund expenses includes reference to the repayment of interest on the fund's debt.
- **Investment period termination.** Lenders should review LPAs to determine in what circumstances 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 that vote, capital calls are permitted only to the extent they would be permissible after the expiration of the investment period.
- **Excuse or exclusion provisions.** LPAs usually also contain excuse or exclusion provisions, which permit investors to be excused or cause investors to be 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.** 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.
- **Percentage limitations.** 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.

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 right 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 private equity capital call facility.

Next Step: Review investor subscription agreements 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 limited partnership. 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. 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 performing a diligence review. By executing a subscription agreement, 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.

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. Lenders and counsel should review subscription agreements 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.
- **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 explicitly accept the capital commitment pledged by an investor. In the absence of an executed subscription agreement confirming the investor's subscription in the fund, the lender should follow up with the fund manager to confirm that the general partner has accepted the investor and to request a copy of a fully executed subscription agreement. 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 has pledged 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. These are more often found in side letters.

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 such agreement 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, 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 borrowing fund. Terms in side letters that restrict an investor from funding, or that limit its obligations to fund, capital commitments 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 into a fund, and will require side letters to memorialise their 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. 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 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 place agents or other intermediaries by a fund to steer investments 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 a guarantee 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.

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

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.
- **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 organisational 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 authorised 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 authorised to enter into the loan documents and perform thereunder;
- **copies of all the organisational documents of the fund** and the applicable affiliates, along with a representation and warranty that such organisational documents have not been modified or amended in any manner;
- **incumbency certificates** for each person who is authorised to execute the loan documents on behalf of the fund and its applicable affiliates; and
- **certificates of good standing or status** from the applicable governmental authority in the fund's and applicable affiliates' respective jurisdictions of formation or organisation.

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 realisation 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) 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, forex 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 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 and complexity 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 such as the European Markets Infrastructure Regulation (EMIR) and the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd Frank) have seen significant new 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 do not have ready access to the sorts of assets that can be posted as margin collateral. Even for those funds that do have 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. 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 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 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.

<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 general 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 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, but usually applies 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, will not entertain any suggestion that the fund be permitted to grant 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. 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 restricting the granting of guarantees (such as designating the guarantee as financial indebtedness for the purposes of the limitation on financial indebtedness or for any leverage-style financial covenant). If so, the fund will need to understand how the guarantee will be valued for the purpose of the limitation. 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, very rarely seen – probably because subscription lenders are prepared to rely on their security over the investors' uncalled commitments (and will not allow a derivatives counterparty to take security – second ranking 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. Finally, from a lender's perspective, the cost and complication of negotiating such arrangements are unlikely to be palatable.

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 is often little opportunity to negotiate the events of default to a significant degree (or 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 such triggers to material breaches only (such as 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.

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) *Ability 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) 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 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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All shapes and sizes: subscription facilities as financing tools for investment funds

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Introduction

The subscription line facility, also known as a commitments-based or capital call facility, has become a significant and useful financing tool for numerous investment funds, in particular those managed by large and middle market fund sponsors. Borrowers utilise subscription line facilities in a variety of ways ranging from short-term borrowings to bridge liquidity needs between investor capital calls (and/or to delay or avoid making frequent capital calls) to long-term leverage, which may potentially enhance the fund's internal rate of return. As the number, variety and complexity of investment funds have grown[1], subscription line facilities have adapted to the changing landscape, with sponsors and lenders working together to develop financing solutions to address the evolving needs of fund borrowers. The subscription facility market today is a robust and sophisticated one, which affords borrowers effective and efficient access to capital in an environment where funds and banks alike benefit from the significant knowledge base of its participants acquired over the years.

This article discusses the breadth of types of subscription financings currently in the marketplace by examining aspects of facilities for two specific kinds of investment funds, which can be viewed as being on opposite sides of the fund structure spectrum. We focus first on separately managed accounts in the form of a limited partnership or another entity (SMAs, sometimes also referred to as funds-of-one), and then turn to highly structured funds with large and commingled investor bases, who may invest through several separate entities within one fund family, utilising multiple tiers and/or parallel vehicles. There are, however, common characteristics underlying facilities of both kinds (as well as almost all other subscription line facilities), and so we begin our discussion by presenting some of those basic principles. Finally, we conclude by bringing the analysis into the context of certain current trends in the market, highlighting lessons from our recent experience in the fund financing space and a brief outlook for the year ahead.

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 assets that the borrower (or a related entity) provides as collateral for its loan. Any such assets must meet certain specified eligibility criteria in order to count towards the "borrowing base" against which a bank will advance loans. While traditional asset-based lending primarily considers equipment and receivables as suitable credit support, the concept of lending against assets has taken root in the fund finance space, where investment funds are able to utilise other forms of collateral as well, including the underlying investments of a fund. In contrast to such asset-based facilities, a subscription line facility's collateral package is anchored by the commitments of the fund's investors that have not yet been funded. A subscription line facility is thus typically secured by way of a pledge 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 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, because the collateral for a subscription facility is intrinsically tied to the ability of the investors to make capital contributions, the legal relationship between the investors and the fund/borrower. 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 negotiated in unique situations. 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. The organisational documents are not technically part of the transaction documentation for a subscription facility, however, their relationship to the loan documentation in some respects resembles that of the merger/acquisition agreement to the loan documents in a leveraged buy-out context (e.g., care needs to be taken to ensure that the loan documentation conforms to the parameters of the organisational documents much like it would have to conform to the merger/acquisition agreement), while remaining unique in other aspects (as the organisational documents are also the primary evidence of the underlying collateral). 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, and in particular 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 fund/borrower (and potentially, should the fund/borrower ever default on the subscription facility, the lender) to call capital both during and after the investment period in order to repay the debt under the subscription facility. Given the importance of the organisational documents, lenders are sensitive to amendments 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 materially and/or adversely affect a lender (and, of course, such amendments typically need to be approved by the investors themselves). Accordingly, many fund sponsors now, with assistance from counsel, have started incorporating the appropriate provisions into their organisational and offering documents at the outset of the fund (or at a later point in time when a subscription facility is being put in place). Additionally, in some cases (in particular, when organisational documents do not contain the requisite provisions), lenders may seek to also have investors enter into consent letters with lenders, which address the pertinent issues and also 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

While emphasis on the collateral and the fund's organisational documents is common in all subscription line facilities, the variety of fund structures and underlying investor pools can result in differing considerations and often requires customised loan documentation for specific transactions. Below, we highlight 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 SMAs (which may have only a single investor) on one hand, and complex commingled funds (which may have hundreds or more investors and utilise numerous entities that are part of one fund family) on the other hand. Depending upon the nature, size and complexity of the fund, there is a wide range of factors to be considered, and just a few examples are addressed here to illustrate this diversity.

<u>Separately Managed Accounts (SMAs) – Addressing the single investor</u>

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. The credit quality of the investors and their ability to meet calls on the capital commitments are aspects that can influence the commercial terms of the facility, including margins and fees, concentration limits, exclusion events and events of default resulting from investors' failure to fund. 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. These considerations, however, can usually be addressed through appropriate structuring and documentation.

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 in 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. Finally, when structured as a limited partnership or similar entity, an SMA may offer an increased legal protection from liability, much like a commingled fund would.

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, whether it be a limited partnership agreement or similar operating agreement, need to satisfy the general requirements of subscription lenders. As such, the operative document of an SMA 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 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 with respect to representations and covenants relating to the pledge of the uncalled capital commitments in favour of the lenders, the funding of capital calls and related matters. As mentioned above, such a letter establishes a direct contractual relationship with the lenders, which gives them an increased comfort level. In addition, the investor letter may also address the less frequent cases where the operating agreement for an SMA gives certain consent rights concerning the SMA's ability to enter into financing arrangements to the investor, and the parties do not wish to formally amend the constitutional document itself. Also, because many investors in SMAs are government pension plans or sovereign wealth funds, an investor letter might address sovereign immunity issues that such investors may potentially present to lenders, in particular a concern that an investor may raise sovereign immunity as a defence to funding capital calls. One possible approach is to incorporate a waiver (which may be appropriately limited to address the relatively narrow scope of lender concerns) of sovereign immunity defences. The treatment of such issues, however, 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 in theory 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 borrowing 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. This is true 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, an event of default would be triggered under such 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/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).

Even if an SMA is not looking to borrow directly under a subscription line facility, there may be additional considerations if an SMA is an investor in a commingled fund that is taking advantage of a subscription line facility. As an investor in a commingled fund, one would expect an SMA will be assigned advance rates and concentration limits consistent and comparable with other institutional investors; however, in certain situations where the lenders are requiring investor consent letters, they may further request that the underlying investor in the SMA also enter into such a letter (either directly with the lenders and/or with the commingled fund/borrower). Sponsors should therefore be cognisant of such considerations when projecting their borrowing bases, and may wish to discuss sufficiently in advance the potential need for an investor consent letter, and whether the underlying investor needs to be a party to the same.

<u>Multi-layered commingled funds – Financing solutions for complex structures</u>

As we have seen, an SMA, with its single investor, presents some unique considerations in the context of a subscription line facility, a number of which were analysed above. 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 (e.g., high net worth individuals and 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 (or, as the case may be, depending on a particular structure, non-U.S. limited partnerships) for U.S. federal income tax purposes, are often formed in various jurisdictions (frequently Cayman Islands, British Virgin Islands or Bermuda and increasingly, 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 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. In short, with proper assistance from counsel, there are many options available to sponsors and lenders which can address virtually all relevant structuring considerations.

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 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, where a lender, in exchange for greater credit and legal comfort based on direct privity with the investor, may be able to, among other things, 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.

As illustrated here, multi-layered, commingled funds differ significantly from SMAs in many respects, including the level of structuring, investor composition and management. These differences often inform the specific legal and underwriting considerations that should be addressed when entering into a subscription line facility for such divergent funds. The fact that sponsors and lenders have developed the concepts and documentation necessary for subscription facilities for these disparate types of funds evidences the growth and increased sophistication of the subscription financing industry.

Conclusion and outlook

The finance group at Fried Frank has seen a continued and steady increase in the volume and number of fund financing transactions (and subscription line facilities in particular) over the past several years. We believe that the popularity of this product is driven in part by the strong performance that these loans have demonstrated over extended periods of time, including through the economic downturn. In our practice, we have not become aware of an event of default under any of the subscription facilities where we have acted as counsel.[2] 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 see increasing appetite for a combination of subscription and asset-based facilities, 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).

At the same time, we believe there are certain aspects of subscription lending that will continue to attract attention of lenders and sponsors alike. For example, the interplay between excuse rights (i.e., situations where investors in a fund may be excused or excluded from funding a capital call for certain reasons permitted under the relevant fund documentation) and treatment of such investor's commitment under the fund's subscription line facility is coming under increased scrutiny even though investors are generally always obligated to fund capital calls for purposes of repaying the subscription facility. Another area which presents challenges, simply from a transaction process and timing perspective, is the increased frequency and scope of side letters (i.e., individualised arrangements with particular investors that alter terms of the basic organisational documents which otherwise would be the same for all investors) that investors are entering into with funds. In addition, as alternative investment vehicles (i.e., "side-car" vehicles through which funds may seek to make certain investments for specific regulatory, tax or investor preference reasons) gain popularity, the treatment of how capital commitments are allocated to such vehicles is coming into focus.

In short, while many issues have been addressed, there are and always will be new developments. Negotiations between borrowers and lenders will continue to result in innovative solutions that balance the competing interests and shared goals of the parties. This article, through its analysis of subscription facilities for SMAs and complex commingled funds, is not intended to be exhaustive and address every structuring alternative (which would be practically impossible), but to simply illustrate that the industry has been able to respond and find solutions to many of these challenges, and continues to search for ways to deliver the capital call facility product to all those who have an interest in it, and as efficiently as possible.

We are happy to note that the subscription facility market appears to remain very active even as it takes 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 capital markets in many ways, such as affecting the bond market, the U.S. loan market, including the fund financing space, has largely been stable. Anecdotally, our firm continues work on numerous subscription facilities which commenced last year and are proceeding towards execution without any significant delays or complications, and is being instructed on multiple others that are just starting. We remain cautiously optimistic about the future outlook for the industry, while we wait to see how the national and international political and economic situation plays out in the longer term.

* * *

Acknowledgment

The authors would like to thank Gerald H. Brown, Jr. (gerald.brown@friedfrank.com), Suzanne Dissinger (suzanne.dissinger@friedfrank.com), Joseph Fox (joseph.fox@friedfrank.com), Michelle Gold (michelle.gold@friedfrank.com), F. William Reindel (f.william.reindel@friedfrank.com) and Rebecca Zelenka (rebecca.zelenka@friedfrank.com) for their invaluable contribution to this chapter.

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Endnotes

1. The recent report published by Preqin and presented at the 2nd European Fund Finance Symposium in October 2016, titled ‘Private Equity in Europe’, highlights ten different fund types that investors view as presenting the best opportunities in the current financial climate, namely, Small to Mid-Market Buyout, Venture Capital, Distressed Private Equity, Growth, Fund of Funds, Secondaries Funds, Natural Resources, Mezzanine Funds, Large to Mega Buyout and Cleantech.
2. The participants and panelists at the recent European Fund Financing Symposium held in London in October 2016, and Global Fund Financing Symposium held in New York in March 2016, did not report any transaction defaults or institutional investor exclusion events that resulted in losses. However, some technical defaults have been reported. We have experienced instances of such technical defaults in our practice as well, but as far as we are aware, they have been remedied to the relevant parties’ satisfaction in all cases.

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The evolution of subscription facilities in light of changing fund structures and financing needs

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Introduction

A subscription facility, also known as a capital call facility, is a credit facility made available to a private investment fund that is typically secured by (1) the unfunded capital commitments of the fund's investors, (2) the fund's rights to call capital, receive capital contributions and enforce the investors' funding obligations, and (3) the fund's bank account into which capital contributions are deposited. Fund borrowers can use capital call facilities for a variety of purposes, including to:

- bridge investor capital calls and other sources of capital that may not be ready at the time of an investment;
- avoid the need to call capital well in advance of closing an investment, or return capital contributions to investors if the investment is delayed or does not occur;
- smooth out investor capital calls by grouping them on a periodic basis rather than calling capital for each investment;
- avoid rebalancing between the initial and final closings of the fund;
- pay fees and partnership expenses, including organisational costs of the fund;
- cash collateralize hedging exposure with same or one business day's prior notice of borrowing;
- provide longer-term leverage during the life of the fund;
- enhance the fund's internal rate of return (or "IRR");
- obtain loans for portfolio companies (with a fund-level guarantee) at cheaper rates than may be available at the portfolio level; and
- issue letters of credit and provide other credit support for portfolio level activities.

More than a dozen years ago, capital call facilities were most commonly seen as relationship loans to real estate funds for the purpose of bridging capital calls to a large number of highly rated, institutional investors. The early facilities were often demand lines or 364-day lines of credit (renewable annually) provided by a single bank on either a committed or an uncommitted basis. It was not unusual for a fund sponsor to wait until after a fund's final closing to put a subscription facility in place and to terminate the facility when the fund's investment period ended. Over the last decade, however, as fund sponsors have become more cognizant of the various benefits afforded by capital call facilities, they have sought to put these facilities in place: (1) as soon as possible after the fund's initial closing; (2) so as to continue after the end of the fund's investment period; (3) for multiple borrowers, including the main fund, parallel funds and alternative investment vehicles, as well as holding or portfolio companies (i.e., "qualified borrowers") below the fund level; (4) in multiple currencies, to support the fund's global activities; (5) across a range of fund types, including private equity, real estate, energy, infrastructure and debt funds and funds-of-one; and (6) from a syndicate of lenders in larger facility amounts, to accommodate all of the fund's borrowing needs during its life, including the ability to increase the facility size on a permanent basis during fundraising, and on a temporary basis to finance specific investments.

At the same time that funds are making increased use of leverage, sponsors are responding to fund investment needs and investor demands by offering more alternative (and often complex) fund structures. The subscription facility market has expanded significantly to address these changing fund structures and increased financing needs. This article aims to highlight how evolving fund structures and changing needs for fund financing are playing out in the subscription facility market.

Fund structures: parallel funds, alternative investment vehicles, feeder funds, blockers & funds-of-one

Fund structures were initially straightforward: investors came directly into a single fund by subscribing for an interest in, and agreeing to make capital commitments to, a limited partnership. However, as sponsors broadened their investor base, this simple structure has evolved to accommodate new investors' legal, tax, regulatory, accounting and other needs. As a result, funds that used to operate as a single limited partnership now encompass various entities, including parallel funds, alternative investment vehicles, feeder funds, blockers and funds-of-one.

Parallel funds. In order to address the preferences of certain investors, including, for example, tax-sensitive investors focused on limiting exposure to unrelated business taxable income, many sponsors offer alternative options for investment known as parallel fund vehicles. A parallel fund is a sister to the main fund, has a separate pool of investors, and invests on a *pro rata* basis with its related main fund in each investment. By grouping all investors who share a similar structuring need in a single, separate parallel vehicle, the sponsor can address their need without impacting the manner in which other investors participate in investments. A parallel fund often has fewer investors than its related main fund and therefore a smaller pool of capital. However, because a parallel fund invests alongside its related main fund, the parallel fund will likely have similar borrowing needs as the main fund.

The limited partnership agreement of a parallel fund and its related main fund are typically interconnected in a number of key respects, including with respect to the overcall mechanics in the event of an investor funding default or excuse. For example, if a limited partner in the main fund defaults on a capital call or is excused from a particular investment, all of the non-defaulting (or non-excused) investors – including limited partners in the parallel fund – may be required to increase their capital contribution to make up the deficit. In such a case, the non-defaulting (non-excused) investors' obligations to contribute additional capital would be capped by their unfunded capital commitments, and would likely be subject to other limitations (e.g., an investor cannot be required to fund more than 150% of the initial capital contribution funded). Similarly, the main fund and its related parallel funds typically vote on a combined basis.

Alternative investment vehicles. Alternative investment vehicles ("AIVs") may also be created to address investors' tax and regulatory structuring needs for a particular fund investment or a subset of the investments made by the fund (for example, if the portfolio company is structured as a flow-through entity for tax purposes). The partnership agreement of the master fund entity (i.e., a main fund or parallel fund) will provide that its general partner has the authority to structure the making of all or any portion of an investment through an AIV and, as a result, each investor is obligated to make capital contributions directly to the AIV to the same extent, for the same purposes and on the same terms and conditions as they are required to make capital contributions to the related master fund. Capital contributions to an AIV reduce the unfunded capital commitment of each investor to the same extent as if the capital contributions were made to the master fund, and the investment performance of each AIV is typically aggregated with that of the master fund for purposes of the fund's waterfall.

Feeder funds. A feeder fund is an investment vehicle that "feeds" or invests into a master fund which, in turn, will invest the contributions of the feeder fund and any other investors. Rather than committing capital to a master fund, an investor may choose to sign a subscription agreement directly with a feeder fund. Feeder funds provide flexibility for certain investors with tax or regulatory concerns by, for example, electing to be taxed as a corporation for US federal tax purposes and thereby blocking certain undesirable tax attributes. Certain tax-exempt investors and foreign investors may choose to invest through a feeder structure taxed as a corporation to block unrelated business taxable income ("UBTI") and effectively connected income ("ECI"), respectively. Additionally, some sponsors may establish an aggregator fund for high net-worth individuals, which in turn acts like a feeder fund into a master fund.

Blockers. If a fund makes an investment that may result in its investors incurring UBTI or ECI (for example, if investing in an operating company that is itself a partnership or LLC or investing in real property), the fund may allow certain investors to make their capital contributions to a blocker entity, which is typically taxed as a C-corporation, as opposed to contributing directly to an AIV. A main benefit of this approach is to shield non-US investors from having to pay US income tax and file a US federal tax return, and to shield tax-exempt investors from recognising UBTI. Some funds will create a separate blocker for each flow-through investment that an AIV makes. Unlike a feeder fund, investors do not commit capital to blockers and there is no separate subscription agreement signed by an investor and the blocker. Additionally, depending on the ERISA and tax sensitivities of investors electing to contribute capital to blockers, the organizational documents of blockers will often specifically require that once capital is contributed to the blocker, the monies can only be contributed to the AIV(s) into which the blocker invests.

Funds-of-one. As the private funds market has evolved, funds have expanded their offerings to investors, and many large institutional investors have shifted to writing bigger cheques to a smaller number of funds. This trend has driven the rise of "funds-of-one", which are fund vehicles with a single limited partner. The fund-of-one approach provides a highly negotiated, customized product for an investor who wants more control over its fund. A fund-of-one may allow the single investor different economics from the investors in a commingled fund, or allow the single investor to create bespoke investment guidelines, including allowing for a wider approach than the focus of the master fund, and flexibility to invest across different asset categories over time. Additionally, a fund-of-one may be structured to insulate the investor from the overcall mechanics a classic commingled fund requires. This feature is particularly attractive to investors whose mandate or regulatory situation demands that they not have their capital commitment "collateralize" or backstop the capital commitments of other investors. The fund-of-one option offers this protection but still allows for investing with a related master fund.

Implications of fund structures on the borrowing base

The first subscription facilities were offered as relationship loans from a single bank to a preferred sponsor's commingled main fund. Early subscription facilities envisioned a simple borrower structure where all investors invested in a single fund. Typically, these facilities had minimal reporting obligations and included a simple coverage test requiring the fund to maintain sufficient uncalled capital commitments (or a multiple thereof) of all of its investors to repay the fund's outstanding borrowings and other indebtedness. As fund structures have evolved and borrowing needs have increased both in terms of amount and tenor, subscription facilities have become more complicated and many now contain detailed borrowing tests as well as additional reporting and other compliance requirements.

Large, syndicated, longer-term subscription facilities now frequently include tests that measure borrowing availability against a borrowing base of eligible investor commitments, rather than a simple uncalled capital coverage test. Lenders diligence each investor in the fund (including their subscription agreements, side letters, ratings and financial information) and assign advance rates to the uncalled capital commitments of only those investors that are deemed to be creditworthy. Those advance rates might range from 60% to 100%, depending on the credit quality of the individual investor, and might further be subject to concentration limits so that no single eligible investor comprises an unduly large portion of the borrowing base. The credit agreement will also set forth a list of exclusion events (such as bankruptcy or non-payment of capital contributions that continues for an agreed period of time) that will result in an eligible investor being excluded from the borrowing base.

Calculation of the borrowing base. A borrower is typically required to calculate its borrowing base on a periodic basis, including at the time of each request for loans and letters of credit, promptly following a capital call from its investors, in the event that any eligible investor is excluded from the borrowing base and with each quarterly compliance certificate. If, at any time, a borrower's outstanding loans and letters of credit exceed its borrowing base, the borrower will be required to make a mandatory prepayment to restore borrowing base compliance.

The imposition of a borrowing base test is fairly straightforward with a single fund structure. However, with the formation of parallel funds and their separate pools of capital, lenders and sponsors are faced with a challenge: either each parallel fund has to meet its own borrowing base test, or the facility has to be structured with a single borrowing base such that all borrowers benefit from (and the bank is secured by) a pool of capital that combines the capital commitments of the main fund and each parallel fund. A single borrowing base provides funds with certain advantages. First, there are reduced administrative burdens with calculating a single borrowing base. Second, depending on the characteristics of its investor pool, a parallel fund may not be able to obtain a credit facility with sufficient borrowing capacity unless the borrowing base also includes commitments of the main fund investors.

Joint and several liability. In order to maintain a single borrowing base while allowing parallel funds to access the entire credit facility, the commitments of all investors need to be available to repay the obligations of all borrowers under the subscription facility. To achieve this, some lenders insist that the main fund and its parallel funds be jointly and severally liable. With this approach, each borrower is liable for the full amount of the debt, and the lenders may call capital from investors in either or both of the main fund or any parallel fund during an event of default, regardless of which entity borrowed. However, this approach could have some significant pitfalls. For example, many limited partnership agreements limit how much debt a fund can incur to a percentage of capital commitments. As there is often a large disparity in the amount of investor commitments to parallel funds compared to the main fund, making a parallel fund jointly and severally liable for the obligations of the main fund could cause a parallel fund to violate the debt or investment limits in its partnership agreement. Even worse, depending on the borrowing needs of the larger main fund, a smaller parallel fund could be rendered insolvent immediately upon the initial borrowing by the larger fund.[1]

Guarantees. Guarantees raise many of the same issues as joint and several liability, because partnership agreements often include guarantees in the debt covenant calculation. An alternative approach to joint and several liability or mutual guarantees is to require that the main fund guarantee the debt of the parallel fund, with the parallel fund only liable for its own debt (and not the debt of the main fund). This approach may be difficult for some sponsors to accept because it treats investors in the main fund differently from the parallel fund investors. However, the possible negative ramifications may be mitigated by having the main fund and parallel funds execute a reimbursement and contribution agreement, providing that each fund will reimburse the other fund if, as a result of any payment it makes under its guarantee (or as a joint and several obligor), it pays more than its fair share of the debt. However, despite some of the benefits of such an agreement, guarantees and joint and several liability may be problematic from a funds and/or tax perspective.

Cross-collateralization. As a result of the challenges posed by guarantees and joint and several liability, the subscription facility market has evolved such that many lenders will, instead, accept cross-collateralization between main fund and parallel fund borrowers. With this approach, borrowings by the main fund and any parallel fund are on a several basis, but the obligations of each borrower are secured by the combined uncalled capital of all investors in each of the funds. The main fund borrower grants a lien on its uncalled capital (as well as the right to call capital contributions and the bank account into which such contributions are funded) in order to secure its own obligations and the obligations of the parallel fund borrowers, and *vice versa.*

Lenders have become comfortable with cross-collateralization for a number of reasons. First, subscription facilities tend to be significantly over-collateralized, which lessens the credit risk of a several borrowing structure. Second, because the pools of investor commitments of the main fund and each parallel fund ultimately support the borrowings of all fund entities, lenders benefit from a wider range of investors and a larger collateral base. Finally, overcall provisions in limited partnership agreements can often be calculated by looking at the capital commitments of the main fund and parallel funds as a whole (rather than on an individual fund entity level), which in turn reduces the risk that the bank will not be repaid if there are significant investor defaults.

Treatment of AIV borrowers. Due to the fact that an AIV has the ability to call capital from the full pool of investors who committed capital to the related master fund, there is no reason to have a separate borrowing base for any AIV of the master fund. Likewise, there is no need for a master fund to guarantee or provide any credit support to any of its related AIVs for their borrowings, or *vice versa*. From a funds and tax perspective, avoiding such linkage between a fund and its related AIVs is often critical because AIVs are typically set up to segregate particular tax attributes of an investment away from the master fund. Having an AIV provide credit support to the master fund (or *vice versa*) increases the risk that this segregation will not be respected. In order to preserve the separateness of each AIV for tax purposes, each AIV should secure only its own obligations and not the obligations of its related fund or other related AIVs. Therefore, joint and several liability, guarantees and cross-collateralization as between a master fund and its related AIVs should be avoided.

Treatment of funds-of-one. There can be some scenarios where a cross-collateralized structure will not work. For example, the partnership agreement for a fund-of-one may prohibit the fund from providing credit support to other related funds. The single investor in the fund-of-one may have specifically negotiated to participate in an investment vehicle where it would not be subject to any exposure from other investors. In these vehicles, there is no risk to the single investor that another investor might default.

Funds-of-one may have similar borrowing needs as a commingled main or parallel fund. However, to obtain financing, a fund sponsor will need to seek lenders that can lend to a vehicle on a several basis and are comfortable with the credit quality of the single investor and the lack of overcall ability to other investors or vehicles. A fund-of-one may have its own subscription facility or it could participate in a subscription facility with multiple fund-of-one borrowers, which provides for separate borrowing bases and separate borrowing sub-limits so that each fund-of-one may access only a portion of the facility depending on the relative size of its investor commitment. Alternatively, if the partnership agreements of the fund-of-one and a related commingled fund permit cross-collateralization between such funds, the fund-of-one may be a borrower under the commingled fund's subscription facility, with several borrowings but a combined borrowing base.

Challenges posed by SPVs & foreign investors. As funds seek to broaden their investor base, non-US investors and sovereign wealth funds, in particular, are becoming key players in the fundraising process. These investors may have tax, regulatory, confidentiality and other concerns that drive more complicated fund structures. For example, these investors may make a commitment to a fund through a special purpose vehicle that is specifically established for investing in the particular fund and therefore does not have any financial history. Given the relationships between the fund sponsor and the investor's ultimate parent, funds are often willing to accept a commitment from a special purpose vehicle without any guarantee or specific financial support from the investor's parent.

Lenders consider a number of factors when deciding whether to include the uncalled capital commitments of a foreign sovereign in the borrowing base, including confidentiality restrictions, available financial information, parent credit support and sovereign immunity. If a foreign sovereign requires confidentiality, it may be challenging for lenders to diligence the investor at the outset and on an ongoing basis. Also, many sovereigns will negotiate an exception to the fund's partnership agreement that would otherwise require the investor to provide financials periodically if requested by the general partner. Lender concerns are amplified when the capital commitment is made by a special purpose vehicle, but the sovereign itself (or an arm thereof) is not willing to provide a guarantee or comfort letter with respect to the special purpose vehicle's commitment. Although a fund sponsor may be willing to accept a naked commitment from a special purpose vehicle investor, lenders may have concerns about lending against that commitment. Additionally, some lenders are concerned about the assertion of sovereign immunity. Few sovereigns are willing or able to waive sovereign immunity (and, in fact, most explicitly reserve it), though many will acknowledge that the investment constitutes a private commercial action, which is often sufficient to get lenders comfortable. Finally, lenders express concern about their ability to enforce a judgment against a sovereign, even if they are able to obtain it.

Despite these challenges, many lenders have become comfortable lending against special purpose vehicles used by sovereign investors, especially if these entities have a good track record of funding. Some lenders include these investors in the borrowing base subject to a lower advance rate and/or a concentration limit. An alternative approach is to give borrowing base credit to the investor's capital commitment (or, if borrowing base credit has already been given, to increase the advance rate) only after a certain percentage of capital has been called and funded by the investor. At that point, the investor will have more "skin in the game" and the default remedies in the fund's partnership agreement (many of which the lenders have the right to enforce as part of their collateral package during an event of default under the credit facility) will be a more powerful deterrent to any failure to fund capital contributions.

Fund structures & collateral package

Feeder funds and the cascading pledge. In a secured subscription facility, a master fund grants a lien on the right to call capital from its direct investors, which includes any feeder fund. If some investors choose to commit capital to a feeder fund, as opposed to making a direct commitment to a master fund, lenders will likely need to diligence these underlying feeder investors when providing financing to a master fund. If a master fund wants borrowing base credit for the commitments of the investors in its feeder fund, lenders to the master fund may want a lien on the right to call capital from the feeder fund's investors, even though the debt is incurred by the master fund (and not the feeder). In order to accommodate such a request from lenders, the feeder fund and its general partner would enter into a security agreement to grant a security interest on such commitments in favour of the master fund, and the master fund in turn would enter into another security agreement to grant a security interest to the lenders on its right to call capital from its investors as well on-pledge its rights under the feeder security agreement. In the unlikely situation where there is an event of default under the subscription facility, this back-to-back security arrangement, or "cascading pledge", allows the lender (a) to step into the shoes of the general partner of the master fund and call capital from the master fund's direct investors (including the feeder), and (b) by way of the cascade, to step into the shoes of the general partner of the feeder fund and call capital from the feeder fund's direct investors. Even though, as a practical matter, upon receiving a capital call from the master fund (or its lender), the feeder fund would initiate a capital call on its investors to satisfy its capital contribution obligation, the back-to-back pledge enables the lender to call capital from the investors in the feeder.

HNW feeders. Some sponsors create feeder funds to pool capital commitments from a group of high net worth ("HNW") investors who may invest smaller amounts than institutional investors. Since the feeder fund is treated as a single investor of the master fund, this avoids having a large number of HNW investors admitted directly into the master fund. If a lender is unwilling to give much (if any) borrowing base credit to the commitments of these HNW investors, or that of the pooled vehicle investor through which they invest, the master fund borrower may wish to avoid having this vehicle sign cascade security documentation.

A benefit of this approach is that, because the pooled vehicle is the investor, the main fund need not report to its lender each transfer of HNW commitments. Regardless of the borrowing base treatment of such a pooled vehicle, the fund will also want to make sure that any event of default in the credit agreement based on significant investor funding defaults treats the pooled HNW vehicle as a single investor and includes only the default portion of the vehicle's contribution in any investor default calculation.

AIV borrowers. The limited partnership agreements of master funds will allow for the creation of AIVs, which may have the same borrowing needs as the related main fund or parallel fund. If a subscription facility is entered into early in the life of the fund, before all investments have been identified, it is likely that not all AIVs may be formed and joined as borrowers when the credit facility closes. In these circumstances, a fund will need to notify the lenders of new AIVs, and the lenders will need an opportunity to diligence each AIV. This process may be complicated if the AIV is formed in a jurisdiction that is different from the related fund borrowers, although there should be some efficiencies given that the lenders have already completed their diligence process on the underlying investors. There are also timing considerations for the fund to manage, as an AIV cannot be joined as a borrower until it has admitted investors and has the ability to call capital from the investors. Some partnership agreements or side letters require an investor review period before the AIV's partnership agreement can be amended and restated and investors can be admitted to the AIV. As a result, these timing considerations will need to be taken into account if the AIV intends to borrow for its first investment.

Depending on the nature of the investment(s) to be made by an AIV, the sponsor may determine that an AIV does not need access to a subscription facility. However, lenders may nevertheless be focused on all AIVs because these entities have access to the collateral package (i.e., the uncalled capital of investors) and therefore may require that all AIVs be added as borrowers to (and become bound by the negative pledge and other covenants under) the credit facility. Adding all AIVs as borrowers can increase administrative costs to the fund, particularly if an AIV is formed in a foreign jurisdiction where local counsel must be engaged or foreign law-governed security agreements may be required. As a compromise, lenders may agree not to require that all AIVs become borrowers, so long as the aggregate amount of capital contributions to the non-borrower AIVs either does not exceed an agreed threshold or result in a borrowing base deficiency under the credit facility.

Collateral accounts. As part of the collateral package for a subscription facility, the fund borrower typically pledges the bank account into which capital contributions are deposited by its investors. If there is an event of default, the lender will be permitted to step into the shoes of the general partner of the borrower, call capital into such borrower's pledged account, take control of the account, and apply the amounts therein to the payment of such borrower's credit facility obligations. If the account is not held with the administrative agent, the borrower will need to put a control agreement in place over its pledged account at closing. This tri-party agreement among the fund borrower, the administrative agent as secured party, and the depository institution can often take time to negotiate.

As fund structures have become more complicated, with master funds, feeders, blockers and AIVs all being able to receive capital contributions from the direct and/or indirect investors in the master fund, fund sponsors may find it administratively convenient (and cost-effective) to set up a single master collateral account for the main fund and a separate master collateral account for each parallel fund borrower. By having a single master collateral account, it is not necessary that a master fund's related feeders, blockers and

AIVs open separate accounts for capital contributions, pledge those accounts, administer those accounts, and arrange (and pay) for control agreements in respect of each of such separate accounts. Further, having a master account simplifies capital call notices and wiring instructions to investors by directing capital contributions to just one account. Each AIV appoints its related master fund as its agent to receive capital contributions on its behalf and to grant to the lender a lien on such capital contributions to secure the credit agreement obligations of such AIV. Similarly, each feeder and blocker either appoints its related master fund as its agent to receive capital contributions from its investors and to grant a lien on such contributions, or directs that capital contributions be deposited into that fund's master account. With a master account, the account holder agrees to act as agent for each of the appointing entities, agrees to grant a lien on the amounts in the account that are held for any such entity to secure the respective obligations of such entity, and acknowledges that it has legal title to the account (rather than equitable rights to the monies attributable to the other entities). It is best practice for the fund, as the account holder, to track the equitable owner(s) of the moneys in the account, as those amounts are held in trust by the fund for such other entities.[2]

Expanded features of subscription facilities

Qualified borrowers. Some funds have found it advantageous to structure borrowings below the fund, in which case it is helpful to have the ability to add other entities as borrowers under the subscription facility. For example, many subscription facilities allow the joinder of "qualified borrowers" or "portfolio company borrowers", which are entities that a main fund, parallel fund and/or AIV owns a direct or indirect ownership interest in, or through which such fund borrower may acquire an investment. Qualified borrowers do not have access to uncalled capital, and therefore do not provide collateral when joined as a borrower under the subscription facility. Instead, the lenders look to the applicable fund borrower(s) to guarantee this borrowing and secure that guarantee by the same collateral that secures its direct borrowings under the subscription facility. Because of this fund guarantee, qualified borrowers can access the subscription facility to the same extent as the fund borrowers, which may include flexibility to obtain letters of credit, and can serve as interim financing until a permanent financing is entered into at the portfolio company level.

Same-day borrowing / Multi-currency options. To take full advantage of a subscription facility, many funds look to lenders to provide same-day borrowing capacity, which allows borrowers to respond quickly to investment opportunities, cash-collateralize derivatives and manage their borrowing needs more efficiently. Similarly, many funds appreciate the flexibility to borrow and obtain letters of credit in foreign currencies, rather than having to borrow and manage currency exposure outside of the facility.

Changing needs during a fund's lifecycle. Given the attractiveness of subscription facilities, funds increasingly want the credit facility to be in place through each stage of the fund's life cycle. Each stage presents different challenges to a fund. During the fundraising stage, a fund may want to borrow (rather than call capital) to pay expenses, make investments and avoid rebalancing investor commitments as investors are added to the fund. However, putting a facility in place early in the life of the fund may mean that the investor pool is smaller and less diversified than it is expected to be after final closing, resulting in limited borrowing base capacity. Concentration limits may further reduce the borrowing base, so borrowers may need relief from concentration limits until the final closing of the fund.

A fund may also seek to structure the size of its credit facility to reflect its borrowing capacity. Early in its life, a fund borrower may want a smaller facility size, and thereby avoid paying a large upfront fee as well as unused fees on the portion of a larger facility that cannot be accessed due to a smaller borrowing base. As fundraising progresses, a fund borrower may want flexibility to increase its facility size by exercising an "accordion" option as investor commitments are added. Lenders may agree to an accordion option in the loan documentation, on either a committed or an uncommitted basis. From the borrower's perspective, a committed accordion provides assurance that the credit facility will grow along with the fund's borrowing capacity and long-term financing needs.

After the fundraising period is complete, there may be specific investment opportunities that a fund may wish to finance through use of a subscription facility. Some subscription facilities offer borrowers temporary increased capacity to meet one-off needs of the fund. This feature provides funds with flexibility to increase the facility size for a short-term period, rather than incur the cost of a permanent accordion that does not reflect the fund's longer-term needs.

Funds may face pressure in their subscription facilities when they are later in their lifecycle and there is less uncalled capital to support the borrowing base and the financing needs of the fund. To address these concerns, some sponsors seek increased borrowing base capacity later in the life of the fund. This increased borrowing base may take the form of increasing advance rates for investor commitments, including the values of the fund's investments in the borrowing base calculation, and/or admitting certain investors into the borrowing base that were previously not included.

Even after the end of the fund's investment period, many funds want flexibility to borrow for follow-on and follow-up investments and expenses. Although older credit facilities often terminated with the end of the investment period, newer credit facilities often permit credit extensions after the end of the investment period as long as the fund's partnership agreement permits the fund to call capital for the purposes of repaying such debt.

Conclusion

Access to a subscription facility can provide significant benefits to a fund throughout its life. As a result, sponsors who wish to incorporate a subscription facility into a fund's investment strategy should be mindful during negotiations with investors about how the fund expects to use leverage and how the fund's ultimate structure will impact its ability to obtain a subscription facility and the terms of such facility. Similarly, sponsors should work with their lenders to ensure that the subscription facility provides the fund with the desired flexibility, and ease of execution, to accommodate the fund's structure and financing needs from the fund's initial closing until the fund is no longer able to call capital to repay its debt. Specifically, sponsors may want their funds' subscription facilities to provide any or all of the following features:

- an accordion to permanently increase the facility (whether on a committed or an uncommitted basis) as the fund adds investor commitments;
- a holiday from borrowing base concentration limits during the fundraising period;
- the ability to temporarily increase the facility to accommodate specific investment opportunities;
- same-day borrowing capacity to enable the fund to respond quickly to investment opportunities and other financing needs;
- multicurrency capacity consistent with the fund's financing needs in foreign jurisdictions;

- a streamlined process for joining borrowers to the facility (whether they are parallel funds, alternative investment vehicles or qualified borrowers) and putting in place any related collateral security documentation (including cascade documents);
- a basket for non-borrower AIVs that do not need access to the facility and for which the fund does not want to incur the expense of joinders;
- a master collateral account structure for capital contributions to a master fund and its related entities;
- increased borrowing capacity after a significant percentage of capital contributions have been funded (whether by increasing advance rates or adding previously excluded investors to the borrowing base, or both);
- capacity to borrow after the end of the fund's investment period, and after a key person event, for follow-on and follow-up investments and other purposes for which the fund is permitted to call capital; and
- an extension option for the fund to extend the term of the facility (on a committed or an uncommitted basis) for one or more periods of 364 days.

* * *

Acknowledgment

The authors wish to thank Thomas A. Wuchenich, Partner, Simpson Thacher & Bartlett LLP, for his assistance in the preparation of this chapter.

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Endnotes

1. To mitigate this result, a facility that provides for joint and several liability, or for mutual guarantees, should include savings language that will limit the smaller fund's liability to the maximum amount that may be incurred without rendering it either insolvent or in violation of its partnership agreement.
2. It is important to confirm with tax and accounting advisors to make sure that this approach will work for a particular fund. Some funds may use a master account for the fund and its related AIVs but use a separate account for a feeder. If the feeder has a separate account for capital contributions, lenders may require a "cascading" pledge of the feeder account.

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Capital call subscription facilities: the borrower's view

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Introduction

The attitude of private fund sponsors and investors toward capital call subscription facilities has changed significantly. Historically, investors and sponsors were not enthusiastic about fund credit facilities secured by the investors' unpaid capital subscriptions for several reasons. Investors were concerned that borrowings by the fund limited partnerships would increase tax risk: tax-exempt United States investors (such as endowments and pension plans) might incur unrelated business taxable income if they were deemed to be actively involved in a U.S. trade or business for federal income tax purposes by reason of making investments with borrowed funds, as opposed to merely investing resources they already own. Similar concerns troubled foreign investors, who avoid investment leverage to minimise the appearance of conducting a taxable trade or business within the U.S. Sponsors resisted the drag on fund earnings from interest expense, upfront fees, unused availability fees and transaction costs, as well as the added overhead expense of administrating a credit facility on behalf of the fund.

In today's market, however, capital call subscription facilities are increasingly popular with investors and sponsors. Many private fund groups that had not used capital call facilities in previous years are adding them for the first time in their later fund series. What are the reasons for this change of attitude?

Primarily, investors have grown more comfortable with private funds incurring short-term borrowing, which has become increasingly widespread without adverse consequences from taxing authorities. In addition, the universe of investors in private funds has become much larger and more varied, and now includes many smaller endowments and pension plans that do not have the administrative capacity to fund capital calls on a weekly basis from the numerous funds in which they invest. Capital call facilities enable funds to use borrowed amounts to make investments and pay expenses in the ordinary course of business from week to week, then pay down these borrowings every quarter or six months with regularly scheduled capital calls. Moreover, while tax concerns still discourage long-term leveraged investing (as opposed to short-term liquidity loans), even short-term borrowing provides an incremental boost to the return-on-equity performance of a fund.

While investors now frequently demand that a fund use capital call borrowings, what are the risks and issues that sponsors (and their counsel) should understand in negotiating these facilities? This article discusses five key areas that fund sponsors (and their counsel) need to understand when negotiating these facilities with their lenders.

Partnership agreement and investor concerns

As the sponsor's first step in preparing for a fund capital call facility, the sponsor should make sure that the limited partnership agreement contains the necessary provisions that lenders will require to accommodate such a facility. Planning for a capital call facility as part of the initial formation of the fund is important because of the unusual nature of capital call facilities: the loans are not secured by the investment assets of the fund borrower, but only by the fund's right to call on the capital commitments of the fund's investors (the proceeds of which will repay the loans). Because these capital commitments are embedded in the fund's organisational documents, lenders (and their counsel) will conduct extensive diligence on the provisions of the limited partnership agreement and related subscription agreements and investor side letters to make sure that they authorise a capital call facility and related lender rights. Including appropriate provisions to accommodate a capital call facility will limit the extent of lender requests to investors when establishing the facility, and avoids the need for an amendment to the limited partnership agreement where a provision objectionable to a lender may have been inadvertently included.

Lender partnership agreement requests

At a minimum, the lender will insist that the partnership agreement authorise the general partner to borrow on behalf of the fund and to pledge: (a) the right to call unfunded capital; (b) the right to enforce remedies against investors who default on the payment of their capital commitments; and (c) the deposit account into which all capital contributions must be paid. Most lenders will also want specific language obligating the investors to make capital contributions in response to a capital call issued directly by the lender (as opposed to the general partner), and third-party beneficiary language entitling the lender to rely on these provisions in the partnership agreement.

In a similar manner, the lender will want to be sure that any debt restrictions in the partnership agreement (or related side letters), such as limiting outstanding debt to a certain percentage of total capital commitments or requiring debt to be repaid within 180 days, provide adequate flexibility to permit the contemplated capital call facility. Similarly, the partnership agreement should provide that, even after termination of the fund's investment period, capital may still be called to repay loans, either expressly or by including principal, interest, fees, expenses, etc., from a credit facility in the definition of "Partnership Expenses", for which capital may be customarily called after the investment period ends. In the absence of this language, the lender will be required to terminate the credit facility upon expiration of the investment period, whether at scheduled maturity or upon an early termination event.

Beyond these basic provisions, lenders may require other provisions that are more controversial. Many lenders request partnership provisions that require investors: (a) to waive offset rights and similar defences against the fund and its general partner when a capital call is made by the lender (though these claims may be brought separately against the fund and its general partner); and (b) to subordinate any claims against the partnership or general partner to the prior payment in full of the credit facility. While these provisions may not be objectionable to the sponsor and are not unusual in the context of secured credit facilities generally, many investors object to any diminution of their rights, particularly if the investors have invested with the same sponsor in earlier series of funds that did not contain these provisions.

Other lender requests

Sometimes lenders request individual letters from each investor, who must make the waivers and agreements described above (and often other undertakings, such as financial reporting or periodic confirmation of outstanding capital commitments) directly to the lender. While such letters were commonly requested in prior years when partnership agreements did not routinely contain provisions to accommodate capital call financing, now that fund partnership agreements typically contain these provisions, most private funds do not agree to provide investor letters except for facilities where the borrower is a "fund of one" or specially managed account for a single investor or very small group of large investors. Contrary to practice in some European countries, most notably the Cayman Islands, the Uniform Commercial Code does not require notice to, or an acknowledgment from, investors in order for the lender to receive a perfected security interest in the investors' capital call obligations.

Lenders may also request expanded collateral that includes other fund deposit accounts and investment assets, in addition to uncalled capital and the related deposit account. Such expanded collateral is typical only for very small funds or in a hybrid borrowing base that gives credit for the fund's portfolio investments, as well as its uncalled capital commitments, as discussed in the Section, "Borrowing base", below.

<u>Lender diligence issues</u>

In addition to reviewing the partnership agreement, lenders will also conduct investor-level diligence, including the review of investor credit ratings and financial information (where available), know-your-customer information and any side letters between an investor and the fund (these may be redacted before being provided to the lenders to protect sensitive economic or other terms). In reviewing side letters, a lender's primary focus will be any restrictions on the incurrence of debt by the fund, or on the use of a particular investor's capital commitments to repay fund debt, and any assertion by an investor of sovereign immunity. Sovereign immunity provisions in particular require careful legal analysis, which will vary depending on the jurisdiction of the investor, as to whether such immunity could prevent the enforcement of a capital call against the investor.

Confidentiality issues are critical in connection with the lender's diligence investigation. The sponsor should make certain that the lender's confidentiality obligations to the fund explicitly extend to investor information. At the same time, the sponsor needs to make sure that its own confidentiality obligations to the investors permit the sponsor to disclose to the lender on a confidential basis the investors' financial data and know-your-customer information. In instances where investors (most often sovereign wealth funds and high net worth individuals) will not permit such disclosure to lenders, the absence of financial data will exclude the investor from the borrowing base, as described in "Borrowing base", below. Even more difficult issues for the lender arise from the absence of know-your-customer information for a particular investor. In such cases the sponsor must either negotiate limited disclosure by the investor or make the lender comfortable with the results of the sponsor's own know-your-customer diligence investigation.

Borrowing base

The key credit aspect of a capital call facility is the borrowing base, which is expected to provide the source of repayment to the lenders. Under a borrowing base, outstanding loans (as well as exposure from letters of credit and hedging) may not exceed an aggregate amount for all investors equal to the product for each investor of (a) the uncalled capital of such investor multiplied by (b) an advance rate based on such investor's credit-worthiness. For some lenders, the advance rate may be a single percentage applied to the uncalled capital of all investors in the fund, as a whole. For most facilities, however, the advance rate for a particular category of investor varies based on the relative credit-worthiness of the applicable investors in such category deemed eligible to be included in the borrowing base.

Eligible investors

Investors with an investment grade credit rating or pension plans with very large asset size are typically deemed eligible to be included in the borrowing base either without lender approval or with lender approval not to be unreasonably withheld, assuming that these investors pass customary know-your-customer requirements.

Other investors may require lender approval and special diligence in order to be deemed eligible for the borrowing base. If financial information is available for non-investment grade borrowers and smaller pension plans, the lender may include the investor in the borrowing base, but at a lower advance rate. Sovereign wealth investors may be particularly troublesome if they are unwilling to provide financial information. An experienced lender may have encountered such a sovereign investor in other facilities, and be comfortable including it in the borrowing base at a reduced advance rate. In other instances, the lender may be willing to include such a sovereign investor in the borrowing base only after it has already paid 50% of its uncalled commitment to establish a sufficient track record. In a very few instances, confidentiality restrictions may prevent the lender from obtaining even the identity of a sovereign investor. While such an investor would typically not be included in the borrowing base, in these cases the lender may be able to lend to a fund that includes such an unknown investor only if the lender can rely upon the sponsor's own diligence for know-your-customer requirements and be provided at least contact information (such as a post office address) for the investor to receive capital calls from the lender in the exercise of default remedies.

Many lenders will not include high net worth individual investors in a borrowing base as a matter of policy, though others may make exceptions, particularly for sufficiently large family offices or feeder funds comprised of a group of high net worth individuals.

Borrowing base exclusions

Lenders often require concentration limits, which exclude the portion of an investor's uncalled capital from the borrowing base in excess of a certain percentage of all uncalled capital. If the fund is obtaining the capital call facility after only a single closing or in an early stage of fund-raising, the sponsor should request a ramp-up period during which the concentration limits will not apply. Sometimes lenders also reduce the borrowing base by the percentage of uncalled capital of the single largest investor, which results in an exclusionary effect even more severe than concentration limits.

Eligible investors may be removed from the borrowing base upon the occurrence of various default-type events that reflect a loss of credit-worthiness. Exclusion from the borrowing base for a material adverse change or loss of net worth should apply only to non-rated investors, on the assumption that a material adverse change or loss of net worth in a rated investor will be reflected by a rating downgrade. For exclusion of an investor who fails to make a required capital contribution, the sponsor should take account of the grace period provided in the partnership agreement, typically five or 10 business days. Sponsors and their counsel should also make sure that the exclusion for an investor excused from a particular investment disqualifies that investor only with respect to an advance made to fund an investment in the particular industry or jurisdiction for which the investor is excused under its side letter or the partnership agreement, and not with respect to other investments generally.

Other borrowing base issues

While it is customary for the borrowing base calculation to deduct the amount of any debt of the fund incurred outside the facility, sponsors should make sure that they are not required to deduct liabilities that would not be expected to be paid from capital calls, such as (a) cash-collateralised exposure under letters of credit and hedging provided by third parties, and (b) non-recourse pledges of portfolio assets, for example, to secure portfolio company debt (in the case of a private fund) or asset securitisation financing (in the case of a debt fund).

Some capital call facilities permit the borrower to include investment assets in the borrowing base, either on a secured or unsecured basis. This approach may be appropriate for: (a) a fund near its maturity, where the amount of its assets under management far exceeds its uncalled capital; or (b) a debt fund that uses a hybrid capital call/portfolio asset borrowing base early in its life as a warehouse facility until it accumulates enough assets for a securitisation financing. In both cases, the investment assets are typically included at a relatively low advance rate, based on the most recent asset value as reported by the fund to its investors from time to time.

Large sponsors sometimes employ a single capital call facility for the use of multiple funds across different investment strategies. In such multi-fund facilities, each fund uses only its own borrowing base and collateral. The fund borrowers are never jointly and severally liable for each other's obligations, and a default by one fund borrower would not trigger a cross-default for the other fund borrowers. New fund borrowers can be added to the facility from time to time. The advantages to the sponsor of a multi-fund facility are: (a) to economise on transaction costs with a single credit agreement covering multiple funds; and (b) to minimise the facility size, with the resulting reduction in upfront fees and unused availability fees that would otherwise arise from separate facilities for each fund. These savings are based on the assumption that the different funds will use the facility in a similar manner, but with peak borrowings at different times. Problems may arise if most of the funds need to borrow at the same time. Common expenses generally applicable to all the funds, such as upfront fees, unused availability fees, indemnities and transaction costs, are typically allocated based on relative uncalled capital of the funds from time to time.

Basic borrowing terms

Capital call facilities often mature every 364 days (with renewal in the lender's sole discretion) in order to take advantage of the reduced capital reserve requirement for a lender providing only a short-term facility, and the resulting lower interest rate. In such cases, the expectation of all parties is to renew the facility year to year, absent compelling circumstances. Other facilities are typically three years, often with annual extensions in the lender's sole discretion.

Note that letters of credit and hedging issued under the facility will need to extend beyond the facility maturity date, but must be cash-collateralised prior to such maturity date if the facility will not be extended. Similarly, the lender's commitment should not terminate upon expiration of the fund's investment period if the partnership agreement provides that capital may be called from the fund's investors to repay loans even after the investment period ends.

Funds often require (a) a temporary increase in availability for a 90- or 180-day period to facilitate large investments or other unusual cash needs, and (b) an accordion feature to increase the lender's commitment as new investors are added to the fund through subsequent investor closings.

Covenants

The scope of covenants that a capital call facility lender will expect is narrower than the covenants in a typical revolving credit facility for an operating company. Financial ratios and restrictions on asset dispositions and investments are not typical in capital call facilities.

Negative covenants

From the fund's perspective, restrictions against liens that apply only to the lender's collateral are ideal, and typical. If the lender insists upon a broader liens restriction covering other fund assets, the fund will need to permit, at a minimum, (a) cash collateral for third-party letters of credit and hedging, and (b) liens on portfolio assets that secure obligations of portfolio companies (in the case of private equity funds) or warehouse or other asset-based leverage facilities (in the case of debt funds).

Similarly, the ideal indebtedness covenant from the fund's perspective would permit any indebtedness authorised by the partnership agreement. While this approach is acceptable to many lenders, others will insist upon a broader debt restriction. In addition to permitting the types of debt associated with the lien exceptions described above, sponsors should make sure that ordinary course obligations to make acquisitions or other investments pursuant to bids and purchase agreements are not prohibited by the debt covenant.

Limitations on fund distributions to partners, and the payment of management fees and expenses to the sponsor, raise sensitive issues. Many capital call credit agreements prohibit payment of these items during a potential default or mature event of default. Sponsors will want these payments blocked only when loans or letters of credit are outstanding under the facility, and push for blockage only upon a mature event of default, preferably only relating to payment (including as a result of a borrowing base deficiency or an unpaid mandatory prepayment) or bankruptcy. Sometimes sponsors will insist that tax distributions and management company out-of-pocket expenses be paid regardless of an event of default.

Prepayment covenant

Mandatory prepayments, whether on account of a borrowing base deficiency, key person event under the partnership agreement or other factor, as well as capital adequacy and similar event-driven payments, require special attention. While a typical revolving credit agreement for an operating company would require the borrower to make these payments immediately, a fund borrower will most likely not have sufficient cash on hand to make these payments. As a result, in a capital call facility these payments should be due within two business days to the extent of available cash, with the balance due within the period necessary to make and collect a capital call on investors, typically 10 to 15 business days.

Covenants relating to investors

Because the lender's collateral and source of repayment is so closely tied to the fund's organisational documents, the lender will be especially sensitive about waivers and amendments of the fund's partnership agreement and investor subscription agreements and side letters. Many capital call lenders want consent rights for any amendment or waiver to these agreements, as well as for any new investor side letters and subscription agreements, for the purpose of reviewing whether adverse provisions would trigger most-favoured-nation clauses in side letters for previous investors that are already in the borrowing base. As a starting point, sponsors will want to limit these lender consent rights only to changes that would materially adversely affect the lender, including adjustments to the fund debt limit, changes to capital calls and commitments and similar items. Even with this sort of limitation, the lender may require an extensive pre-clearance procedure, such as 10 business days for the administrative agent or lead lender to determine whether the proposed waiver or amendment would have such an adverse effect, then 10 additional business days to obtain approval from any other lenders. A preferred approach is for the sponsor to make the initial determination whether an amendment is adverse to the lender, and then provide a lender with a pre-approval period only for such adverse amendments. If the sponsor is unable to avoid initial pre-clearance, the sponsor will want to shorten the review periods as much as possible.

Either as a closing condition or covenant, lenders often require that the sponsor notify all fund investors that the capital call facility is in place. Typically sponsors agree to provide such notice only in the next regularly scheduled periodic investment report. For funds organised in the Cayman Islands, however, notice to investors is a required step to perfect the lender's security interest in uncalled capital, so a special notice prior to the next periodic report may be necessary. The form of notice may be negotiated with the lender, but should be primarily drafted by the fund sponsor, in order to present the facility in an optimal manner from an investor relations perspective.

Defaults and remedies

Capital call credit facilities contain several events of default and remedies that do not customarily appear in a revolving credit facility for an operating company.

<u>Capital call facility defaults</u>

Transfers by investors of more than a certain percentage (typically 10% or 15%) of the fund's total capital commitments is a common default in capital call facilities. At a minimum, the sponsor should push to exempt from this default transfers from an investor to one of its own affiliates. The sponsor could try to limit the default only to those investors included in the borrowing base, or even eliminate the default altogether on grounds that such a transfer should only reduce the borrowing base, and not terminate or accelerate the entire facility.

Another special default trigger is the failure of a certain percentage of investors (typically 5% to 15%) from paying a capital contribution when due. At a minimum, the sponsor should push to include the payment grace period from the partnership agreement. As with the default trigger for investor transfers, the sponsor could also try to limit the default only to those investors included in the borrowing base, or eliminate the default entirely and protect the lender only through a borrowing base reduction.

Often the occurrence of a key person event or change of control under the partnership agreement constitutes an event of default. If the partnership agreement provides a standstill period (typically 30 to 60 days) before the limited partners may dissolve the partnership or permanently suspend new investments as a result of such an event, the sponsor should consider making the occurrence of such an event only a justification for the lender to cease making new advances, as opposed to an event of default that could result in termination and acceleration of the facility. If the investors decide to reinstate the investment period, advances may again be requested. If the investors terminate the partnership or permanently suspend new investments, a mandatory prepayment would occur.

<u>Special remedy concerns</u>

One of the most important protections for a sponsor in a capital call facility is to prevent the lender from calling capital as a result of an event of default, unless the general partner fails to do so for a period of five business days (or other reasonable period) after demand by the lender during the existence of an event of default. Even during a default, the sponsor should make every effort to maintain usual operations with respect to the fund's investors, and not have to negotiate an amendment or other workout with the lender threatening to contact the fund's investors at any moment. Lenders are usually amenable to this protection, but sometimes insist that this protection should apply only if the default can be cured by a capital contribution, and that during a default the lender should control the issuance of all capital calls. Notwithstanding these lender arguments, the sponsor should always retain the right to call capital during a default for the purpose of paying the facility in full. From an investor relations perspective, it is essential for the sponsor to demonstrate that the fund is operating in the ordinary course of business to the extent practicable. A payment demand upon the fund investors from a third-party lender would be extremely disruptive to relations between the sponsor and its investors.

Even though the lender limits its loans to a borrowing base comprising only eligible investors, the lender's collateral extends to the uncalled capital of all investors in the fund, even those who are not included in the borrowing base. Similarly, even though the lender is secured only by uncalled capital and related rights, the lender's recourse to the fund is not limited only to its collateral: a capital call lender could bring a claim as an unsecured creditor against all investment and other assets of the fund.

Sponsors typically limit this recourse only to fund assets, and not to the general partner's assets, as would be the case under partnership law. General partner assets may include direct or indirect ownership in the management company or other interests of the sponsor that it does not want to expose to a lender at the fund level. Exceptions to such a non-recourse provision typically include: (a) the pledge by the general partner of its right to call capital and exercise remedies on behalf of the fund; and (b) damages resulting from wilful misconduct or fraud by the general partner.

* * *

With the foregoing issues in mind, the sponsor (and its counsel) should be able to negotiate a capital call facility that brings the desired benefits to the investors and the fund, while providing sufficient flexibility for the fund to operate without undue interference from its lender.

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Historical perspective and evolution of investor issues in subscription financing – from credit analysis to enforcement

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The first subscription-secured credit facilities were documented in the late 1980s. The structure, under which lenders provide a revolving line of credit secured by the right to call on the capital commitments of the investors in a private equity fund, introduced lower-cost financing and simplified documentation compared to real estate-secured facilities. Use of the product has burgeoned over the last 25 years, expanding globally and used by private equity funds of all types.

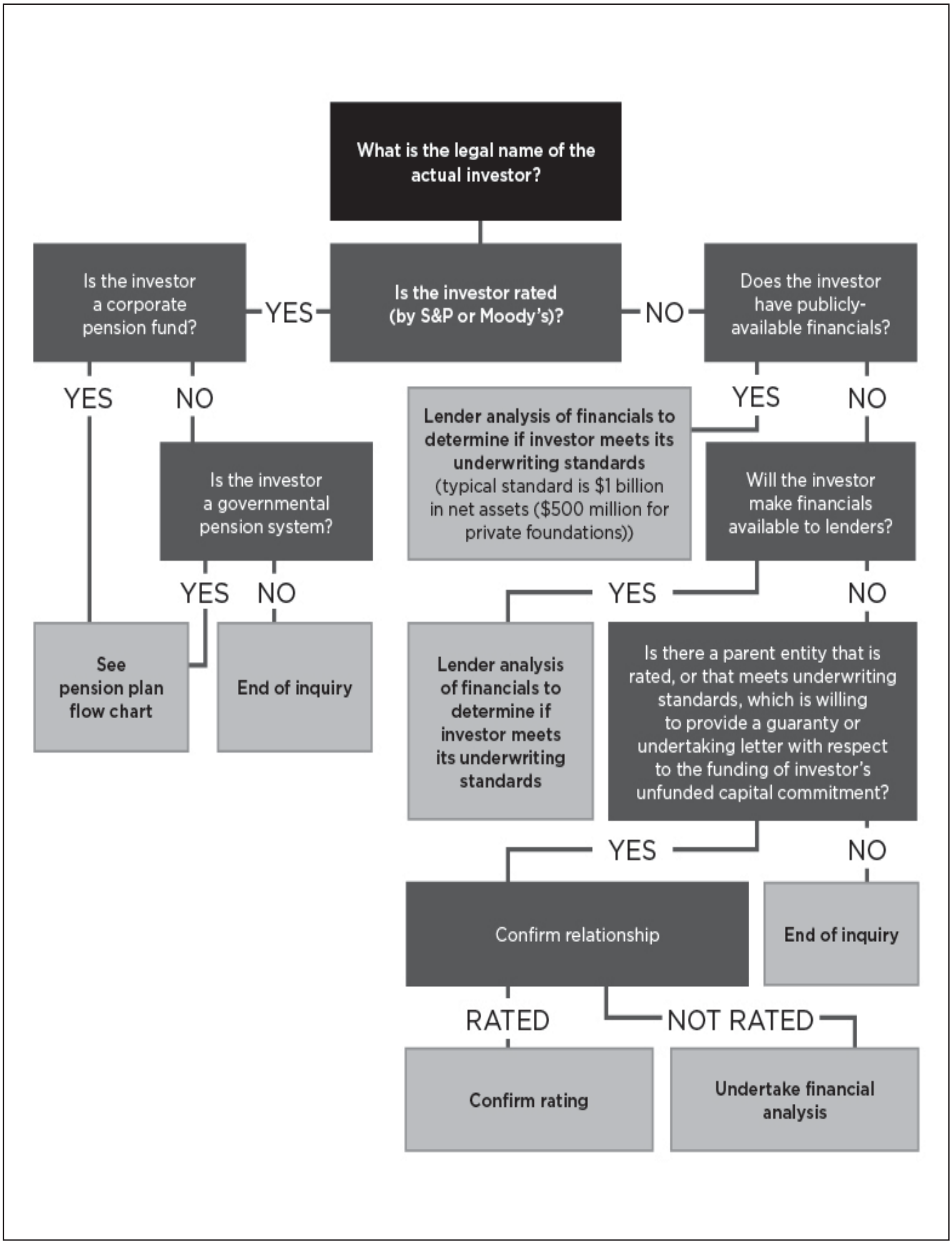
In the early days of subscription facilities, lenders and their counsel worked to develop standards for underwriting the facility based on the credit of the investors in the fund borrower. Corporate pension plans, insurance companies and bank investment subsidiaries were the typical investors at that time, soon followed by governmental pension systems and universities. Most investors made direct commitments to the funds, and many of them were rated entities (or, in the case of bank subsidiaries, were frequently supported by guaranties of the parent bank holding company), making the credit analysis simple.

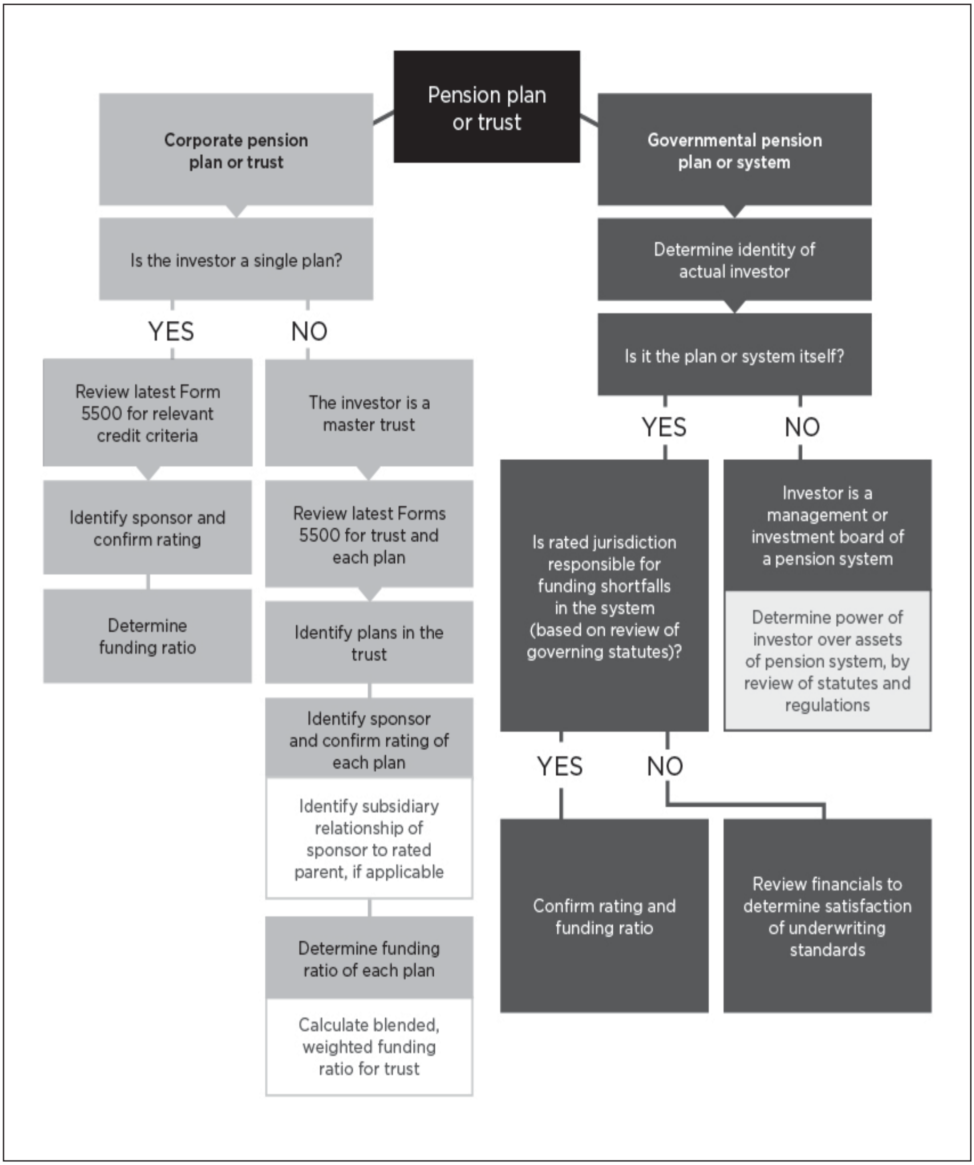
Corporate pension plans governed by ERISA required more analysis. The standard developed quickly and relied both on the rating of the corporate sponsor as well as how well-funded the plan itself was, and is used to this day. Over time, more rigorous scrutiny of the statutes governing governmental pension systems led to a more well-defined understanding of the related credit issues, resulting in differentiating rated and non-rated systems. Today, investor types run the gamut from directly-investing universities, governmental plans, ERISA-governed trusts (including university or church plans) and stand-alone investment funds to investment subsidiaries of all of the above. While there are many investor types, and each requires separate scrutiny, the fundamental credit considerations remain constant.

A complete understanding and analysis of the credit issues for each type of investor, together with proper due diligence with respect to documentation, sovereign immunity and jurisdiction issues, are required to assess the potential borrowing base of each subscription facility.

Investor credit analysis

The inquiry begins with the seemingly obvious question of, "Who is the actual investor?" which is not always obvious when a potential borrower presents a lender with a list of its investors. If the signatory to the subscription agreement is "Allstate Life Insurance Company," an entity rated AA-/Aa3, the answer is quickly resolved. However, nearly every other type of investor will require more diligence. The following graphic "decision trees" outline the questions to ask in order to assess the investor's credit.





Once the credit status of each investor is determined, the lender can construct the potential borrowing base. Note that for facilities with a designated investor structure, in which all or almost all investors comprise the borrowing base, investors that do not meet the credit standards above may also be included in the borrowing base at a reduced advance rate and with concentration limits.

Identity risks

Along with the credit analysis, lenders must consider risks of enforcement related to the "identity" of the investor. Governmental entities will have sovereign immunity with respect to certain kinds of claims, and the ability to enforce, and process of enforcing, claims against investors organised in a jurisdiction outside of the governing jurisdiction of the facility must be understood and acceptable to the lenders.

Typically, rights of sovereign immunity extend to claims in tort, claims for actions taken by a governmental entity or related person in its role as a state actor, and not to contractual claims. A governmental investor will usually provide, in an investor letter or side letter, assurance that its right to sovereign immunity does not impair its agreements under the relevant fund or facility documents. In the absence of such assurance, separate research by counsel may sometimes resolve the issue. When doubt remains about whether sovereign immunity may impair a lender's ability to enforce claims against a particular investor, the investor will be excluded from the borrowing base.

Jurisdiction considerations include whether an investor is subject to the jurisdiction of the courts in the venue that the borrower has agreed to under the facility, and whether, if a judgment is obtained, the judgment may be enforced in the country where the investor's assets are held, if local assets are not sufficient for the claim. "Foreign" investors may consent to jurisdiction and venue, or service of process, in the fund's partnership agreement, or in an investor letter or side letter, some combination of which may give comfort to lenders on this issue. To the extent a lender anticipates the need to enforce a judgment in a particular country, counsel can typically advise whether an international convention or treaty applies, or whether issues relating to reciprocity or public policy concerns need to be considered.

Documentation risks

Partnership agreements (and the equivalent organizational documents for non-partnership entities) have evolved over the decades that the subscription facility product has been available, to better accommodate the use of subscription facilities, and to provide clear terms regarding the obligations and rights of the fund and its investors with respect to facility repayment.

At a minimum, typical partnership agreements will specifically include the ability to borrow money, or to guarantee the borrowing by subsidiaries or affiliates, and to secure debt with a pledge of the right to call on the capital of the investors, together with related rights of enforcement. Most partnership agreements will also include an agreement that capital commitments are irrevocable and that the investors agree to fund capital calls without defense, set-off or counterclaim. The latter may be agreed generally, or in the context of calls to repay a subscription facility.

A lender should review the partnership agreement closely, to identify terms that may adversely impact its ability to obtain repayment from capital calls on the investors. It is important to keep in mind that subscription facilities are structured so that the source of repayment is the unfunded capital commitments of the investors, and that facility advances are made to the fund in lieu of calling capital from the investors. This means that the facility advances may be at risk if, between the time of the borrowing and maturity, an investor against whose capital commitment a lender has advanced funds transfers its interest or withdraws from the fund, without an adjustment to the borrowing base and opportunity to call on that investor, or if the investor has an excuse right that applies to a call to repay the facility. Investors commonly enter into side letters with the fund, which should be considered amendments to the partnership agreement, and which often contain terms that impact payment obligations, so it is essential to review side letters as well.

Note that giving the lender and its counsel the opportunity to review and suggest revisions to the partnership agreement and side letters before they are finalized will often help avoid the need for complex and potentially onerous terms in the credit facility documentation, or exclusion of investors from the borrowing base. Typically these revisions merely clarify the intent of the parties and do not alter the business deal between the investor and the fund.

Specific credit and risk analysis

Corporate pension plans. Corporate pension plans, which are subject to ERISA, were often significant investors in fund borrowers in early subscription facilities. Since pension plans themselves are not rated, lenders developed a two-pronged test to assess their credit. By looking through to the rating of the plan sponsor, together with relying on the funding ratio of the plan (a test of assets over liabilities, on an actuarial basis), lenders balanced the credit of the corporation that is responsible for funding the pension plan with the funding strength of the plan itself. The plan of a highly rated sponsor could have a slightly lower funding ratio and be designated as an included investor, the analysis being that the sponsor had the ability to fund the plan if required, and a lower-rated sponsor's plan would meet the test if it were well-funded.

However, the inclusion of corporate pension plans in borrowing bases gave rise to other risks. As the subscription loan market progressed in the late 1980s, these pension plans constituted an increasing percentage of the investor pool, presenting two significant issues, either of which might result in a prohibited transaction under ERISA.

The prohibited transaction provisions of ERISA regulate transactions between a plan and a "party-in-interest". The definition of a "party-in-interest" is extremely broad, and lenders should assume that any lender in the facility may be a party-in-interest with any plan investing in the fund borrower. Specifically, prohibited transactions include:

(a) a direct or indirect lending of money or other extension of credit between a plan and a party-in-interest; or

(b) a direct or indirect transfer to, or use by or for the benefit of, a party-in-interest, of any assets of the plan.

The first prohibited transaction risk is common to any loan to a limited partnership that has corporate pension plan investors. If the borrower itself (or a guarantor) is deemed to be holding "plan assets", loans made by the lenders to the borrower would be treated as an extension of credit to the plan investors, and may be considered prohibited transactions. The interests of funds and their lenders are aligned, however; in most instances the fund is required to avoid holding plan assets, and will either qualify as an operating company under ERISA and the Internal Revenue Code, or keep the percentage ownership of its corporate pension plan investors to below 25%, in each case in order to avoid holding "plan assets". Typically, representations and covenants in subscription credit facility documents will require the fund to confirm that it does not hold plan assets, and to maintain its status as an operating company or otherwise avail itself of the 25% safe harbour, and will require the fund to deliver related legal opinions or certificates.

The second prohibited transaction risk is more specific to subscription facilities. Although the delivery of "investor letters" from the fund's investors is not always required, in the early days of subscription lending, investors were required to deliver documentation that ran directly to the lender, sometimes in the form of a security agreement under which the investor granted a lien in its partnership interest. This evolved over time into an investor letter that accomplished three essential agreements, in which the investor (a) acknowledged the grant by the fund of the right to call on the investor's capital to repay the facility, (b) agreed to fund capital calls for such purpose without defense, set-off or counterclaim, and (c) agreed to make payment of all capital contributions into an account of the fund which was pledged to the lender as collateral for the facility. The problem was that the delivery of the investor letter to the lender might be deemed to result in a prohibited transaction, the analysis being that the lender (assuming it was a party-in-interest with that ERISA investor) was obtaining a special agreement from the investor that was not granted to the fund itself. That is, the lender could be seen to leverage its party-in-interest relationship with the investor to obtain a transfer of assets of the plan.

Prior to 2003, this potential prohibited transaction was avoided by drafting the investor letter in such a way that the ERISA investors were not actually making any agreements with the lenders, requiring lenders to represent their status as a party-in-interest (or not), and adding provisions to the credit facility documents that would re-allocate collateral should a lender be a party-in-interest. In many cases, individual applications to the U.S. Department of Labor (the "***DOL***") for a prohibited transaction exemption for the facility were made. This approach was cumbersome, time-consuming and costly.

Eventually, we developed the concept of a "global" prohibited transaction exemption that would apply to all subscription facility transactions for a particular lending institution who was the agent or lender in a facility. In early 2004, Bank of America, N.A. obtained such an exemption from the DOL that applied to subscription facilities with specific parameters, which global exemption was retroactive to January 1, 2003. The global exemption approach also accomplished the following:

(a) validation by the DOL of the interpretation of the ERISA rules by affirming that a prohibited transaction problem did exist with respect to certain funds; and

(b) providing a template for a solution on a lender-by-lender basis.

At the time, it took about a year to obtain a global exemption ruling, and it involved presentations to, and multiple conferences with, the DOL. Once the first ruling was published, other lenders applied for their own exemptions. Fast-forward to present-day, and nearly every major player in the market has obtained its own global exemption ruling.

Note that a lender's reliance on the global exemption requires confirmation of aggregate plan asset value, the investment in the fund being an arm's-length transaction, and other measures. These factors are typically confirmed in the investor letter of the ERISA investors, but with the advent of no-investor-letter deals, lenders will sometimes rely on a combination of exemptions (including the service provider exemption) to reach the desired comfort level about the underlying ERISA issues.

Governmental pension plans. Governmental pension systems are not subject to ERISA, so the funding obligations and credit of a governmental pension plan must be analysed with reference to state and local statutes and regulations, on a case-by-case basis. In particular, governmental multi-employer pension plan investors pose unique underwriting issues.

Most governmental pension plan investors are "systems" that include many separate pension plans for employees of a state, county, or city, administered centrally by an investment board. Some plans may have a single employer as the responsible party (or "sponsor"), but many others comprise employees of many separate employers, such as local school districts or police departments. Governmental pension systems are rarely rated by S&P or Moody's, so the practice has been to analyse the (a) net assets, (b) funding ratio, and (c) percentage of a dominant employer. In addition, some states provide a constitutional guarantee of funding for some or all of the pension plans in the state.

The funding ratios of governmental pension plans tend to be lower than those of corporate pension plans. Under ERISA, if a corporate pension plan's funding ratio decreases below a certain point, it will be required to fund the plan to achieve a higher funding ratio, or it will be at risk of takeover by the U.S. Pension Benefit Guaranty Corporation.[1] Governmental plans are creations of state law, and there is no minimum funding ratio that generally applies. However, most lenders will look for a minimum funding ratio of 70%.

If a plan (or system) is dominated by a single employer, such as the state, lenders may decide to rely on the rating of the state for included investor designation. A system in which 90% or more of the employees are employees of the state (or a subsidiary jurisdiction) may reasonably be "linked" to the credit of the state, since the state will likely be responsible for funding shortfalls in the plans. Thus sometimes governmental system investors will be designated as rated included investors, although generally they will fall into the non-rated category. Note that city governmental plans are almost always considered to be rated investors, since there is rarely a subsidiary jurisdiction that would have employees included in such a plan, so they are essentially single-employer plans.

Investor documentation

Twenty-five years ago, investors were likely to deliver a security agreement to a lender in connection with a subscription facility. In those days, the facility would have been non-recourse to the borrower, so the lenders not only had the ability to call on the investors for repayment, but could foreclose on their partnership interests and thus have access, to an extent, to the value of the borrower's underlying investment value.

At the time, some lenders took an alternative approach, requiring nothing more than an estoppel certificate from each investor, which essentially confirmed the investor's commitment to the fund and the amount of its unfunded commitment. The estoppel certificate was typically in the form of a letter to the lender, and was about one-half of a page in length.

These deals were highly structured and the fund was required to seek the lender's approval prior to making each investment. In turn, the lender would conduct a substantial amount of due diligence on the investment and the underlying assets, but would not require the investors to pledge their partnership interests. Eventually, the lead banks taking this approach reduced their participation in the market, just as more lenders entered and competition for deals increased.

Soon, a more streamlined documentation approach became the norm. Lenders gave up taking a pledge of the investors' partnership interests, and the loans were made recourse to the borrower. A hybrid of the former security agreement and simple estoppel was created that still serves as the current form of investor letter. Lenders that adopted this documentation gained market share for several years, further developed their expertise in investor credit analysis, and started to accommodate more complex borrower structures.

Over time, as sponsors who had utilized subscription facilities formed their third or fourth fund, and more and more sponsors obtained subscription financing, they added provisions to their partnership agreements to better accommodate a subscription facility. Although some sponsors made delivery of an investor letter part of their closing process and included a form as an exhibit to their partnership agreement, others found the process of obtaining a letter from each investor cumbersome, and sought alternatives.

Around 2007, an historically profitable year for private equity funds, there was significant competition among lenders for subscription facility business. The funds therefore had leverage to affect the terms, and increasingly focused on eliminating the investor letters from the documentation requirements. A few early deals, for large private equity funds with robust track records and strong banking relationships, were closed without investor letters, and without all of the terms that would now be viewed as essential, "bankable" partnership agreement provisions.

Now, although many deals still require the execution of investor letters, a significant number of other deals do not. Partnership agreements typically include all of the key terms that would otherwise have been in an investor letter, including not only the three key agreements, but representations about ERISA and sovereign immunity matters as well. Partnership agreements should include not only basic provisions such as a clear power to borrow, and to secure borrowings with a pledge of the investor capital commitments, but recognition of the rights of lenders under the key agreements, which may include specific third-party beneficiary reliance or a carve-out from the typical restrictions on such reliance.

While lenders do not have direct privity with investors in no-investor-letter transactions, between the partnership agreement terms, security interests granted in the credit facility documents, and underlying partnership law, lenders continue to have rights of reliance and recourse to the unfunded capital commitments of the investors as a source of repayment.

Enforcement issues

General issues of enforcement

State laws, including the UCC[2] and case law, support the enforceability of the investors' agreement to fund without defense, set-off or counterclaim.[3] Generally speaking, parties to a contract may contractually agree to waive certain rights. A party may waive a defense to a contract,[4] and courts have enforced such waivers if the waiver language is manifested in some unequivocal manner.[5] 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[.]"[6] The court held that this provision was enforceable based on the degree and specificity to which it explicitly waived the defendant's rights.[7]

Although material 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 fund's full repayment of the facility, usually from proceeds of a capital call on the investors. Lessons learned include the need to keep contact information for each investor current in the lender's records, and to communicate early and often with the fund.

Enforcement against non-U.S. investors

As described above, to address "identity risk" with respect to non-U.S. entities, lenders have to be concerned with establishing personal and subject matter jurisdiction (which requires the same analysis as with domestic entities[8]), and once jurisdiction has been established, effective service of process. Once a judgment is obtained, enforcement of the judgment against the investor and its assets, which process may need to occur in a non-U.S. jurisdiction, requires further analysis and action.

Submission to jurisdiction and agreements with respect to service of process may be in an investor letter or the fund documents. An agreement to accept service of process by certified or registered mail should be enforceable unless the foreign fund demonstrates that such service is precluded by foreign laws.[9] If the manner of service contained in the credit agreement 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.[10]

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.[11] 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.[12]

One advantage of service by registered mail, according to *Article 10(a)*, is efficiency. The time for a foreign Central Authority to process a formal service request can be fairly lengthy. The Hague Conference on Private International Law states that most Central Authorities accomplish service within two months.[13] One significant disadvantage to using registered mail, however, is that it may make any U.S. judgment very difficult to enforce in the foreign country. Enforcing a U.S. judgment in a foreign country requires taking the judgment before a foreign court and asking it to give the judgment full effect in the foreign country. A common criteria most foreign courts examine when deciding whether to uphold a foreign judgment is whether service was proper under the laws of the foreign country itself.[14]

As a practical matter, lenders may end up seeking service by utilising several different methods simultaneously. 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 significant cost and there is always the chance the defendant will respond to it and appear in court.

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. A declaratory judgment issued by a court has the force and effect of a final judgment or decree.[15]

Enforcing the judgment against the investor's assets can be time-consuming and difficult; however, the U.S Federal Rules of Civil Procedure provide for very broad post-judgment discovery of a judgment debtor's assets in the United States,[16] and all of the related discovery tools are available to an enforcing lender.[17] Federal courts have broad authority to sanction judgment debtors that refuse to comply with post-judgment discovery.[18]

Should no U.S. assets be available, enforcing a U.S. judgment abroad presents its own challenges. Unlike many countries, the United States has no treaty or agreement with any other country respecting the enforcement of judgments.[19] Therefore, a country-by-country analysis is required. Usually another country's recognition of U.S. judgments will depend on reciprocity given in U.S. courts to judgments of that country. That is, if U.S. courts will recognize and enforce judgments issued by courts of another country, the courts of that country will recognize U.S. judgments.

Typical requirements for an enforceable judgment include:

- finality of the judgment;
- the judgment must have been decided on the merits (that is, not a default judgment);
- the court rendering the judgment must have had jurisdiction (including the concept that proper service of process shall have been made);
- the judgment shall not be contrary to public policy (being international public policy, under which stability of international trade is one factor) (this is unlikely to affect a monetary judgment for actual damages (as opposed to punitive damages)); and
- reciprocity by the courts of the jurisdiction issuing the judgment (*e.g.*, the State of New

York) must be provided for recognition and enforcement of foreign judgments with parameters that are neither stricter than nor substantially different from those of the country in which enforcement is sought, with respect to similar subject matter judgments.

As a practical matter, registration and enforcement of a judgment abroad will involve collaboration with local foreign counsel, who will be able to advise on strategies specific to each foreign country involved.

Conclusion

Thirty years ago, mentioning "subscription financing" would have resulted in a blank look. Today, it is a multi-billion-dollar product. Lenders have an increasingly sophisticated understanding of the credit issues and risks of subscription finance, and the product has evolved to meet the needs of a modern, competitive market. The fundamental reliance on the credit of fund investors to provide an elegantly structured facility with minimal, but strong, documentation, has not changed, and its strength is evidenced by its successful use through several decades of business cycles. With only slight evolutionary changes, subscription financing continues to provide private equity funds with reliable, flexible financing, and provide lenders with a stable product and a vanishingly small default rate. The success of subscription financing is due in no small part to the market's understanding of its ultimate source of repayment, the credit of fund investors.

* * *

Endnotes

1. The PBGC was established by Congress to insure corporate pension plans, and has the power to terminate plans that do not meet minimum funding requirements. *About Us: Who We Are*, Pension Benefit Guaranty Corporation, http://www.pbgc.gov/about/who-we-are.html (last visited Dec. 12, 2016).
2. *See* U.C.C. § 9-403 (2014) (detailing the conditions required for a valid agreement not to assert a defense).
3. *See* Chase Manhattan Bank v. Iridium Afr. Corp., 474 F. Supp. 2d 613, 615 (D. Del. 2007) (concluding that under the LLC Agreement provided, 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].").
4. *See* 17B C.J.S. Contracts § 862 Waiver of Defenses (2011).
5. *See* Wells Fargo Bank Minn. Nat. Ass'n v. Nassau Broad. Partners, L.P., 2002 U.S. Dist. LEXIS 17191, at *5 (S.D.N.Y. Sept. 12, 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.").
6. Relational Funding Corp. v. TCIM Servs., No. Civ. A. 01-821-SLR, 2003 U.S. Dist. LEXIS 7594 at *3 n.1 (D. Del. Apr. 29, 2003).
7. *Id*. at *5 ("Defendant's additional evidence does not change the plain language of the Lease.").
8. The analysis will be the same as with a domestic entity. *See supra* text accompanying notes 2–7.

9. *See, e.g.*, Mastec Latin Am. v. Inepar S/A Industrias E Construcoes, No. 03 Civ. 9892(GBD), 2004 WL 1574732 at *2 (S.D.N.Y. July 13, 2004) (illustrating how a Brazilian defendant specifically agreed by contract to service of process upon its designated agent in New York and that because New York law permitted such an agreement, 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, 934 (N.Y. 2008) ("Since a New York plaintiff need not comply with foreign law absent a treaty, we must lastly consider whether the defendants were properly served under New York law."). *See also infra* text accompanying note 19.
10. *See HCCH Members*, HCCH, https://www.hcch.net/en/states/hcch-members (last visited Dec. 12, 2016) (listing the 82 different members of the Hague Conference).
11. *See Hague Convention of 15 November 1965 on the Service Abroad of Judicial and Extrajudicial Documents in Civil or Commercial Matters,* HCCH, (Nov. 2009), https://assets.hcch.net/upload/outline14e.pdf (outlining in a practical manner the service of process under The Hague Convention where each participating government designates its own "Central Authority."). The United States' Central Authority is the Office of International Judicial Assistance, a part of the Justice Department. (*Legal Considerations: Service of Process,* TRAVEL.STATE.GOV, http://travel.state.gov/content/travel/en/legal-considerations/judicial/service-of-process.html (last visited Dec. 13, 2016)). England's Central Authority is The Senior Master of the Royal Courts of Justice, in London. (*United Kingdom – Central Authority & Practical Information,* HCCH, https://www.hcch.net/en/states/authorities/details3/?aid=278 (last visited Dec. 13, 2016)).
12. *Convention on the Service Abroad of Judicial and Extrajudicial Documents in Civil or Commercial Matters*, HCCH, Article 10(a), https://assets.hcch.net/docs/f4520725-8cbd-4c71-b402-5aae1994d14c.pdf (last visited Dec. 13, 2016). Note that the United Kingdom and the Cayman Islands have made no objection to service by mail. *See* McCarron v. British Telecom, No. 00-CV-6123, 2001 U.S. Dist. LEXIS 7424, 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).
13. *See Hague Convention of 15 November 1965 on the Service Abroad of Judicial and Extrajudicial Documents in Civil or Commercial Matters*, *supra* note 11("[S]tatistical data shows that 66% of requests are executed within 2 months.").
14. *See* Committee on Foreign and Comparative Law, Association of the Bar of the City of New York, *Survey on Foreign Recognition of U.S. Money Judgments* July 31, 2001, at 13, *available at* www.brownwelsh.com/Archive/ABCNY_Study_Enforcing_Judgments.pdf (highlighting how the courts in Canada, Italy, and Japan decide whether to uphold a foreign judgment). *See also* Yvonne A. Tamayo, *Catch Me If You Can: Serving United States Process on an Elusive Defendant Abroad*, 17 HARV. J.L. & TECH. 211, 236 n.173 (2003) ("With few exceptions, foreign countries will not recognize judgments obtained pursuant to service effected in contravention of their laws.").
15. *See* 28 U.S.C. § 2201(a).
16. *See* British Int'l Ins. Co. Ltd. v. Seguros La Republica, S.A., No. 90 Civ. 2370 (JFK) (FM), 2000 U.S. Dist. LEXIS 7509, at *16 (S.D.N.Y. June 2, 2000) ("Under the Rule,

a judgment creditor is entitled to a wide range of discovery concerning the assets and liability of a judgment debtor.”).

17. *See* Greyhound Exhibitgroup., Inc. v. E.L.U.L. Realty Corp., No. 88 CV 3039 (ILG), 1993 U.S. Dist. LEXIS 1929, at *3 (E.D.N.Y. Feb. 23, 1993) (“The Rule authorized the use of all of the discovery provisions of the Federal Rules for the purpose of obtaining information regarding the judgment debtor’s assets.”).
18. *See* Banco Cent. de Paraguay v. Paraguay Humanitarian Found., No. 01 Civ. 9649 (JFK), 2006 U.S. Dist. LEXIS 87093, at *30 (S.D.N.Y. Nov. 30, 2006) (explaining the “broad discretion” and “inherent power” that courts have to impose sanctions).
19. *Legal Considerations: Enforcement of Judgments,* Travel.State.Gov, http://travel.state.gov/content/travel/en/legal-considerations/judicial/enforcement-of-judgments.html (last visited Dec. 12, 2016) (“There is no bilateral treaty or multilateral convention in force between the United States and any other country on reciprocal recognition and enforcement of judgments.”).

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The rise of private equity secondaries financings

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Summary

Whilst the use of leverage facilities by secondary fund managers 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 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 2016 exceeded US$10bn globally and we believe that the majority of large private equity secondary acquisitions now invariably rely on debt financing. Whilst US$10bn may seem small compared to the estimated size of the global fund finance market, this figure represents a significantly larger percentage of total capital raised by secondary funds (estimated at over US$35bn in 2016) 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 US$1bn+ funds. This drives larger transactions which, in turn, drives a greater need for debt financing. However, as the product becomes more commonplace and better understood, the past five years have also seen a significant increase in smaller secondary transactions and secondary fund managers using leverage to accelerate distributions to its investors. As the secondary market has matured and become more liquid, so has the lender community's confidence that, in the unlikely event of a downside scenario, there will be a liquid market for the sale of these positions.

Whilst a large number of these transactions involve the acquisition financing of a diversified pool of LP interests in high quality private markets managers, recently we have seen an increase in the number of financings of GP restructurings, direct interests and less diversified portfolios (where, in some cases, the financing is of a single fund interest) as debt providers and secondary fund managers look to push the boundaries of these facilities.

However 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 10 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 secondaries 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 managers are increasingly looking to finance secondary transactions with debt finance and use debt as a portfolio management tool;
- how specialised lenders are comfortable with the risk profile of these transactions;
- how secondary financing structures have evolved over the last 15 years; and
- how we expect the market to develop in the future.

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

With echoes of the fund finance market, the secondaries market has rapidly emerged over the past few years as a mainstream alternative asset class with volume in 2016 by Q4 reaching US$31bn[1]. Whilst this figure represents a decline in secondary deal activity comparative to the same period in 2015 as a result of broader macroeconomic factors, the aggregate capital raised globally by secondary funds by the end of Q3 2016 reached almost US$40bn representing an increase of over 40% from 2015. Over 50 secondaries funds are currently in the market targeting almost US$35bn in 2017. Compare that to the approximately US$10bn raised by secondary fund managers 10 years ago and you have a market which 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 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 2016 average pricing was approximately 90% of NAV 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, with the largest sellers and buyers being private equity funds of funds.
- 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.
- Buyers looking for access to the private markets to increase their private equity exposure are attracted to the level of diversification 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.

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.

Secondary structures

The past…

…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 in its nascence, 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 also 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 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 protected 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 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 inhibit 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 managers 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 can be construed so as to 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 can be construed so as to 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 really only makes sense where 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 could 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 financing, 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:

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;

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, in most cases 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, coupled with a security power of attorney. Note that the survival of the power of attorney in an insolvency scenario will need to be taken into consideration in determining the value of this power of attorney.

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 the manager and their relationship with the manager and (ii) the quality/value/diversification of the underlying assets, we have seen lenders get comfortable with either:

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 control of the assets 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 secondary fund manager's interest in the underlying assets.

The outlook for 2017

A combination of a low interest rate and difficult macro environment 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 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. Figures to be updated.

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ERISA issues in subscription credit facilities

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Introduction

A subscription credit facility is a credit facility made to a private equity or other investment fund that is secured by the fund's rights with respect to uncalled capital commitments of the investors in the fund. The Employee Retirement Income Security Act of 1974, as amended (ERISA), imposes duties on fiduciaries holding benefit plan assets. This includes banks, funds and other entities that manage ERISA plan assets. This article explores ERISA issues that lenders should consider in subscription line transactions.

Overview of ERISA

ERISA is a federal law that was adopted in 1974 [P.L. 93-406, 93d Cong., 2d Sess. (1974), codified at 29 USC §§1101 *et seq*.]. The purpose of ERISA is to protect the interests of employee participants in employee benefit plans and their beneficiaries by mandating standards of conduct and responsibilities that apply to plan fiduciaries and other persons or entities that are responsible for managing and administering employee benefit plans. The protections provided to participants of employee benefit plans include standards of competence for the investment of plan assets and the operation of the plan, as well as rules to prevent parties who have some involvement with the plan from dealing with the plan to the detriment of the plan's participants.

Employee benefit plans are defined under ERISA to include "employee welfare benefit plans" (plans that provide for medical, disability, day care or similar benefit programs) and "employee pension benefit plans" (plans that provide retirement income). The employee benefit plans covered by ERISA ("Plans") are generally those maintained for the benefit of employees of a specific employer in the United States. ERISA does not apply to governmental plans, church plans, or plans maintained outside of the United States primarily for the benefit of non-resident aliens, although as a practical matter many government plans follow rules similar to those of ERISA.

As mentioned above, ERISA was passed to provide protections for employee benefit plans. These benefit plans exist because, in addition to cash compensation, employees often receive benefits from their employers such as pensions or retirement health benefits. In order to fund these benefits, employers set up accounts that are often managed by advisors. If there is a shortfall in funds, the company's retirees may not receive the benefits that they were expecting. The ERISA rules are intended to avoid these funds becoming unavailable due to any self-dealing or actions by the managers of these retirement funds that are not in the interests of the employees.

Concerns for subscription line lenders – Prohibited transactions

One of the significant concerns in subscription credit facilities is the application of ERISA's prohibited transaction rules. [ERISA Section 406; Section 4975 of the Internal Revenue Code of 1986, as amended.] Plans are often investors in private equity or real estate funds that are borrowers under subscription credit facilities. However, these ERISA prohibited transaction rules apply only to transactions between a Plan and a "party in interest" (such as a fiduciary or service provider) to the Plan. Therefore, the prohibited transactions rules are a concern only in situations where (1) either the borrower or an investor in the borrower is a Plan, and (2) a lender is a party in interest to such Plan. A lender that engages in a prohibited transaction is subject to penalties under ERISA and related sections of the Internal Revenue Code. Under the Internal Revenue Code the penalty could, in some instances, be equal to 100% of the loan amount. As a result, while there are limited situations in which ERISA issues will create a problem for a lender, the penalties can be onerous.

If it is clear that none of the lenders in a deal is a party in interest to any Plan investing in the borrower, and will not be a party in interest to any of the Plans investing in the borrower during the term of the loan, then the lenders do not need to worry about the subscription line credit facility being a prohibited transaction. However, most large banks have affiliates that routinely serve as fiduciaries or service providers to ERISA plans, and it is often difficult for banks to keep track internally as to whether the bank is a party in interest to a particular Plan. For this reason, and because the identity of all of the lenders and investors may not be known at the time a facility is entered into, the credit agreement is usually drafted with the assumption that the lenders are parties in interest to all Plans.

The two main circumstances in which ERISA considerations arise in subscription credit facility transactions are: (1) the making of the loan by the lender to the borrower; and (2) capital calls made by the lender directly to an investor that is a Plan following an event of default by the borrower.

Parties in interest and prohibited transactions

"Parties in interest" to a Plan generally include the following:

(i) fiduciaries (and their affiliates) to the Plan;

(ii) service providers to the Plan;

(iii) the employer sponsoring the Plan;

(iv) a union having members covered by the Plan;

(v) a direct or indirect owner of 50% or more of the interests of an entity described in (iii) or (iv);

(vi) any spouse, ancestor, lineal descendent, or spouse of a lineal descendant of an individual described in (i), (ii), (iii) or (v);

(vii) an entity, 50% or more of which is controlled, directly or indirectly, by an entity described in (i), (ii), (iii) (iv) or (v); and

(viii) a 10% or more shareholder or partner of any of (ii), (iii), (iv), (v) or (vii).

While the above is a relatively long list, a lender is most likely to fall under items (i) and (ii), fiduciaries and service providers. A service provider for a plan is not defined in ERISA beyond a person who provides services to a plan or an affiliate of such person. This category includes investment fiduciaries, record-keepers, and trustees.

In general, a fiduciary is any a person "with respect to a plan to the extent (i) he exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets, (ii) he renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so, or (iii) he has any discretionary authority or discretionary responsibility in the administration of such plan" [ERISA Section 3(21)(A)]. It should be noted that there are persons who are both service providers and fiduciaries, such as investment advisers, and there are service providers who are not fiduciaries, such as record-keepers, and other service providers who assist the plan in operating but whose duties are ministerial in nature and not discretionary.

In 2016, the U.S. Department of Labor issued regulations that greatly expanded the categories of advisers to a plan who could be considered fiduciaries. In general, the new regulations would not affect the subscription credit facilities discussed in this article. In addition, as of the date of this article, such regulations are at risk of being invalidated by Congress and the new administration.

ERISA's prohibited transaction rules prohibit a party in interest to a Plan from engaging directly or indirectly in the following transactions with such Plan [ERISA Section 406(a)]:

- the sale, exchange, or leasing of any property between the Plan and the party in interest, such as the sale of property by a Plan to a Plan's investment advisor;
- the lending of money or extending of credit by the Plan to the party in interest, such as a loan made by a Plan to a service provider;
- the furnishing of goods, services, or facilities by the Plan to the party in interest or by the party in interest to the Plan;
- any transfer to, or use by or for the benefit of, the party in interest, of any assets of the Plan, such as a payment to a service provider unrelated to its servicing of the Plan; and
- causing the Plan to acquire and to retain employer securities or employer real property that do not meet certain requirements or exceed 10% of the Plan assets.

These transactions are often referred to as "*per se*" prohibited transactions.

The prohibited transactions rules also prohibit a fiduciary from engaging in transactions where there is a risk that the fiduciary's judgment may be affected by its own interests or potentially adverse to the interests of the Plan or its beneficiaries. A party in interest that is a fiduciary to a Plan is prohibited from engaging in the following transactions [ERISA Section 406(b)]:

- dealing with Plan assets in its own interest;
- acting in a transaction involving the Plan on behalf of a person whose interests are adverse to the interests of the Plan; and
- receiving any consideration for the fiduciary's own personal account from any party dealing with the Plan in connection with a transaction involving the Plan's assets.

These transactions are often referred to as "self-dealing" prohibited transactions.

A fiduciary causing a Plan to enter into a prohibited transaction becomes liable under ERISA §409(a) to "undo" the transaction to the extent possible and make good any losses to the Plan resulting from such prohibited transaction (including reimbursement of any fee paid by the Plan). In addition, any party in interest (including a fiduciary) engaging in a prohibited transaction is subject to an initial excise tax under section 4975 of the Internal Revenue Code of 15% of the amount involved for each year (or part of a year) in the period beginning when the prohibited transaction occurs and ending when it is corrected, by either undoing the transaction to the extent possible or restoring the Plan's financial position. There is an additional excise tax of 100% of the amount involved if the transaction is not corrected within 90 days after the IRS mails a notice of deficiency to the taxpayer. The "amount involved" is defined as the "greater of the amount of money and the fair market value of the other property given or the amount of money and the fair market value of the other property received…"

In some circumstances, exemptive relief from the prohibited transaction rules is available. ERISA contains a number of statutory exemptions and authorises the U.S. Department of Labor ("DOL") (which enforces ERISA) to issue administrative exemptions on both a class and individual basis. Where a particular transaction satisfies the requirements for exemptive relief, the parties in interest are permitted to engage in the transaction without triggering penalties under ERISA or excise taxes under the Internal Revenue Code.

Is the borrower considered an ERISA plan or deemed to hold ERISA Plan assets?

As discussed above, the ERISA prohibited transactions rules apply to transactions between a Plan and a party in interest to that Plan. If a lender is a party in interest to a Plan at any time during the term of the loan, the lending of money by that lender to the Plan will constitute a prohibited transaction unless there is an available exemption.

Although subscription line credit facilities rarely are directly between a lender and a Plan, the borrower (typically a private equity fund) can itself be considered to be a "plan asset vehicle" and, in such a case, the prohibited transaction rules would apply. This is known as the "look-through rule". While the DOL plan asset rules provide for exceptions to the look-through rule, in general if 25% or more of any class of the borrower's securities are held by Plans, the borrower will be considered a plan asset vehicle. If the borrower is a plan asset vehicle, a loan to the borrower by the lender is considered, for the purposes of ERISA's prohibited transaction rules, to be an extension of credit directly from the lender to the Plan investors of the borrower. Assuming that a lender in the deal is a party in interest to one of the Plan investors in the borrower, unless there is an applicable exemption, the loan would be a prohibited transaction that would subject the lender to the excise taxes described above, as well as a duty to "undo" the transaction to the extent possible.

As a result of this concern, most subscription credit facilities will be drafted so that the borrower makes representations and covenants that the borrower is not a plan asset vehicle. There are various ways for a borrower having ERISA investors to enable itself to make these representations and covenants. The first is to limit the amount of ERISA investors in the borrower to less than 25% of all investors. Under ERISA's plan asset rules, the 25% threshold is applied separately to each class of equity securities issued by the borrower, and is calculated by disregarding the equity interests held by any managers of the funds or their affiliates (other than Plan investors).

In some cases, adhering to the 25% threshold is not a practical alternative for a borrower, either because monitoring the threshold will be difficult or impossible (for example, if interests in the borrower are freely transferrable), or because for business reasons the borrower does not want to restrict the amount of ERISA money that can be invested in the borrower. If that is the case, the borrower may try to fashion itself as a "venture capital operating company" (a "VCOC") or a "real estate operating company" (a "REOC"). An entity that qualifies as a VCOC or a REOC is not considered a plan asset vehicle even if its ERISA investors exceed the 25% threshold; provided that 100% of the interests in the borrower are not held by one Plan or a group of Plans sponsored by the same employer or controlled group members of the employer.

To qualify as a VCOC:

(i) on the first day in which the borrower makes any long-term investment (i.e. an investment that is not a short-term investment pending long-term commitment), at least 50% of its assets (other than short-term investments) must be invested in operating companies with respect to which the partnership has or obtains right to influence the management of the borrower (the "VCOC 50% Test"); and

(ii) at some time during that year the partnership must actually exercise these management rights (the "VCOC Management Rights Test").

In each subsequent year, at some time during the partnership's "annual valuation period" (which is a period of up to 90 days that is set during the borrower's first year) the VCOC 50% Test must be met, and at some time during that year it must meet the VCOC Management Rights Test.

The requirements for a REOC are similar to those of a VCOC, except that a VCOC's investments are in operating companies, whereas a REOC's are in real estate under management or development.

To qualify as a REOC:

(i) on the first day on which the borrower makes any long-term investment (i.e. an investment that is not a short-term investment pending long-term commitment), at least 50% of its assets must be invested in real estate that is managed or developed and with respect to which the partnership has the right to substantially participate directly in the management or development activities (the "REOC 50% Test"); and

(ii) at some time during that year it must actually be engaged directly in management or development activities of the real estate (the "REOC Management Rights Test").

In each subsequent year, at some time during the partnership's "annual valuation period" (which is the period of up to 90 days set during the borrower's first year) the REOC 50% test must be met, and at some time during that year it must meet the REOC Management Rights Test.

Another method of ensuring that the lender will not be engaging in a prohibited transaction is to qualify for an exemption from the prohibited transaction provisions. For the reasons discussed below, most subscription line facilities do not rely on these prohibited transaction exemptions. Typical exemptions for this purpose are the "QPAM exemption" and the "Service Provider exemption" of ERISA Section 408(b)(17).

The QPAM exemption generally requires the borrower to enter into the loan under the discretionary authority of a qualified professional asset manager (a "QPAM"), which must be a bank, savings and loan institution, insurance company or registered investment adviser with at least $85 million under management, and shareholders' or partners' equity of at least $1 million. In addition, none of the lenders can have the power to appoint or remove the QPAM or to negotiate the terms of the QPAM's management agreement with the borrower. Furthermore, the lenders cannot be related to the QPAM. Very generally, a lender is considered related to the QPAM if (i) the QPAM or a person controlling or controlled by the QPAM owns a 10% or more interest in such lender, or (ii) such lender or a person controlling or controlled by the lender owns a 10% or more interest in the QPAM. Because of the highly factual analysis that must be taken to ensure that the QPAM exemption applies, it is not generally useful in subscription facilities where there are often numerous lenders and Plans.

The Service Provider exemption applies only if the lenders are parties in interest to the investing Plans because they are service providers who are not fiduciaries who have authority over the decision of the Plans to invest in the borrower or over anything relating to the loan. There is also a requirement under this exemption that the Plans not receive any less than "adequate consideration" in the transaction as a whole. There currently are no regulations describing the meaning of "adequate consideration" or how it would apply to a loan between a Plan and a party in interest. Again, because of the highly factual determination this exemption would require, it is rarely relied upon in subscription lines.

Are capital calls by the lender prohibited transactions?

A typical feature of subscription credit facilities is the ability, in the event of the borrower's default, for the lender to directly call capital from the investors in the borrower in accordance with the terms of the relevant loan and security documents and the borrower's limited partnership agreement or equivalent agreement. One issue is whether a lender's capital call on an ERISA investor might be considered a "transaction" between the lender and the Plan that could trigger the prohibited transaction provisions of ERISA. Most practitioners have got comfortable concluding that a capital call made by a lender to an ERISA investor is not actually a transaction between the lender and the ERISA investor. They have reached this conclusion because the lender's right to call capital from investors is established in the borrower's agreement with the ERISA investor (typically the limited partnership agreement or equivalent agreement of the fund). The theory is that the lender is only stepping into the shoes of the borrower and exercising the borrower's right to call capital. When capital is called, the investor typically pays its capital to an account of the borrower over which the lender has a security interest (and not to a lender account). In order to ensure that the borrower and its counsel agree that calling capital does not cause a prohibited transaction, the borrower is routinely required to make a representation to that effect, and its counsel may be asked to render a written legal opinion to the lender to the same effect.

Note that the theory that there is no transaction between a lender and an ERISA investor when calling capital does not apply to any transaction that is a self-dealing prohibited transaction. A self-dealing prohibited transaction could occur if the lender or its affiliate is the fiduciary for the ERISA investor who has investment authority over the assets invested in the borrower. In such a case, the lender would be considered to be on "both sides" of the interaction between the lender and the ERISA investor and, as a result, a decision by the fiduciary to invest plan assets in the borrower, or to respond to a capital call that could benefit itself or its affiliate acting as the lender, could violate ERISA's prohibited transaction rules. This concern does not apply where neither the lender nor any of its affiliates has any involvement with the plan as a fiduciary or service provider, or where its involvement with the plan does not include authority over the assets of the ERISA investor invested in the borrower.

A possible alternative to obtaining the borrower's representation and its counsel's opinion is for the lender to obtain an exemption from the DOL that the ability of a lender to call capital on employee benefit plans is exempt and not a prohibited transaction. This exemption was first granted to Bank of America, as exemption PTCE 2004-2 (the "Exemption"). Because there were a number of banks who wanted similar exemptions, the DOL permitted banks to apply for the Exemption on an expedited basis, called the "ex-pro" application process. The process for obtaining this exemption on an ex-pro basis expired in 2014, and it is not clear whether the DOL would currently entertain granting a similar exemption, or how long it would take to obtain the exemption if the DOL were receptive to granting it.

Very generally, this exemption permits:

(i) a borrower to assign the capital commitments of investors, including ERISA investors as collateral for a loan;

(ii) the lender to call capital from investors, including ERISA investors following an event of default under the loan agreement; and

(iii) ERISA investors to acknowledge the right of the borrower to assign the borrower's right to capital contributions to the lender, and the right of the lender to call capital without the right of the borrower to claim any counterclaim, setoff, or defence.

The conditions for the exemption to apply are:

(i) the transaction is on terms no less favourable to the Plan than what the Plan would get in an arm's length transaction;

(ii) the decision-maker for the Plan is not the lender or an affiliate of the lender, and no such lender or affiliate has any investment authority for the Plan with respect to such investment;

(iii) the Plan (or group of related Plans) has assets of at least $100 million; and

(iv) not more than 5% of the Plan's (or group of related Plans) assets are invested in the fund.

As mentioned above, the ability to obtain the Exemption expired in 2014. Lenders who did not obtain the exemption before then do not have this exemption available to them. As a result, lenders without the Exemption generally rely on the borrower's representations and the written legal opinion of borrower's counsel.

Relevant credit agreement provisions

Credit agreements for subscription lines can cover ERISA issues in the following sections:

(i) Representations and warranties –

- Representation by the borrower that the assets of the borrower are not Plan assets.
  - While the borrower typically makes certain representations about its ERISA status, it is advisable for lenders to do their own diligence. Lender diligence for subscription credit facilities could include reviewing information about the investors in the borrower (not just the "included investors" that are analysed for credit purposes of the borrowing base).
- Representation by the borrower that, subject to certain assumptions about the lender, the transactions will not constitute a non-exempt prohibited transaction under ERISA that would subject the lender to any tax or penalties imposed under ERISA or Section 4975 of the Internal Revenue Code.

(ii) Affirmative covenants –

- Covenant by the borrower to notify the lender if the borrower has reason to believe that the borrower's assets constitute Plan assets of an ERISA investor.
- Compliance with law covenant should include a reference to ERISA.
- Covenant by the borrower that it will require all investors to make capital contributions to a particular account over which the lender will have a security interest.
  - A review of the borrower's limited partnership agreement or equivalent agreement is often part of lender diligence. One item to look for is a requirement in the limited partnership agreement that investors make their

capital contributions to a particular fund account specified in the drawdown notice. In the alternative, this could be addressed by a covenant by the borrower in the credit agreement (although this is less desirable).

(iii) Negative covenants – Subject to certain assumptions about the lender, the borrower will not take any action or omit to take any action in connection with the transaction that would give rise to a non-exempt prohibited transaction under ERISA or Section 4975 of the Internal Revenue Code that would subject any lender to any tax or penalty on prohibited transactions imposed under ERISA or Section 4975 of the Internal Revenue Code.

(iv) Events of default – Other than due to inaccuracy of the assumptions about the lender referred to above, an event of default if the transaction constitutes a non-exempt prohibited transaction under ERISA or Section 4975 of the Internal Revenue Code.

(v) Legal opinions – A lender sometimes requires that borrowers provide a legal opinion regarding the ERISA status of the borrower as a condition to making the loan. If the limited partnership agreement or equivalent agreement of the borrower requires the borrower to provide its investors with an ERISA opinion or certificate regarding ERISA status, the credit agreement may require the borrower to provide a copy of this opinion or certificate to the lender and allow the lender to rely on such opinion or certificate.

Borrower limited partnership agreements – ERISA items

As noted above, lender diligence for subscription credit facilities should include a review of the borrower's limited partnership agreement. Below are some ERISA-related provisions to look for:

(i) Collateral account – Requirement that investors make capital contributions to the account specified in the drawdown notice.

(ii) ERISA opinion or certificate – The partnership agreements of subscription line borrowers may have a requirement that the borrower provide its investors with an annual legal opinion or a certificate regarding the ERISA status of the borrower. ERISA investors often insist on this requirement in order to protect their Plan asset exceptions. Subscription line credit agreements may require the borrower to provide a copy of this opinion or certificate to the lender and allow the lender to rely on such opinion or certificate.

(iii) ERISA related authority of General Partner – Provision stating that the general partner of the fund will operate the fund such that its assets will not be deemed to be ERISA plan assets, and that the general partner has the power to take action to prevent its assets from being deemed plan assets.

(iv) ERISA related transfer restrictions – Restriction on transfer of interests by an investor if, in the judgment of the general partner, the transfer would cause the fund's assets to be Plan assets.

Conclusion

ERISA issues may not be at the top of the list of lenders' concerns when entering into a subscription credit facility. It is important, however, for lenders to understand how ERISA impacts on these financings, including to avoid the risk of severe penalties. Given the difficulty for many banks and other institutional lenders in determining whether or not they are a “party in interest” to a Plan investing in a borrower, lenders need to diligence whether the borrower is a plan asset vehicle, and that the financing is not a prohibited transaction. Lenders can additionally protect themselves through inclusion of representations, covenants and defaults in the credit agreement and through diligence of the borrower’s partnership agreement.

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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.

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 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 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.*

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

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 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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The use of net asset value facilities for portfolio acquisitions

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Background – NAV Facilities and the fund finance market

In recent years, secured credit facilities provided to 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 lately for newer funds with significant unfunded capital commitments, with the loans secured by the fund's right to call those capital commitments from its investors. Subscription Facilities are generally intended to serve a fund borrower's short-term capital needs by bridging the time between the time of the issuance of the call on investors and the time of performance. For many funds, Subscription Facilities are not a viable option, however, either because the fund's organisational documents do not permit such facility (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 a significant portion of such commitments.

In these cases, funds have sought to raise capital through a net asset value, or "asset backed" facility: a "<u>NAV Facility</u>". NAV Facilities are credit facilities backed by the assets included in the fund's investment portfolio. In the case of a "fund-of-funds", the principal focus of this article, such assets will typically be limited partnership and other equity interests in (mature) hedge funds and private equity funds, often purchased by the fund-of-funds borrower in the secondary market. Availability under a NAV Facility is subject to a "borrowing base" 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 the NAV Facility to the then applicable borrowing base (the "<u>LTV Ratio</u>") exceeds a specified threshold (usually in the 30–60% range), the NAV Facility will require the borrower to make a mandatory prepayment to bring the facility into compliance with that maximum LTV Ratio.

NAV Facilities have often been used by funds to effect "dividend recaps" by paying investors a distribution with loan proceeds during the mid to later stages of the fund's term (in advance of a full runoff of the underlying portfolio). In this article, however, we focus on issues that may arise from the increasing use of NAV Facilities to finance (or refinance) the acquisition of portfolio investments, including the use of separate subsidiaries to effect such acquisitions.

Structure and collateral

In a typical NAV Facility, the fund establishes two special purpose vehicles ("SPVs"). The first SPV, the borrower (the "Borrower"), is created by the fund for the sole purpose of obtaining the financing under the NAV Facility and holding the equity interests of the second SPV ("Holdco"), which directly owns the portfolio investments included in the borrowing base. The Borrower generally provides an "all assets" pledge to the NAV Facility lender to secure its repayment obligations, including a pledge of 100% of the equity interests of Holdco (the "Equity Interest Collateral"). If the Borrower is a limited partnership, lenders will require that the general partner of the Borrower (the "General Partner") also provide a pledge of its general partner interests in the Borrower (the "GP Interest"). Holdco most typically guarantees the Borrower's obligations under the NAV Facility and secures such guarantee with a pledge of its deposit and securities accounts into which distributions on and proceeds of the portfolio investments are paid.[1]

This SPV structure, especially the pledge by the Borrower of the Equity Interest Collateral and, if applicable, the pledge by the General Partner of its 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 right to manage the wind-down of the underlying portfolio investments. To ensure the perfection of the collateral granted by the Borrower and Holdco, UCC financing statements are filed against the Borrower and Holdco, and any such deposit or securities accounts are required to be subject to account control agreements in favour of the lender.

NAV Facilities and acquisition financings

Purchase and sale agreements

The acquisition of hedge fund and private equity fund interests in the secondary market is generally documented pursuant to a purchase and sale agreement ("PSA") between the buyer and seller of the applicable interests (the "Fund Interests"). The PSA will contain the purchase price for each Fund Interest as well as the various conditions precedent to the transfer, or closing, of such Fund Interest. One fundamental condition to each such closing is that the general partner, managing member or other applicable entity controlling the Fund Interest consent to such transfer (the "GP Consent"), as required by the organisational documents of the Fund Interest being acquired. Typically, once an agreement to sell a portfolio of Fund Interests has been reached, the seller (or, in certain cases, the buyer) will approach the general partner, managing member or other applicable entity controlling each Fund Interest to obtain the GP Consent with respect to such Fund Interest. Depending on the number of Fund Interests being purchased under a single PSA – and the number of general partners, managing members or other applicable entities controlling such Fund Interests – a PSA may provide for several closings, with the first closing occurring at the end of the quarter during which the PSA is executed, at which time GP Consents with respect to a material portion of the Fund Interests have been obtained.

Issues to consider in NAV Credit Facilities

As noted above, NAV Facilities are increasingly being used by funds to finance the acquisition of underlying hedge fund and private equity fund investments in connection with the closing of a PSA. Several issues may arise in this context that are important to consider. First, a fundamental condition precedent to funding under a NAV Facility is provision by the Borrower of satisfactory evidence of ownership of the portfolio investments to be included in the borrowing base and LTV Ratio calculations. In the case of a NAV Facility utilised to made a "dividend recap", such evidence often takes the form of an accountants' certification as to the fund's (or, more precisely, Holdco's) ownership of such investments in connection with the most recent audited/reviewed financial statements of the fund.

In the acquisition context, by contrast, even assuming that all conditions to the closing have been satisfied, such statements will generally not be available as of the closing date. In addition, given the nature of the underlying interests in the NAV Facility, such evidence is significantly more difficult to obtain than for other types of acquisition financings, where the purchase of an asset may be evidenced by a stock or merger certificate (in the case of the purchase of, or merger with, another company) or the crediting of (listed) equity or debt interests to the Borrower's brokerage accounts (in the case of a margin or similar loan). To address this concern, recent NAV Facilities have required that as a condition precedent to funding, the fund's counsel (or its trustee) certify to the lender that all conditions to the PSA have been satisfied and all such underlying portfolio investments have, in fact, been acquired by the fund.

A second, related issue that arises in this context results from the fact that, as mentioned above, the formal transfer of legal title to the buyer of Fund Interests will almost certainly be subject to applicable GP Consents. Unless obtained in advance, there are no guarantees that such consent will be provided; even if provided, a GP Consent often will not be granted until after the purchase price is required to be paid by the buyer under the PSA.[2] However, if the purchase price under the PSA is being financed (in whole or in part) by a NAV Facility and the funding under such facility is subject to the purchase of such investment (which purchase is, in turn, subject to GP Consent), what results is a "chicken and egg" problem whereby the fund will be unable to consummate the PSA until the financing is provided under the NAV Facility, but absent consummation of the PSA and transfer of the underlying Fund Interests to the buyer, the lender will not be willing to provide such financing.

Possible solutions

There are a few potential solutions to this problem. Most conservatively, a lender may exclude from the borrowing base any portfolio investments the transfer of which remains subject to GP Consent. Once GP Consent is obtained with respect to such investment, the Borrower would be permitted to access the remaining financing under the NAV Facility on a delayed draw basis. One problem with this solution is that the PSA almost always requires that the entire purchase price attributable to a Fund Interest be provided upfront at the closing of such Fund Interest. As such, depending on the maximum LTV Ratio under the NAV Facility and its other available sources of capital, a Borrower may not have sufficient funds available to pay the full purchase price if investments subject to outstanding GP Consent are excluded at the outset.

A more tailored solution, most effective where GP Consents with respect to all investments are expected soon after the closing date, is to include as a condition precedent to the funding of the NAV Facility a certification from the Borrower's counsel that all conditions precedent to the closing of the PSA have occurred, other than the payment of the purchase price and release of executed GP Consents. Once the purchase price has been paid (with the proceeds of the NAV Facility) and the GP Consents are released, the lender may require an additional certification from such counsel that formal transfer of the underlying investments to Holdco has occurred. Under this structure, in the event that the GP Consents are not provided within a specified time period (e.g., three business days after funding), the lender may require the Borrower to prepay the outstanding loans in amount sufficient to reduce the LTV Ratio to a maximum specified rate.

Holdco subsidiaries

For various legal, regulatory, tax and accounting reasons, it may be required or beneficial to a fund to purchase and hold one or more Fund Interests through subsidiaries domiciled in jurisdictions other than that of Holdco ("Holdco Subsidiaries"). Given that any debt of Holdco Subsidiaries would be structurally senior to the debt of Holdco and the Borrower, prior to including any investments held by Holdco Subsidiaries in the borrowing base and LTV Ratio calculation, it is critical to ensure that the lender maintains its secured creditor rights with respect to such investments. As described above, the key rationale for the two-SPV structure of NAV Facilities is for lenders to be in a position to control the wind-down of the underlying portfolio investments following a default under the facility. Absent additional structuring, however, a subsidiary of Holdco would fall outside of the Equity Interest Collateral, negating the desired control. To address this gap, and to avoid being structurally subordinated to the holders of any Holdco Subsidiary debt, certain lenders have permitted the formation of Holdco Subsidiaries to hold portfolio investments included in the borrowing base, subject to such subsidiary providing a guarantee of the borrower's obligations under the NAV Facility (secured by a pledge of its deposit and securities accounts), and to Holdco pledging the equity interests of such subsidiary.[3] Taken together, and assuming UCC financing statements are filed against both the Borrower and Holdco and account control agreements with respect to the accounts of the Holdco Subsidiaries are entered into, lenders are put in the identical position they would have been had such portfolio investment been held by Holdco, rather than its subsidiary.

Conclusion

As the frequency and size of sales of Fund Interest portfolios in the secondary market continues to rise, we expect to see a concurrent increase in the use of NAV Facilities as a means of funds obtaining capital to finance the purchase of such portfolios. To ensure that lenders retain the customary protections around the borrower's ownership of the underlying Fund Interests, we expect to see further developments in the conditions evidencing that the individual Fund Interests have been validly purchased, and in the scope of entities permitted to own such interests.

* * *

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 the 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, in certain transactions, the General Partner agrees to automatically release the GP Consent upon payment of the purchase price for the Fund Interests. This article addresses those cases in which the GP Consent to the transfer of the Fund Interests is not automatically released with respect to all, or part, of those Fund Interests.

3. We note that there may be instances in which Holdco cannot pledge the equity interest of certain Holdco Subsidiaries. In such cases, lenders have been able to get comfortable without a pledge of the equity interest of the Holdco Subsidiaries on the basis that the lenders can still control the wind-down of the underlying portfolio investments, albeit indirectly, via their Equity Interest Collateral and, if applicable, the General Partner's pledge of its GP Interests in the Borrower.

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The internationalisation of the subscription facility market

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Introduction

The market for subscription facilities (particularly in the UK and Europe) has experienced a period of "internationalisation" over the last few years, driven in part by the increased number of European funds in the market, the increased proliferation of international investors in those funds, and an increase in the number of lenders (including US lenders) wanting to establish themselves in the UK subscription facility market. This has been compounded by the significant shift away from large bilateral facilities to a more common club of three-to-six banks, driven by a combination of reduced balance sheets from the previously dominant lenders and the wish of finance directors to have a wider pool of bank relationships.

This chapter will initially look at the historical origins and defining features of subscription facilities in the UK and the US markets, then consider the factors that have led to this period of internationalisation, and the impact of this internationalisation in the UK and Europe. We will conclude by touching on some of the recent trends seen in respect of limited partnership agreement terms and investor requirements in the fund documents, and how these trends might impact on lender considerations.

UK market

The UK market for subscription facilities originally developed as a result of UK lenders identifying opportunities to make facilities available to funds at the fund level in order to support existing (and related new) funds with which the UK lenders had existing broader fund/sponsor relationships in the leveraged/acquisition facility market. Consequently, UK subscription facilities have historically been "relationship" lending, with the credit assessment undertaken by UK lenders placing emphasis on the success/track record of the fund/broader sponsor group itself, rather than the creditworthiness of the investors in the fund(s) which are borrowers/guarantors under the subscription facilities. This "relationship" approach to UK subscription facilities is evident in certain of the "UK specific" features/terms of the subscription agreement, including the type of financial covenants which have historically applied to the UK subscription facilities, the security packages and the negotiations around the timing for delivery of security notices to investors (particularly where the fund is an English limited partnership).

US market

In comparison to UK subscription facilities, US subscription facilities originated with a greater focus on the credit of the underlying investors. This has necessarily meant that the terms of US subscription facilities contain more restrictive controls around the credit quality of the investors in the fund, including imposing a borrower base restriction, which may apply advance rates to investor commitments, reflecting the bank's credit assessment on the likelihood of individual investors or a class of investors defaulting on their obligation to advance commitments to the fund. This focus on the investors rather than the fund has also led to investors sometimes being required to provide letters in favour of the lender, acknowledging and consenting to the security granted in connection with the US subscription facility and providing certain undertakings in favour of the US lenders.

UK and US subscription facilities – common defining features/characteristics

Subscription facilities in the UK and US markets typically take the form of a revolving credit facility which the fund can utilise by way of cash loans, or by requesting the issuance of letters of credit. Historically, subscription facilities were provided to funds predominantly as "bridging" facilities, to allow funds to make acquisitions efficiently and quickly (without the need to draw down funds from investors) and to smooth over the frequency of capital calls made on investors in a fund. As a result, the tenor of these facilities was typically for a period of no more than 364 days – subject in some cases, to an extension option for a further 364 days. (It's worth noting that this was also driven by the historic 300 rating for 364-day facilities which, of course, no longer applies but used to have significant priority benefits). More recently, the appetite of funds to use subscription facilities for a wide range of purposes, including general working capital purposes and to fund the costs and expenses of the fund, and as a tool to increase the internal rate of return (IRR) of the fund, has seen the tenor of the subscription facilities increase to two or three years, with clean-down mechanics included in the subscription facility terms where the limited partnership agreement (the "**LPA**") of a funds specifies a requirement for short-term borrowings.

The key characteristic and focus for subscription facilities in both the UK and US markets are the uncalled commitments of the investors in the fund which the facility is being made available to (or, in the case where there are multiple borrowers and/or guarantors under a facility, the investors in those borrowers and/or guarantors). These uncalled commitments are both key from the perspective of controlling the leverage of the fund and from a security/collateral perspective.

Both UK and US lenders will exercise control of the uncalled commitments of the investors in a fund (which will be counted for financial covenant purposes (including any borrowing base restrictions)) as follows:

(a) A lender will assess the investor pool of a fund and notify the fund, at the time of entering into the facility agreement (or, in the case of any new investors coming into the fund, at the time the new investors have been notified to the lenders), which of the investors (the "**Included Investors**") the lender is happy to count towards financial covenant calculations (including any borrowing base restrictions).

(b) The lender will then seek to exclude an Included Investor from financial covenant calculations where certain events occur in respect of that Included Investor, for example: where there is a material adverse effect on that Included Investor's ability to comply with a drawdown notice issued by the fund; where that Included Investor is excused from its obligations to comply with a drawdown notice; or where an insolvency event has occurred in respect of that Included Investor.

(c) Lenders may want to apply "haircuts" to the uncalled commitments of an investor (or a group of investors) so as to ensure that there is not an overconcentration of credit risk placed on that one investor, or group of investors.

The amount of the uncalled commitments of Included Investors will then be used to limit the amount of drawings that may be made under a Subscription Facility and the leverage of the fund generally, through the operation of the coverage ratio and/or the borrowing base restrictions.

Subject to any jurisdiction-specific requirements in relation to the creation and perfection of security, the typical security package for UK Subscription Facilities and US Subscription Facilities has been largely aligned, with lenders requiring:

(a) security over the rights of the general partner (or the person(s) having the right to issue those drawdown notices under the LPA) under the LPA to oblige the investors in a partnership to advance commitments to the partnership and to issue drawdown notices to investors in that partnership ("**Capital Call Security**"); and

(b) a charge over the bank account of the partnership into which the commitments of investors are deposited, which typically operates as a floating charge until the occurrence of an event of default which is continuing (or if the trigger is negotiated, until the bank has taken steps to accelerate the facility).

In the UK market, it has also been commonplace for lenders to require that a security power of attorney is granted by the partnership and/or general partner to the lender, which enables the lender, post an agreed trigger, to issue drawdown notices to investors. This is particularly so where the fund is an English limited partnership, as legislation[1] provides that an appropriately drafted security power of attorney will survive the insolvency of the grantor. Where a fund is established in other jurisdictions, whether or not there is value in obtaining a separate power of attorney (in addition to the security over capital call rights and the bank account) will depend on a lender's particular requirements and whether the laws of that jurisdiction provide for the granting of irrevocable powers of attorney and powers of attorney that survive the insolvency of a grantor. In some cases, UK lenders, particularly those with historically strong "relationship" lending approaches, get comfortable lending to funds on the basis of a security power of attorney only, and do not require additional security in connection with a fund.

In some cases, where limited partnership agreements do not permit the grant of security over the right to call down commitments from investors or partnerships to negotiate successfully against providing security, predominantly due to a strong relationship between the UK lender and the fund, UK lenders have historically been known to accept a security power of attorney as the sole "collateral" support for a UK subscription facility; given the change to club groups, this is becoming less common.

UK and US – specific defining features

While the immediate preceding section sets out the common defining features of UK and US subscription facilities, historically there have been several features that have been unique to either US or UK subscription facilities. It is in particularly in respect of these defining features that the UK subscription facility market is now seeing a convergence of the US- and UK-specific terms.

UK subscription facilities – coverage ratio

UK subscription facilities have traditionally applied a coverage ratio to control the availability of the facility and the overall leverage of the fund. The coverage ratio measures the uncalled commitments of the Included Investors in the fund against the aggregate financial indebtedness of the fund (including drawings under the facility), requiring at least a 1:1 ratio or, more likely, a minimum 1.2:1 ratio. It is uncommon in UK facilities for UK lenders to apply an advance rate to the uncalled commitments of an Included Investor, meaning that save any concentration limits (or an Included Investor becoming an excluded investor) the full amount of an Included Investor's uncalled commitments will be counted for the purpose of calculating the coverage ratio, which is consistent with a UK subscription facility's origin as a "relationship lend" rather than a credit lend against the underlying investors in the fund themselves.

US subscription facilities – borrowing base mechanism

In contrast to the UK facilities, US lenders typically limit the amount that may be drawn by a fund under a facility by reference to a borrowing base calculation. The borrowing base calculation is similar to the coverage ratio approach, however the borrowing base approach reduces the amount of an Included Investor's uncalled commitments which can be counted towards the borrowing base calculation by applying an advance rate to Included Investors. The advance rates, which are specified as percentages, are determined by the lenders based on their internal credit policies and risk assessment and are generally applied to groups of investors, grouped by reference to either a common rating level or a common investor type (e.g. a pension fund or an insurance/reinsurance company). Borrowing bases operate to reduce the available facility (i.e. amount that remains available for a borrower to draw) and to require a partial prepayment of drawings under a subscription facility if, at any time, the amount of drawings under the facility (or if calculated based on overall financial indebtedness of the fund, the total indebtedness of the fund) has resulted in a breach of the borrowing base. The inclusion of borrowing base restrictions, and the application of advance rates, reflects the emphasis that US lenders place on the creditworthiness of the underlying investors in the fund.

UK subscription facilities – perfection of English law Capital Call Security

In the UK, the creation of English law security over the rights of the general partner (or the person who has authority to issue drawdown notices to investors under the LPA) under an English law-governed LPA occurs at the time the security document is entered into, unlike in jurisdictions such as Guernsey, where the giving of notice to an investor of the grant by the general partner over its interest to deliver drawdown notices and enforce capital calls, creates the security interest. This means that the delivery of notices of security to investors in an English law limited partnership is solely a perfection step, intended to establish priority of the lender's interest over those of another secured creditor.

As a consequence, the timing for delivery of notices of security to investors under capital call security has historically been negotiated quite heavily between the UK lenders and the fund. In many cases, funds have expressed reluctance (both from a relationship perspective and administrative perspective) to notify investors of the capital call security until the occurrence of an event of default. Lenders have agreed as a commercial matter (largely reflective of the "relationship" basis on which the UK lender has agreed to advance the facility) a number of variations on the requirement to deliver notice of the capital call security to investors, including an obligation to only notify investors of the security upon the occurrence of an event of default or, in some cases, agreeing on interim measures being put in place, such as investors being notified of the grant of security by way of a notice published in the periodic reports prepared and sent to investors, with notice of capital call security to then be delivered to each investor in that fund within a certain period of time.

In other jurisdictions, the requirement to deliver notices to investors will, of course, be determined by any specific local law requirements in relation to the creation and/or perfection of security.

<u>US subscription facilities – Investor letters</u>

Under US subscription facilities, US lenders have traditionally required the delivery of investor letters, pursuant to which the investor will typically (among other things) acknowledge to the lender that they have entered into a subscription agreement, confirm the amount of that investor's commitment in the fund, consent to the grant of security in favour of the lender, give representations and warranties to the lender as to the enforceability of the fund documents against that investor, and undertake to the lender to make payments of uncalled commitments when requested in a drawdown notice issued by the lender post-occurrence of an Event of Default (or the commercially agreed trigger).

The requirement to deliver investor letters to US lenders is particularly commonplace (and is usually a condition to an investor being considered an included investor) where the underlying limited partnership agreement does not contain a broad right to grant security, or the lenders feel that the power to grant security is not as robust as required.

In the UK, lenders have historically tended not to require that investor letters be provided and certainly one of the recent trends with the increased sophistication of investors has been for side letters to include express confirmations from general partners that the investor will not be required to deliver any documents to, or be party to any notices or letters which are addressed to the lender, or to which a lender is also party. In addition, where a limited partnership agreement contains powers to borrow and/or grant security that were not considered sufficiently broad or robust by the lender, the common approach has been to require the fund to amend the limited partnership agreement (where possible), rather than seek express consent from each investor with respect to right to borrow and/or grant security under, or in connection with, the facility.

The recent move in the market towards a hybrid US/UK style subscription facility has seen some lenders introduce investor letter requirements in UK subscription facilities, particularly where the investor pool of the fund comprises only one, or a limited number of investors.

Increased internationalisation of lender base

The subscription facility space has seen a marked increase in the number of lenders wanting to provide subscription facilities to UK and European funds. Whereas traditionally, the UK banks maintained and grew their subscription facility loan books through existing relationships with funds and the broader sponsor group, the increased number of new lenders in the market (encouraged by what is largely seen by lenders as a low-risk lending arrangement, given the low (or non-existent) default record of such facilities)), and the move by US lenders into the UK subscription facility market, have led to lower pricing and an identifiable trend towards terms for UK subscription facilities converging with some of the US subscription facility-style terms.

The aftermath of the financial crisis, which saw a large number of rating downgrades of domestic UK and European banks, resulted in a demand for appropriately rated banks to participate in 'UK subscription facilities', in order that letters of credit issued under those facilities could be issued by lenders with credit ratings that would satisfy the requirements of beneficiaries under the investments being made by the funds. This requirement provided new opportunities for Australian and Canadian banks which were not previously so visible in their sector, and particularly for Infrastructure Funds. The rating downgrades saw many funds bringing new, appropriately rated, banks into existing facilities to provide the local currency component of the facility (and, in some cases, saw existing UK lenders being replaced entirely in existing facilities or new facilities), thereby causing the market for UK domestic lenders to contract.

In addition to increased participation by US lenders and Australian lenders in UK subscription facilities, a number of Nordic banks have entered, or increased their participation in this market, increasing the internationalisation of the subscription facility market and various requirements of lenders that must be considered when negotiating subscription facilities.

Changes to LPA structures and fund documents

There have been a number of trends in limited partnership agreement (LPA) provisions and changes to fund structures over recent years which raise additional considerations for lenders:

Funding of defaulting investor shortfalls

As the number of funds in the market has increased and the level of investor sophistication has increased, it has now become commonplace for LPAs in respect of larger funds to limit the additional amount that a non-defaulting investor will be required to advance in the event that another investor, which received a drawdown notice, defaults in its payment of those amounts to the partnerships. Whilst historically, the provisions of an LPA would more often than not oblige a non-defaulting investor to advance the full amount of its *pro rata* share of any shortfall arising from a failure of another investor (or other investors) to advance amounts pursuant to a drawdown notice (and continue to oblige the investor to do so until the shortfall had been met in full), funds have realised that investors do not want their commitment used to basically make up for another investor's failure to pay, and LPAs now seek to limit this right to an amount not exceeding a certain percentage of the amount that the relevant investor was originally required to advance under the initial drawdown notice for that capital call (whilst percentages vary, these tend to be around 150% of the original amount called).

The impact on lenders of this limitation in relation to shortfalls, is that if an LPA does limit the amount which can be recovered from a non-defaulting investor in this way, the covenants (and the assumptions used in the lender's financial model in respect of recovery/recourse under the facility and security) should be set at a level that takes this limitation into account.

UBTI: structural versus contractual solutions

A trend under LPAs, which is helpful to both funds and the structuring of facilities, is that the market is moving towards dealing with unrelated business tax income (or UBTI as it is otherwise known) by way of a structural solution, rather than the contractual solution which has been used historically. (UBTI is tax levied on the income derived from unrelated business activities of an otherwise tax-exempt entity.)

The historical contractual solution to address UBTI issues for tax-exempt US investors in a fund was to impose a reasonable endeavours obligation (a "UBTI Obligation") on the general partner (or manager, if responsible for operating the fund) to avoid the fund realising income that would constitute "unrelated business taxable income" for US tax-exempt investors, but provide a specific carve-out that provided that the entry into a subscription facility would not constitute a breach of that UBTI Obligation. The limitation of this contractual approach was: (1) the subscription facilities which the partnership would enter into would normally be restricted such that borrowing under that facility could be for no longer than three months (in order to avoid any UBTI issues that might arise as a result of longer-term financing), which limited the ability of the general partner to smooth over drawdowns from investors; and (2) lenders were understandably concerned that, in the absence of an opinion from the fund's US counsel confirming that the entry into the subscription facility (and any drawings made thereunder) would not result in a breach of the UBTI Obligation (which were in practice difficult to obtain), in the event there was a breach of the UBTI Obligation as a result of the entry into the subscription facility (or drawing thereunder), that any UBTI investors would no longer be obliged to fund amounts requested under drawdown notices issued for the purpose of repaying drawings under the subscription facility.

The practical effect of the lenders' concerns regarding a breach of an UBTI Obligation was that if subscription facilities were made available to a fund which was subject to an UBTI Obligation, these were made available by way of a structure which typically involved lending to a SPV, usually of the partnership, pursuant to a facility agreement which sat alongside a put option agreement that obliged the SPV to either put any loans that it had made to investee companies of the partnership, or the investments which it had acquired, to the partnership for market value, thereby enabling the SPV to repay amounts owing to the lenders under the facility agreement from the proceeds it received from the partnership under the put options.

The structural solution which is now becoming more common in the market is for US tax-exempt investors to invest in a fund through a "blocker" partnership for US tax purposes (either by way of a feeder fund into the main fund, or in a co-investment vehicle).

This structural solution means that the question of whether a partnership enters into a subscription facility becomes a commercial decision for the general partner (and the investors in the fund) rather than a technical decision and, if a subscription facility is entered into by the fund, it can be provided in a standard form (with the typical security package) without the need to structure the lending to involve a put option.

To the extent that any UBTI investors do invest in the main partnership through a feeder fund lenders should, of course, still seek to take security over uncalled capital commitments from the UBTI investors in the blocker fund and account security over the blocker fund's collateral account, to ensure that they have direct access to enforce rights over the UBTI investors in case there is an event of default under the subscription facility.

<u>Side letters</u>

It is now commonplace in side letters for investors to require that the general partner expressly acknowledge and confirm that the investor will not be required to provide information or require that any acknowledgements or other documents be signed by the investor in respect of fund financings such as subscription facilities (although this would not typically preclude a general partner from delivering a notice of assignment under security, just requiring that this will be signed). This restriction should be noted by lenders and express consent from investors provided where documents are required directly by lenders (such as investor letters on US-style facilities) and if there are any specific security requirements for investor acknowledging security over uncalled commitments. It's worth noting that any administrative restrictions may also have practical implications regarding the use of Powers of Attorney.

In addition, a number of investors (including US pension funds, US investors and sovereign wealth funds) are negotiating specific withdrawal rights, or the right to cease to fund amounts requested under drawdown notices, upon the occurrence of certain events that either cause issues from a reputational perspective or breach specific provisions in the constitutional documents of the investor. Examples of such events include US pension funds wishing to have the right to withdraw (or cease to be obliged to fund amounts requested pursuant to drawdown notices) where a fund manager uses a placement agent (this requirement having arisen due to entities holding themselves out as "placement agents", having promised fund managers access to the board of a US pension fund upon payment of a fee) and a withdrawal right, seen around 18 months ago, required by US investors, which allowed the US investors to withdraw from the fund if the fund manager managed the fund in a way which breached the Regulations of the Office of Foreign Assets Control (OFAC), and as a result the investor was also taken to have breached OFAC Regulations.

Whilst the side letter confirmations described above, and the right for investors to withdraw from funds, are not new concepts, the ever-changing nature of the market and investor requirements, highlights (and re-affirms) the importance of lenders undertaking due diligence on the side letters of any investors that are to be counted in the coverage covenant or the borrowing base calculations, to understand if, and how, those terms might adversely impact the rights of the lenders under the subscription facilities and security documents.

<u>Fund termination rights</u>

It is now becoming commonplace for limited partnership agreements to include a "no fault" termination right, which allows investors to terminate a partnership by way of an investor special consent, typically from a date falling a couple of years after the anniversary of the final closing date for the fund. Whilst this change should not impact adversely on lenders, as we would expect that all subscription facilities would contain an event of default that is triggered if the partnership is terminated, it does highlight the increasing level of sophistication of investors, and the influence that investors are having on the terms of LPAs.

In conjunction with the right of the investors to terminate a fund on a "no-fault" basis, it is now becoming commonplace under LPAs for investors, if they would have otherwise been entitled to terminate the fund on a "no-fault" (or a "fault basis"), to have the right to:

(i) remove and replace the general partner with a substitute general partner;

(ii) replace any management agreement or investment advisory agreement (and the manager or investment adviser); and

(iii) for the partnership to continue on the terms specified [in that clause of] the LPA.

The rights referred to in the paragraph above, highlight the importance of ensuring that you are cognisant of these rights when negotiating any carve-out on the restrictions to changes to the general partners or managers, to ensure that any agreement to carve out a replacement of a manager or general partner in accordance with the limited partnership agreements is further qualified so that the replacement general partner or manager is an affiliate of the original general partner or manager (or fund group) so as to ensure that the bank does not find itself in a scenario where it is lending to a fund that is no longer operated by, or managed by, entities which are affiliates of the original sponsors.

Sovereign wealth funds

The increase of sovereign wealth funds ("**SWFs**") has raised new challenges and issues for lenders and for funds wanting to put in place subscription facilities, with lenders and funds having to navigate the requirements of sovereign wealth funds and the implications of these requirements (including sovereign immunity) on the credit analysis and terms of the subscription facilities.

A number of lenders in the UK market have accepted the risk of sovereign immunity on the basis of their credit assessment of the government establishing the sovereign wealth fund, and are comfortable making subscription facilities available to funds with SWFs as the sole investor (or investors) in that fund or where there are multiple investors in a fund, to count SWFs as Included Investors for covenant purposes.

The confidentiality requirements of some SWFs mean, however, that side letters between the fund and those SWFs now contain strict confidentiality provisions that restrict the general partner/fund from disclosing the identity of the SWF investor (or if the investor is an SPV of a SWF, the underlying SWF). This raises additional issues for lenders and funds, as the inability of a fund to disclose the identity of a SWF impacts on the ability of lenders to deliver notices of Capital Call Security and enforce rights under the Capital Call Security. Where SWFs are the sole investors in a fund, this confidentiality will mean that a lender is unable to undertake its credit assessment on the SWF – which, of course, becomes a key aspect of a lender's assessment of a facility when there is only one investor in fund, as in those circumstances, the lend essentially becomes a credit lend against the SWF, rather than the fund itself.

Conclusion

The subscription facility market, particularly in the UK and Europe, has experienced a period of internationalisation in the last few years due to an increase in European funds, and US lenders and other non-UK lenders entering the market. This internationalisation has resulted in a number of the terms of UK subscription facility agreements converging, with requirements/features which were historically only seen in the US subscription facility market. As the number of lenders entering the market and the number of funds continue to increase, we think it likely that there will be continued convergence of US and UK terms, and changes to investor bases (including Single Investor's Structures) and investor requirements in the LPA and related fund documents will continue to raise additional issues for consideration by lenders.

* * *

Endnotes

1. Section 4 of the Powers of Attorney Act 1971.

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Fund finance: an ‘offshore’ perspective

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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 (**GPs**) 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 were just under 18,000 exempted limited partnerships registered in the Cayman Islands at the end of 2015, almost 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 in 2016 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?

<u>Fund perspective</u>

It is a truism that market participants would 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 GP's perspective, probably the most important consideration is fundraising. It is crucial that the GP is able to present a fund to market which is established in a jurisdiction which works for, and is familiar to, the target investor audience. This is 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. In contrast, the English Limited Partnership Act was enacted in 1907 and, it is fair to say, was not drafted with the private equity market in mind.

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.

Lender perspective

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, impacts 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.

Mourant Ozannes' 2016 Private Equity Survey

The views expressed above are based solely on our experience in the market as offshore counsel. However, we are acutely aware that this may not tell the whole story. Accordingly, with a view to critically and objectively assessing what benefits both GPs and LPs see in utilising offshore structures (and also to gauge the opportunities, challenges and threats facing our private equity clients in a rapidly changing world), we conducted a survey of leading market participants.

For the 2016 survey, we commissioned independent researchers to interview 200 GPs[1] and 60 institutional LPs spread equally across Asia, Europe, North America and the rest of the world. The results were extremely interesting from an industry perspective.

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 is 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; the mature dispute resolution environment; and cost.

Leaving aside fund raising, 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.

How does this impact fund finance?

The 2016 survey results were interesting from a fund financing perspective for a number of reasons.

First, 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 fund-raising 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 predict that LPs will expect this as they look to their GPs to find and execute the best deals.

Finally, and related to this, we anticipate that the use of net asset value (**NAV**) facilities will 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 on 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 one of the offshore jurisdictions. 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.

Fund documentation and due diligence

Given that the primary focus of local counsel is on the borrower entity formed in the 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 the GP can exercise default remedies; or granting 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 concern themselves primarily with aspects of the documentation which may be impacted by local law.

As discussed above, most offshore jurisdictions are sensitive to the demands of their principal user bases, 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 upon default. Ultimately, this will be determined by the relative negotiating 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 practical matter, 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, 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, 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 fund raising 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 2016 Mourant Ozannes 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 next 12 months.

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 transactions over the last 12 months. These have tended to be fairly 'plain vanilla' subscription lines, although we have seen a variety of terms and 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.

Broadly, the lenders we have seen in Asia can be split into three categories:

- Firstly, US banks who are actively seeking subscription line opportunities in the Asian market.
- Secondly, UK and European banks offering such facilities from time to time to key relationship clients.
- Finally, Chinese and other Asian banks, who are newer entrants to the market and eager to compete by offering cheap lending with low 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.

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 fund-raising environment in Europe has been dominated by the introduction of the Alternative Investment Fund Managers Directive (AIFMD). Almost all of the GPs surveyed in the 2016 Mourant Ozannes survey confirmed that they have found it more challenging to raise funds from investors based in the European Union since the introduction of the 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, the 2016 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 anticipated 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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Asia overview: a dynamic and diverse market

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Introduction

Composed of 48 countries recognised by the United Nations and a handful of other countries and autonomous territories, covering about 30% of the earth's total land area and home to approximately 60% of the global population, Asia is the world's largest, most populous and diverse continent. Three Asian countries – China, India and Indonesia – are the first, second and fourth-most populous countries in the world. Five Asian countries rank in the top 20 largest economies in the world. According to the World Bank, in 2015, China's GDP ranked second in the world, at approximately US$11trn, which was behind the first-ranked United States at around US$18trn. Japan came in third at approximately US$4.1trn, India seventh at around US$2.1trn, followed by South Korea and Indonesia ranking at 11th and 16th, respectively.

Despite the geographical, demographic and economic dominance of the continent, Asia's private equity market is still proportionally small. According to Preqin, private equity and venture capital funds raised US$335bn globally in 2015, but only US$46.7bn in Asia, which amounts to only about 14% of the global share. After a slower start in 2016, fundraising in Asia recovered in the second half of the year, ending with approximately $50bn of fresh capital, according to Asia Private Equity. With respect to M&A activity, the aggregate M&A transactions announced in 2016 in Asia, according to Dealogic, were valued at US$799.3bn, constituting approximately 21.7% of global M&A activity. Ex-Japan Asia's M&A activity fell 28% year-on-year, a steeper drop-off than the 15% global decline. In a survey conducted by Preqin Fund Manager Survey in June 2016, Asia-based fund managers have identified fundraising and the exit environment to be the two key challenges in the industry in the subsequent 12 months.

Much of the complexity of the Asian private equity market stems from the region's diversity. There is no common language, religion, currency or legal system unifying the region. Further, Asian countries are in various stages of economic growth and development, with vastly differing demographic profiles. China and Japan dominate the investor base for fundraising, while other Asian countries offer opportunity for deploying capital. The risk-return profile of investing in Japan is vastly different from India and Southeast Asia. As a recognition of the complexity of the Asian private equity market, sponsors are raising an increasing number of Pan-Asia funds. For example, in 2013 KKR & Co raised KKR Asia II, a US$6bn Pan-Asia fund, which is the largest fund focused on Asia or any Asian country. KKR is reportedly raising its third Asia fund, with an increased target of US$7bn. In 2015, RRJ Capital raised US$4.5bn with a focus on China and Southeast Asia; Baring

Private Equity Asia raised US$3.9bn to invest in companies in Asia as well as non-Asian companies with growth plans in Asia; and PAG Asia Capital closed its second Pan-Asia private equity buyout fund at US$3.6bn. These funds were very large by Asian standards, and were among the largest funds raised globally in 2015.

The increase in the number, sophistication and competitiveness of private equity funds in Asia have given rise to an increase in the utilisation of capital call facilities (also known as subscription facilities), a form of credit facility made available to a fund, which is typically secured by: (i) the unfunded capital commitments of the fund's investors; (ii) the fund's rights to call capital and receive capital contributions; and (iii) the fund's bank account into which capital contributions are deposited.

This article will first take a high-level overview of the private equity market in China, Japan, India, South Korea and Southeast Asia. It will then introduce how capital call facilities have been utilised in Asia, and the issues to be considered during negotiation of those facilities.

Overview of the private equity market in Asia

China has been the dominant power in the region. According to Preqin, 27% of investors in Asia are based in China, followed by 25% in Japan, 10% in each of South Korea and Hong Kong, and 9% in India. China and Japan combined hold 73% of the US$34trn in assets under management held by Asia-based limited partners. On the deal-making front, out of the US$125bn Asia-Pacific private equity deals recorded in 2015 by Bain & Company, China accounted for about half of the share at US$69bn.

Many factors, including, for example, China's five-month freeze on initial public offerings in 2015, the plunge of the Shanghai index by as much as 25% in January 2016, and slowing GDP growth have made investors more cautious about China. In addition, intensifying domestic competition has influenced China-based funds to explore outbound or to raise Pan-Asia funds. Japan, on the other hand, is enjoying a period of rejuvenated private equity activity after several years of stagnation, as governmental policy has led to ample supply of capital into private equity funds and increased appetite for private equity buyers. Activities in India and South Korea, despite each potentially facing certain near-term challenges, are expected to remain stable. Lastly, more and more investors are excited about the potential in Southeast Asia, especially against the backdrop of a slowdown of the Chinese economy.

China

Aggregate capital fundraising for Greater China (China, Hong Kong, Macau and Taiwan) for 2014 and 2015 reached US$32.4bn and $33.8bn respectively, according to Preqin, but as of August 2016, only US$11.7bn had been raised for 2016, but fundraising is reported to have recovered in the second half of the year, largely driven by an infusion of capital in a handful of RMB funds. The PRC government has been trying to expand the sources of capital. For example in 2015, the China Insurance Regulatory Commission began permitting Chinese private insurers to invest in PRC private equity funds. As reported by Private Equity International ("PEI"), China Life is expected to invest up to 5% of its 2.4 trillion yuan (US$357bn) of assets under management in buyouts and co-investment opportunities in 2017.

Nonetheless, gone are the days where private equity investors could rely on double-digit GDP growth for successful investment programs. Private equity investment in China declined in 2016 to $47bn, about a one-third decline from 2015, according to the Asian Venture Capital Journal. The Chinese private equity market has reached a level of maturity where limited partners can be deliberate about their investment choices. Funds with lacklustre historical performance are struggling to fundraise (even some of the most well-established sponsors), while funds sponsored by firms that have consistently performed strongly across multiple cycles are oversubscribed. As noted in Bain & Company's Global Private Equity Report, internet deals in China accounted for 40% of total deal value in 2015, which is a six-fold increase from the average over the previous five years. In comparison, deal value declined in most traditional industries, which disproportionately harmed long-established sponsors that had not adapted to the change in industry trends.

The other notable development in the Chinese private equity market has been the increase in outbound acquisitions. With intensifying competition and high valuation of quality assets, funds are seeking to make investments outside of their home country in order to diversify and differentiate their portfolios. According to Mergermarket, in the first half of 2016, China-based funds invested US$7.4bn in Europe and North America, exceeding the US$5.8bn invested in 2015. For example, Hong Kong-based PAG Asia Capital and Apex Technology acquired US printer manufacturer Lexmark for US$3.6bn. Chinese buyers are said to have a competitive advantage because they can provide a target with access to the Chinese consumer market. Outbound investments, however, face hurdles as they are subject to regulatory challenges from countries such as the US, Canada and Australia, all of which have formal review processes for foreign investors. For example, the Committee on Foreign Investment in the United States recently blocked Dutch company Philips' plan to sell an 80% stake in the lighting and lighting components business based in California to a Chinese consortium, GO Scale Capital, due to unspecified national security concerns. Outbound investment initiatives also face pressure within China. In November 2016, the Chinese State Administration of Foreign Exchange (SAFE) increased the restrictions on moving RMB out of China, making it nearly impossible to execute outbound deals for RMB fund sponsors who don't otherwise have USD sourced funds.

Although these pressures have triggered turmoil in the Chinese private equity space, some view this as an opportunity for private equity funds to move away from making minority investments and instead take more companies private. According to Bain & Company, the value of buyouts in 2015 was five times higher than the annual average from 2010 to 2014. Further, Carlyle's US$3.7bn take-private deal of China's Focus Media in 2013 illustrates that leveraged buy-outs are possible in China. The current environment in China is forcing Chinese private equity funds to evolve to best manage the uncertainty of the economy, decrease dependence on China and differentiate themselves from other competitors.

<u>Japan</u>

Japan, with an economy that is a little shy of half the size of the Chinese economy, possesses unrealised potential for private equity activity as Japan's private equity market is still small relative to its economy. 2016 is expected to be one of the best fundraising years for Japan-based funds in a decade. In addition, 2016 M&A activity in Japan remained the same as in 2015, with the aggregate value of announced transactions amounting to US$89.4bn. This stands in sharp contrast to the rest of Asia and the world, which declined by 15% and 28% respectively. Abenomics, the economic policy advocated by Prime Minister Shinzo Abe since December 2012 with a focus on fiscal stimulus, monetary easing and structural reforms, combined with entry into the private equity market by new investors, have improved prospects for private equity in the minds of both investors and companies.

The Bank of Japan's monetary easing and lowering of interest rates, ultimately below zero, boosted the Japanese equity markets. The more lasting effect, however, may be that Japanese private equity funds have become more attractive to investors. The Government Pension

Investment Fund of Japan, the world's largest pension investor, announced that it would allocate up to 5% of its assets in alternative investments, including private equity. Recently privatised Japan Post Bank and Japan Post Insurance have made similar announcements. PEI reported that these three institutions combined could potentially steer over US$3trn towards private equity investments. In addition, Japanese mega-banks, regional banks and corporate pensions have begun investing in private equity funds. One unique phenomenon in the Japanese private equity landscape, primarily driven by the investment philosophy of diversification of the Japanese limited partners, has been that a larger number of sponsors are raising smaller funds, generally in the US$250m to US$500m range.

Receptivity towards private equity has gradually become more positive, possibly due to demographic shifts and changes in the regulatory environment as well as potential synergies offered by private equity investments in Japanese companies. According to the Small and Medium Enterprise Agency, there are approximately 3.8 million small to medium-sized companies in Japan. Because of the aging and declining population in Japan[1], many of these companies are struggling with succession planning and/or looking to expand internationally to offset declining domestic consumer demand. Some companies increasingly view private equity firms as potential allies who can help these companies improve their capabilities, continue their legacy, better reach new markets and take the business to new levels beyond what some founders might have imagined possible.

Initiatives such as the amendment of the Companies Act and the implementation of the new Stewardship Code, among others, were enacted with the intention of enticing: (a) companies to appoint independent directors to their boards, provide more transparent disclosure and strive for better return on equity; and (b) institutional investors to more actively engage with the companies in which they invest for medium-to long-term growth. The new policies are intended to induce management and top executives of Japanese public companies, which have for years been conservative, to think more strategically and innovatively, in order to help such companies become more successful and profitable. This had led to a trend of divestitures of non-core operations by public companies and thereby has created an opportunity for private equity funds to acquire such non-core assets.

With such relatively small rates of private equity/M&A penetration, these changes signify that the Japanese private equity market has untapped sources of capital and an increasing pipeline of attractive investment opportunities, which position the market for continuing growth over at least the next year. Bain & Company, in its Asia-Pacific Private Equity Report 2016, noted the outlook on Japan to be positive.

<u>India</u>

Because fundraising has been challenging for India-based funds, the Indian private equity market has largely been dominated by a relatively small number of global or regional private equity players. According to Live Mint News, Amicus Capital Partners was reported to have raised its first US$90m (out of its target US$200m) as of December 2016, the first time that an inaugural Indian fund succeeded in fundraising since Kedaara Capital Advisors Ltd. raised its US$540m debut fund in November 2013. Offshore funds also face near-term challenges due to the amendment of the India-Mauritius tax treaty which comes into effect on April 1, 2017. The amendment also impacts the India-Singapore tax treaty, as the treatment of capital gains is linked to the India-Mauritius treaty. Investments in India have often been made via Mauritius and/or Singapore to benefit from the applicable treaty network. The amendment, which is applicable to any new investments made after April 1, 2017, will make such capital gains taxable in India, resulting in decreased attractiveness of existing structures and forcing private equity firms to consider alternative tax-efficient structures to invest in India.

On the deal-making front, private equity investments into India have been robust – in 2015, aggregate deal value reached US$22.9bn, surpassing the 2007 peak levels of US$17.1bn, according to Bain & Company. Vikram Hosangady, head of deal advisory and private equity in KPMG India, is quoted in Live Mint News that "sentiment on deal street remains strong and the recent passing of the goods and service tax regulations… and the insolvency law adds to the optimism that the government is keen to push through reforms". Successful exits of Indian investments in 2016 are also encouraging signs. KKR's sale of Alliance Tire Group to Yokohama Rubber Co., a Japanese strategic buyer, in the summer of 2016, marked the largest exit from an Indian company by a private equity fund. KKR also agreed to sell a stake in Gland Pharma Limited to Shanghai Fosun Pharmaceutical (Group) Co., Ltd., a Hong Kong-listed unit of Fosun International Ltd. Fosun has also been reported to start a private equity business in India. These exits are also noteworthy from the cross-border Pan-Asian angle since the new buyers are Asian companies looking to make investments into India.

South Korea

The Korean fundraising market has fluctuated in the last few years, with a steady decline in the number of funds closed per year. The KOSPI, the Korea Composite Stock Price Index, has also remained in a range between 1,800 and 2,150 in the last five years, and recent turmoil surrounding the South Korean presidency casts uncertainty on the economy in the near term. Regulatory reforms are being carried out, however, to stimulate activities of private equity funds – the Financial Investment Services and Capital Markets Act was amended in 2015, and in June 2016, the Financial Services Commission, the country's financial regulator, proposed to open up the private equity market to retail investors, which would expand sources of capital. It is also worth noting that Asia's biggest-ever leveraged buyout deal, announced in September 2015, was the US$6.1bn acquisition of Homeplus, the South Korean business of Tesco Plc, by a consortium led by MBK Partners.

Southeast Asia

According to the 2016 Global Limited Partners Survey conducted by the Emerging Market Private Equity Association, Southeast Asia ranks as the most attractive emerging market for private equity investment over the next 12 months, topping India. The same survey indicated that 34% of limited partners intend to begin or expand their investment in Southeast Asia in the next few years. Investors are paying particular attention to Indonesia, which has a population of approximately 250 million (ranking fourth-largest in the world), increased urbanisation, a rising middle class and growing access to technology (it is the third largest online market in Asia behind China and India, according to PEI).

KKR, alongside Warburg Pincus, Farallon Capital Management and Capital Group Private Markets, invested in a US$550m funding round for GO-JEK, an Indonesian motorbike taxi service application company in August 2016. Most of the investments in Indonesia are still minority interests and buy-outs remain rare in Indonesia. This is due to a number of factors, such as the necessity to navigate through complex and evolving regulations, a desire to maintain a local partner, corruption concerns and difficulty accessing the Indonesian debt market. In addition, fundraising efforts in Indonesia have been hampered by the small pool of funds available domestically, and the disadvantageous regulatory environment. As a result, fundraising for funds investing in Indonesia has taken place outside of Indonesia.

Private equity activity in Southeast Asia is likely to experience notable growth, and Bain & Company has characterised Southeast Asia as one of two markets in Asia with a positive outlook for the next two to three years. Investment strategy within Southeast Asia, however, will need to be tailored by country. Quoted in PEI, Ming Lu, KKR's head of private equity in Asia, described KKR's "strategy for Singapore – where buyout opportunities exist and the capital markets are sophisticated – is different from [their] approach in Indonesia, which offers exciting opportunities related to urbanisation, a rising middle class and shifting consumption trends."

Role of capital call facilities

As the Asian private equity market becomes more sophisticated, competitive and global, Asian sponsors have generally been eager to utilise capital call facilities or subscription facilities. Capital call facilities are most frequently used to: (i) bridge or smooth out investor capital calls; (ii) obtain loans, issue letters of credit or provide other credit support for portfolio companies at cheaper rates than may be available at the portfolio level; (iii) enhance the fund's internal rate of return; (iv) reduce the spread between gross and net performance metrics with low-cost financing; and (v) improve competitiveness *vis-à-vis* strategic buyers. These facilities may be sized based on a borrowing base where investors are categorised in accordance with their credit ratings (and different advance rates are applied depending on the rating) or based on a coverage test where availability under the credit facility is capped at a certain percentage (such as 50%) of the aggregate uncalled capital commitments of investors.

Subscription facilities entered into by Asian funds are relatively straightforward but they need to be tailored to address the investor and lender expectations in the Asian private equity markets. For example, Asian subscription facilities tend to be short-term (no longer than one year), as limited partners in Asia do not like indebtedness to be outstanding for a prolonged period. Additionally, although fund sizes are getting larger, Prequin has reported that average fund size among Asia-focused private equity funds has not grown significantly, averaging US$298m in 2015. As lenders will typically offer a credit facility that is 10–20% of the aggregate capital commitment of investors, fund facilities for funds shy of US$1bn in capital commitments are typically bilateral facilities, often provided by a relationship bank as part of the package of services it offers to the private equity sponsor.

Given the diversity of the Asian private equity market, and the growth of global and Pan-Asian funds, the providers of these facilities are expanding. Also, the complexity of these facilities increases as they shift from bilateral deals to those with multi-lender syndicates. While negotiating these fund facilities, sponsors should be mindful of factors such as fund structures and banks' review of limited partnership agreements, especially as the sponsors move beyond working with a small number of relationship banks. Additionally, by the time private equity sponsors are raising their second or third fund, they are increasingly interested in a capital call facility. As a result, subscription facilities are becoming a staple product that financial institutions must provide to remain competitive.

<u>Fund structure</u>

In a typical Asia-focused private equity fund structure, the primary fund vehicle (i.e., the entity that aggregates investors) is frequently a limited partnership that is formed in the Cayman Islands. Such a limited partnership would have a general partner controlled by the sponsor and investors which are limited partners. The fund structure is relatively straightforward, and the limited partnership would be the borrower under the capital call facility.

There may also be a parallel fund vehicle, which has a separate pool of investors from the main fund but is controlled by the same sponsor and co-invests in the same investments as the main fund in a lock-step *pro rata* basis. Often sponsors want the parallel fund to have the same access to a capital call facility as the main fund. In some cases, the lenders request that the main fund guarantee the parallel fund's obligations under the facility (and *vice versa*). Alternatively, lenders may request that the main fund and parallel fund be jointly and severally liable for the obligations under the capital call facility. However, if a parallel fund (which may have a smaller pool of capital commitments) is liable for the obligations of the larger main fund, the assets of the parallel fund may not be sufficient to cover the main fund's obligations. Moreover, any such guarantee or joint and several obligation could cause the smaller, parallel fund to be in violation of its partnership agreement debt covenant, or in the worst case scenario, depending on the relative sizes of the fund vehicles and the size of the main fund's borrowing, the small parallel fund could be rendered insolvent. To address these concerns, sponsors will insist on incorporating savings language into the loan documents, so that the liability of the smaller fund is capped at an amount that would not violate its limited partnership agreement or render the parallel fund insolvent. Another solution may be for the main fund and the parallel fund to be severally liable for their respective credit agreement obligations, but to cross-collateralise their obligations such that the obligations under the credit facility are secured by the uncalled capital of both funds. This cross-collateralisation is a feature commonly seen in the United States.

Fund structures are not always as straightforward, however. Japan, for example, has complex tax rules affecting Japanese and non-Japanese investors differently, leading sponsors to structure funds with two or more independently managed fund vehicles investing in parallel in the same investment opportunities. Depending on the size of the non-Japanese investor group, multiple parallel funds may be needed to minimise the exposure of non-Japanese investors to Japanese tax risks. The independence necessary for each fund vehicle complicates the ability for the fund vehicles to be jointly and severally liable or to be cross-collateralised within a credit facility. Consultation with Japanese tax advisors is key for any Japanese funds to enter into fund facilities.

"Bankable" limited partnership agreements

Subscription facility lenders diligence the limited partnership agreement of the fund borrower to ensure that the partnership agreement permits borrowings, and the pledge to the lenders of the right to call capital from investors. Side letters, which tailor the limited partnership agreement for specific investors, are common in Asia. Lenders are particularly focused on provisions in these letters that deal with sovereign immunity and confidentiality. Sovereign immunity is the judicial doctrine whereby states, governments and government-affiliated entities cannot be sued without their consent. If an investor has sovereign immunity, lenders may be concerned about their ability to enforce a capital call following a default under the capital call facility, since they would be prohibited from bringing an enforcement action against a sovereign investor in court proceedings. As a result, lenders may have difficulty realising a portion of their collateral. Since state-government funds or pension funds are frequent investors in Asian private equity funds, this issue comes up frequently. Some lenders in Asia have become comfortable with lending against the capital commitments of sovereign investors, especially if they have a good history of funding capital calls, while others require such investors to waive their immunity (if possible) or be removed from the borrowing base calculation in the credit agreement.

Certain investor side letters may also restrict the ability of the general partner to disclose the identity of such investor. Without knowing the identity of an investor, lenders may not be able to contact such investor when exercising remedies and calling capital. Depending on the percentage of such confidential investors, certain lending institutions will not participate in a facility for a fund that has confidential investors. Other providers may simply be unwilling to lend against the capital commitments of these investors (although their commitments would still be considered collateral). As a result, the commitments of such limited partners would be excluded from the borrowing base, and the overall borrowing capacity of the fund would thereby be reduced. Fund borrowers ought to be aware of these provisions in side letters, and endeavour to limit these ineligible investors compared to the overall investor pool supporting the capital call facility, as significant exclusions from the borrowing base could affect the viability of the capital call facility.

Prior to the initial closing of a fund, it is advisable for fund borrowers to share, on a confidential basis, drafts of their limited partnership agreements (and side letters) with potential lenders, or to fund finance counsel to ensure that the agreements are "bankable" from a fund financing perspective, as a subsequent amendment is extremely onerous both from an investor-relations standpoint and lender-negotiation dynamics.

Growth of global and pan-Asia funds

Increases in fund sizes, driven in part by the rise of global and Pan-Asian funds, have resulted in the sponsors' desire to have larger capital call facilities which can no longer be supported bilaterally by one financial institution. A multi-lender deal creates opportunities for other financial institutions to compete for a sponsor's business.

A facility with multiple lenders also imposes additional legal complexities. For example, a security agent would typically need to be appointed, which would hold the security interest in the collateral on behalf of all the lenders and would be the representative of these lenders should enforcement ever be necessary. Certain countries, however, do not have the practice of granting security interest to a trustee or agent, and instead require that each lender be the pledgee of collateral. These concerns may be alleviated by setting up funds in jurisdictions such as the Cayman Islands, but sponsors also need to ensure that other collateral (such as the bank account) is located in a jurisdiction with secured transaction rules that permit creation and perfection of a lien in favour of an agent for the lenders.

A larger, syndicated, multi-year credit facility also increases the concern that a lender may want to reduce its exposure during the life of the facility by assigning or participating out its interest in the credit facility to another financial institution. The fund borrower's consent right over such assignment or participation becomes critical because sponsors are sensitive about keeping information regarding the fund and its limited partners confidential, especially from any competitors. The sponsors' desire to control the composition of its lending group needs to be balanced with the flexibility and protection that the lenders customarily want in a large, multi-year credit facility.

Conclusion

The extent of the impact of global events (such as the health of China's economy, withdrawal of the United Kingdom from the European Union, the new U.S. presidency and currency fluctuation) on the Asian private equity market all remain to be seen, but the fundamental growth story of Asia remains intact. According to the Asian Development Bank, GDP in the region is expected to grow 5.7% in 2016 and 2017, contributing to 60% of the global growth in the next two years. Given the relatively limited penetration of private equity in Asia *vis-à-vis* the overall economy, private equity activity in Asia has inherent opportunity to expand. Preqin has reported that as of August 2016, US$110bn of dry power (the amount of capital that is available for investment) exists among Asia-based private equity and venture capital firms. Sixty-eight per cent (68%) of the Asia-based firms responded to the Preqin Fund Manager Survey that they expect to deploy more capital compared to the previous year, and 77% of the general partners plan to launch new funds before the end of 2017.

The dynamic Asian private equity market will continue to remain diverse within the region and will also continue to evolve. To be successful, funds will need to be nimble to these differences and changes. Capital call facilities may be one way for sponsors to remain competitive and to differentiate themselves from others. Sponsors who are interested in entering into fund facilities should consult their legal and tax advisors early on in the fundraising process to ensure that the fund structure and limited partnership agreement are financeable. With growing sophistication of the sponsors, investors and lending institutions, better appreciation for the many uses of these facilities and larger fund sizes, the fund finance practice in Asia is destined to grow in the next few years.

Acknowledgment

The authors wish to thank Mary Touchstone, Head of the Funds Finance Practice at Simpson Thacher & Bartlett LLP, and Julia Kohen, Counsel in the Funds Finance Practice at Simpson Thacher & Bartlett LLP.

* * *

Endnote

1. According to the The World Factbook by the US Central Intelligence Agency, the Japanese population is set to have declined in 2016. Over one-quarter of the population is over 65 years old and the median age is 46.9 years old, which is the second-highest in the world (https://www.cia.gov/Library/publications/the-world-factbook/geos/ja.html).

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Australia

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Overview: Fund finance and funds landscape in Australia

Fund financing facilities have continued to flourish in Australia, providing sponsors, general partners and trustees with additional funding flexibility and liquidity. In 2016, fund financing activity continued a steady growth trajectory. While there is no standard industry data-reporting source tracking fund financing facilities in Australia, from the transactions we have seen, and speaking to the major lenders in the Australian market, the domestic market has displayed steady growth in the past 12 to 18 months. Based on anecdotal evidence from market participants, the size of the Australian market in fund financing for private equity and venture capital funds in Australia is estimated to be in the region of A$2bn to A$2.5bn. 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. In recent years in Australia and offshore, fund finance facilities have continued their track record of having near-zero default rates and no reported payment defaults by investors.[1] 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 quickly obtain capital for investment opportunities and working capital needs.

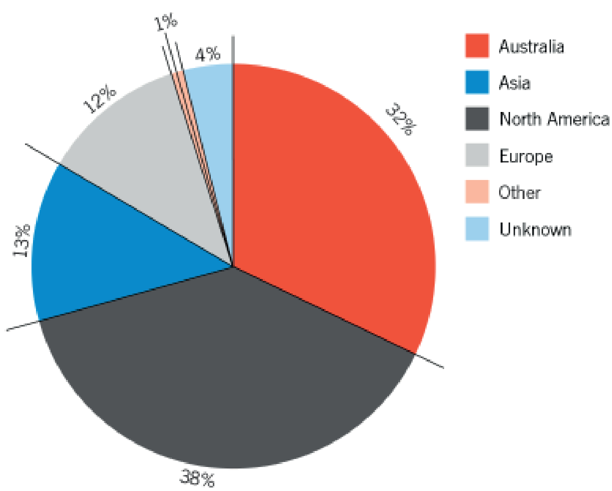
Significant private equity, venture capital and infrastructure fund activity over the course of 2016 resulted in lending to these funds dominating the Australian fund financing market. In December 2015, the Australian Government announced that it will introduce two new collective investment vehicles (***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. The de-leveraging by the Australian domestic banks and major offshore lenders in risk-weighted assets is fuelling the activity of debt funds and further developing fund financing opportunities in the Asia-Pacific region.

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 2016 financial year, with overall fundraising and investment levels remaining strong.[2] While private equity fundraising was lower than the previous year at approximately A$2.1bn, investments by the industry grew by 5%, with a quarter of fundraising earmarked for future growth or expansion deals.[3] In contrast to private equity, venture capital fundraising rose to record levels, with seven funds raising A$568m.[4] Over A$1bn of intended venture capital fundraising was also announced in the 2016 financial year. This growth has been encouraged by Australian Government policy initiatives through the National Innovation and Science Agenda (announced in December 2015).

Private equity funding primarily came from superannuation/pension funds (38%), corporate and financial institutions (23%) and fund of funds (10%), with a majority of investors from North America (48%), Australia (17%) and Asia (16%).[5] For venture capital fundraising, over 90% came from Australian investors, with corporate/financial institutions being the biggest sources of commitments (30%) and superannuation funds (21%).[6] As of 30 June 2016, approximately $7bn of dry powder was also available for investment by Australian private equity and venture capital fund managers, a 13% increase on the previous year's total.[7] 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.

Sources of new PE and VC commitments in FY2016 by region (A$ millions)



Source: AVCAL 2016 Yearbook

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.[8] 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 2016, globally there were 243 unlisted infrastructure funds which raised approximately $42.8bn. The average fund size is now $1.3bn.[9] While fundraising was down globally, fundraising in the Asia-Pacific outperformed 2015, with $3.2bn raised.[10]

In Australia, the federal and state governments are encouraging further involvement in infrastructure investment from private infrastructure funds and superannuation funds to assist in closing Australia's infrastructure gap and provide investors with the opportunity to invest in essential public assets, such as toll roads, airports and rail facilities. The acquisition of the Ausgrid electricity network by IFM Investors and AustralianSuper from the New South Wales state government,[11] and the investment by Partners Group in Sydney Metro Northwest and Melbourne's High-Capacity Metro Trains, are both examples of this.[12] It is likely that the demand for fund finance facilities in Australia will increase, especially to bridge capital calls and to meet the financing and investment needs of infrastructure funds and sponsors to facilitate acquisitions. Direct investments often require provision of credit support documents like guarantees and performance bonds. In light of the above, the fund financing market will remain conservatively strong, given that implementation of financing typically follows fundraising activities.

Fund formation and fund financing

Fund formation and new developments

In regards 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 partnerships (***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.[13] 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.

The Australian fund landscape is changing, with a focus on encouraging foreign investment, particularly from Asia. The Australian Government has announced that it will introduce two CIVs as a tax-effective alternative to current Australian pooled investment trusts. The new vehicles will be a corporate CIV (modelled on the Luxembourg SICAV) and a limited partnership CIV, with each CIV being available from 1 July 2017 and 1 July 2018, respectively. 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.[14] 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 offshore funds enter the Australian market and establish Australian funds, we have seen Australian fund documentation develop, albeit the process is 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 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 days). Terms of facilities are generally structured in alignment with a fund's investment period, and are usually for less than three 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 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 its investment lifecycle. However, as mentioned this kind of facility is less prevalent in Australia than the other abovementioned facilities and are often provided by incumbent financiers that have previously provided capital call facilities to that fund.

<u>Security arrangements</u>

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 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***)[15] 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:

1. 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.
2. The fund directs the investor to pay any capital calls at the direction of the lender upon a default under the financing.
3. 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 acknowledgement. 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*,[16] which provides that where there are competing 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

<u>Sovereign wealth funds and sovereign immunity</u>

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 2016, the total assets of sovereign wealth funds globally is in excess of $6.51trn.[17] Traditionally lenders in the Australian market have chosen to either exclude or at least limit or discount their inclusion in the borrowing base. However, the prevalence and size of their investment means that this approach can no longer be taken, and 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.[18] 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.[19] 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.

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 2016 quarter, the assets under management of Australian superannuation assets in aggregate were approximately A$2.1trn, growing by 7.4% in total superannuation assets.[20] 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. REST Industry Super, which completed its first direct lending investment to Transurban Queensland in 2015, is a prime example of this.[21]

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 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.[22] 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.

Open-end funds

In the past, lenders have been more inclined to lend to closed-end funds, where investors are locked in, rather than to open-end funds, where investors have the ability to cash out and eliminate further funding obligations. While the certainty of the investor base is fundamental to a fund finance facility, this may potentially be an area for development in Australia, as long as appropriate parameters are set out in the documentation.

Year ahead

In light of the above, we are optimistic that the fund financing market will continue to grow in Australia.

It is anticipated that new lenders will enter the Australian fund financing market. In 2016, some offshore investment banks and commercial banks have shown growing interest in, and have entered, the Australia market as a result of the strong history of near-zero investor defaults and the opportunity to establish and strengthen relationships with funds and their financial sponsors.

Lending to private equity, venture capital and infrastructure funds will continue to dominate the Australian fund financing market; however, real estate funds are a further potential growth area to the market. Traditionally, real estate funds have been financed by the domestic 'big 4' banks, with a corporate facility often secured against its underlying assets. In recent times, Australian domestic banks and some major offshore banks have sought to reduce exposure to domestic residential development as part of their general policy to deleverage against risk-weighted assets. This opens up a funding gap that may be filled by the participation of debt funds as well as the opportunity for the fund and lenders to explore the option of subscription financing facilities that can shift the risk assessment away from the underlying portfolio assets of the fund.

Corporate financing from alternative debt providers, in particular credit funds, in Australia remains relatively nascent but anecdotal evidence from market participants indicates that there has been increase in activity that will likely continue in 2017. This will be a driver for growth in the use of fund financing, as onshore and offshore debt funds take advantage of the potential of this emerging market.

The uptake of capital call facilities in the Australia market has lagged the rapid upward trajectory of the market in the United States and, to a lesser extent, Europe. As lenders become more familiar with the different fund structures and the methods for assessing credit risk on investors, and as funds awake to the benefits that a capital call facility can bring, the Australian market has great potential to grow.

* * *

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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$166bn 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 indicate that the market will continue to expand in 2016, as well as continue to diversify in terms of product offerings.

Bermuda as a jurisdiction is highly responsive to evolving market demands and over the past 18 months 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 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 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 of the 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 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 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, 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.

Contracts Rights of Third Parties

The Contracts (Rights of Third Parties) Act 2016 came into force in March 2016. This legislative change is of particular interest given the current trend to include lenders as third party beneficiaries. It should be noted that this is an opt-in regime and the relevant agreement would have to contain an express intention for the act to apply.

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.

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

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Overview

The Brazilian fund industry has shown itself to be an important element of investment strategies in the country. In 2016, the total assets under management exceeded BRL 3 trillion, distributed across approximately 14,500 funds, which represents more than half of the national GDP. Such figures place Brazil among the top investment fund industries in the world[1].

Nevertheless, several key factors have led to a risk-averse approach by investors: (i) the persistent adverse political and economic scenario in the country; (ii) the high interest rates maintained by the Central Bank of Brazil (CBB) at 14.25% *per annum* until October 2016 for the purposes of controlling the inflation rate; and (iii) the increase in the offer of income tax-free investment solutions such as real estate credit bills and agribusiness credit bills, and intensified competition between investment funds and other types of investment products.

Consequently, the investment fund industry in Brazil recorded next-to-zero net sales[2] in 2014 and 2015. Despite such scenario, Brazilian funds have mostly generated higher returns in 2015 when compared with 2014 due to the profitability of the existing investment funds, which resulted in a continuous yearly increase in the total assets under management in Brazil.

In addition, in 2016 the industry showed signs of recovery by registering net sales of BRL 109.1 billion, which represents the second-highest recorded raising of new funds, exceeded only by the one recorded in 2010 (of BRL 113.5 billion)[3].

The majority of the net sales were registered by pension funds (BRL 48.2 billion), closely followed by fixed income funds (BRL 45.9 billion).

On a yearly average, equity funds led the industry in performance, benefiting from the first yearly appreciation of the Brazilian Stock Exchange Index (Ibovespa) since 2012. High-duration fixed income funds also benefited from the interest rate decrease process started in October 2016 (currently at 13.00% *per annum*) as a result of the expected decrease in the inflation rate.

Overall, the Brazilian fund industry is, in any event, still greatly concentrated in fixed income investments, largely due to the persisting high interest rates, which has culminated in investment funds holding approximately 53% of the federal public bonds as of February 2016. With the expected decrease of the inflation rate and, consequently, the return of interest rates to lower levels, it is possible that diversification of local portfolios will intensify in the near future.

With regard to investor segments (i.e. institutional, corporate and retail), the highest volume of investments in the Brazilian fund industry come from institutional investors, as retail investors have historically focused their investments on national saving. Furthermore, it is also possible to observe a decreasing trend of retail investor participation in the industry (24.4% in 2007 and 15.8% in 2015).

On the other hand, the participation of institutional investors and corporates in the total assets under management in the country has been steady (approximately 40% and 15% respectively) and shows an increase of allocation by such segments in investment funds.

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 in the previous years been subject to a great level of modernisation with the enactment of new rules aimed at reducing costs, as well as promoting higher disclosure of information, 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 previously mentioned adverse political and economic scenario, enabling the total assets under management in Brazil to grow from BRL 740 million in 2005 to BRL 3 trillion in 2015, with an average growth rate of 11.4% per year from 2009 to 2015.

Fund formation and finance

As mentioned above, the CVM has recently established a new regulatory framework applicable to investment funds and securities portfolio management activities. As part of the modernisation process, the CVM 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 for the definitions for qualified and professional investors; Instruction No. 555, of December 17, 2014 ("CVM Instruction 555"), which provides for the general rules applicable to the creation, operation, management and marketing of investment funds; and Instruction No.º558, of March 26, 2015 ("CVM Instruction 558"), which provides for the rules applicable to the accreditation, ongoing obligations and rules of conduct for securities portfolio managers, as further detailed below.

<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 such natural person must be resident in Brazil, and the legal entity must be organised and headquartered in Brazil.

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 purposes 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 introduced the requirement for portfolio managers to prepare and keep updated a reference form similar to a prospectus applicable to listed companies. It is important to note that such reference form must be annually filed with the CVM as well as posted on the portolio manager's website. Portfolio managers must also publish their internal policies and manuals on their website.

Another significant change brought by the new rule is the possibility of portfolio managers to distribute quotas of managed funds, an activity generally the province of duly qualified entities pertaining to the Brazilian securities dealership system (e.g. financial institutions).

The new provision seeks to eliminate a significant obstacle to the access of new portfolio managers to the market, which now are 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.

The rendering of securities advisory services is also subject to the prior authorisation of the CVM, however, pursuant to CVM Instruction 558, asset managers accredited with the CVM will be automatically authorised to provide securities advisory services. This means that duly accredited asset managers will no longer need to obtain a separate accreditation to provide investment advisory services.

Most recently, the CVM has also set for public hearing a proposed rule to replace and regulate in detail investment advisory activities, in order to include similar requirements for accreditation and ongoing obligations as the ones provided for in CVM Instruction 558.

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.

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 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, 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.

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 new 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 now issue depositary receipts in foreign markets that represent, among others, debentures, 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.

<u>Foreign exchange</u>

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).

<u>Offering of foreign securities in Brazil</u>

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 29 December 2003, as amended, which, as a general rule, establishes that public offerings must be previously registered with and authorised by the CVM.

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 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 significantly amended recently, with further amendments expected for ancillary rules. It is important to note that such changes have been largely influenced by the evolution of market practice and demands made by market participants, with proposed rules being set for public hearing by the CVM and subject to receiving comments from the public.

After 10 years of the enactment of the previous regulatory framework, 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.

The new regulations further 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 should be noted.

Local funds operate mainly by investing in local assets for local clients, with local funds investing in foreign products representing currently only 0.5% of the total.

Conversely, the allocation of global investors, through funds located abroad, in local assets is already developed, albeit adversely impacted by the current political and economic scenario in Brazil. Pursuant to the CBB's data, in March 2016 the total amount of global portfolios allocated in Brazilian sovereign bonds was USD 235 billion, and USD 176 billion in equities (including funds and direct portfolios' allocation).

Further, 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 the adverse external factors mentioned previously. Part of such resilience derives from its well-established structure and improving regulations, which have worked to sustain growth in the industry and should pave the way for the recovery and resurgence of the industry once the political and economic factors show signs of stabilisation.

It is also worth mentioning that the new regulatory framework is still very 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 market participants. The CVM's intention was to promote the existence of better-structured portfolio managers (irrespective of their size), as well as facilitating the analysis and comparison between portfolio managers by investors.

Externally, a decreasing trend of interest rates is observed as the inflation rate approaches the target median rate of 4.50% *per annum*, and the expansion of domestic economic activity still struggles. In this regard, the CBB recently lowered interest rates by 0.75% (from 13.75% to 13% *per annum*). This should incentivise investor appetite for riskier and diversified products, including in the investment fund industry, which is still still very focused on fixed income.

Institutional investors and corporate segments should continue outsourcing asset management through funds due to the benefits related to transparency, governance and operating gains, the latter explained by asset managers reducing internal management work, and administrators easing investment accountability by providing daily net asset value.

For individuals, the competition between investment funds and other type of investment opportunities will continue to increase, which may lead to a consistently healthy market environment, provided that all investment opportunities are sold under the same criteria, including the investors' suitability analysis.

In this sense, the simplification of fund investment rules could assist in the growth of the industry with the intensification of retail investor participation. This is exemplified by the creation of the simple funds, the distribution through digital platforms and the offer though open platforms.

In addition, 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 can also benefit the ever-increasing pension fund segment. Nevertheless, it still faces regulatory barriers that limit pension funds to invest 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 investment made abroad.

In conclusion, it was seen that the investment fund industry presented rapid growth in the last decade, with a recent period of stagnation. Nevertheless, the latest numbers show that the growth rate is expected to increase once more, and could intensify if macroeconomic adjustments are made to boost the Brazilian economy.

* * *

Endnotes

1. Based on information provided by the 2016 *Brazilian Mutual Fund Industry Yearbook* published by the Center for Studies in Finances of Fundação Getúlio Vargas.
2. Meaning the difference between the amounts related to new investments versus redemptions.
3. Based on information provided by the ANBIMA Investment Funds Report No. 129 of January 2017.

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Cayman Islands

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Overview

The Subscription Credit and Fund Finance markets have experienced substantial growth since 2011. Excellent credit performance and no public events of default seem to be the norm in this market.

Given that the Cayman Islands has long been a pre-eminent offshore jurisdiction for the establishment of private equity funds, there is a strong correlation in growth in the fund finance market and the Cayman Islands as a jurisdiction. Some insight into private equity fund formation activity in the jurisdiction may be gained from looking at the number of Exempted Limited Partnerships (each an **ELP**) registered in a particular year, given that the ELP continues to be the private equity fund vehicle of choice. According to figures published by the Cayman Islands Registry of Exempted Limited Partnerships up to the end of 2015, there were 17,876 active ELPs in the jurisdiction. Registration figures since then have held steady, with 3,300 ELPs having been registered in the Cayman Islands in 2015, and 2,679 ELPs having been registered in the Cayman Islands up to the end of October 2016.

There are a range of factors contributing to Cayman's dominant position in this space, including: (i) being branded as the "offshore hedge fund capital"; (ii) historical familiarity with the jurisdiction by investors and fund sponsors; and (iii) the increasing convergence of hedge fund and private equity sectors, as more fund managers offer and operate both products from the same platform. In addition, Cayman Islands law, which is derived from English common law and supplemented by local legislation, ensures that Cayman Islands funds are recognised as internationally accepted vehicles. Collaboration between the Cayman Islands government and the private sector also ensures that Cayman laws keep pace with market evolution and demand.

On a global scale, Preqin's Q3 2016 Updates report that the total capital raised by private equity funds has been significantly lower in Q3 than in Q1 and Q2 and that, further, the $62bn secured by the 170 funds that closed in Q3 2016 represents a 22% decrease from the $80bn secured by funds closed in Q3 2015. However, private equity fundraising over the longer term remains strong, as funds closing in the first three quarters of 2016 secured an aggregate $253bn, which is a larger amount than that secured by funds closing in the same period in 2015 ($213bn). In addition, more new funds are coming to market, with 2,935 funds raising a total of $983bn from investors.

The growth in this area seamlessly dovetails into the fund finance space where Appleby's Cayman office continues to see steady growth year on 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 exempted limited partnerships under the Exempted Limited Partnership Law (**ELP Law**). 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. 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 partnership agreement and any subscription agreements (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.

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. It is 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**) that is 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. As such, the proper parties to any grant of security must be the general partner as well as the ELP (acting through the general partner), as the ultimate beneficiary of such assets. The optimal security package should incorporate an express irrevocable power of attorney in favour of the Lender to effectively exercise the general partner's Capital Call Rights following the occurrence of an event of default.

In addition, the security package will also 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, Cayman courts would recognise the grant of security even if such security is 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 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 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, including but not limited to: (i) the ability of the ELP to incur indebtedness and enter into the transaction; (ii) 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 (iii) that the capital contributions may be applied towards the secured obligations.

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, there are generally no perfection steps required in Cayman and, further, there is no general register of security interests in the Cayman Islands accessible to the public.

Although there is no public security registry in the Cayman Islands, 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. 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 limited partnership 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). 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 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 provided to the limited partners ahead of Notice of the first assignment, the subsequent 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 much less resistance by ELPs 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 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. It is increasingly common for 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 partnership 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, rather than proof of receipt by way of a signed acknowledgment by the limited partners. In all cases, the recommendation would be that the general partner sign and deliver the Notices 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 Lender.

Apart from establishing priority, delivery of a Notice to an ELP'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 are discussed below:

- It prevents 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. Once notice of the assignment has been delivered to each limited partner, indicating that limited partners are to make all payments with respect to Uncalled Capital into a designated Lender controlled account, the limited partners 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 continue to work in the same manner. However, the service of notice on limited partners 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 and/or the accompanying subscription documents will now incorporate express waivers on the part of limited partners confirming that they will not rely on any right of set-off in order to reduce their obligations to fund their Uncalled 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) 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 a Cayman Islands exempted company to enter particulars of all mortgages and charges that it creates over its assets (wherever located) in a register of mortgages and charges maintained at its registered office. Importantly, the statute does not aim to impose additional perfection requirements, and failure to enter such particulars will not invalidate the security. However, exempted companies are expected to comply with the requirement. Failure to do so will expose the company to a statutory penalty. Though 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 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, given that legal title to the ELPs 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

The Cayman Islands government has reacted to significant market demand with the introduction of the Cayman Islands limited liability company (**Cayman LLC**) under the Limited Liability Companies Law, 2016 (**LLC Law**), which came into force by commencement order on 8 July 2016, with the necessary regulations being promulgated on 13 July 2016. 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 Cayman Islands exempted company and an ELP.

The LLC Law is a result of a collaborative effort between the private sector and the Cayman Islands government. The introduction of the Cayman LLC was driven in large measure by market demand for an offshore version of the Delaware LLC. As such, although fund structuring trends depend, to a large extent, on onshore tax and regulatory considerations, it is anticipated that the Cayman LLC will be an attractive vehicle for general partner and other carried interest entities and also for management companies. Insofar as fund structuring opportunities are concerned, it remains to be seen if a Cayman LLC might also usefully replace an ELP or a Cayman Islands exempted company as an offshore feeder in a master/feeder structure.

Assuming the use of Cayman LLCs as feeder vehicles gains some traction, we have considered below certain key features of a Cayman LLC which will be relevant to Lenders:

- A Cayman LLC is a body corporate with separate legal personality and limited liability. It can therefore hold property and assets and incur obligations and liabilities in its own name.
- Though constituted by way of registration under the LLC Law, the LLC Law in many instances defers to the LLC agreement as the main governing document of the Cayman LLC. As such, members of a Cayman LLC have relative freedom to determine its structure, governance and administration, including the ability 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 would 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.
- Management of a Cayman LLC either vests in its members acting by a majority in number or, if the LLC agreement so provides, in one or more managers appointed by the members. A Cayman LLC will not need to act by a separate general partner entity in order to maintain the limited liability of its members.

As noted above in relation to ELPs, the LLC agreement and the related subscription agreement will need to be reviewed in detail in order to ensure that such documentation specifically sanctions the subscription credit facility and the related collateral arrangements and, further, includes acknowledgments from the members of the security assignment and of their obligation to fund their capital commitments.

The year ahead

Though the global macro landscape remains uncertain and the markets volatile, there remains an unprecedented number of funds in the market and the supply of unutilised capital has similarly risen to unprecedented levels. We believe that opportunities for Lenders to partner with fund sponsors as they seek to make returns on their investments will continue to grow.

The demand for fund finance solutions continues to increase and is being satisfied by sophisticated lenders willing to offer attractive 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 and extending credit to single investor or all high-net-worth investor funds. Such evolution and innovation are testament to the sophistication of the market players coupled with the strong collaborative relationships between Lenders and fund sponsors alike. The market will continue to evolve and is poised for continued growth in 2017 and beyond.

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Benjamin Woolf is a partner at Appleby, specialising in structured and subscription finance. Benjamin is recommended as a leading lawyer in *The Legal 500* 2015; *The Legal 500* 2010 described Benjamin as having a "strong legal mind with commercial awareness". Prior to joining Appleby in 2011, Benjamin practised in London where he worked primarily on asset-backed financing and securitisation. Since joining Appleby, Benjamin has been heavily involved in Appleby's market-leading fund finance practice, CLOs and M&A. Benjamin is a market leading finance lawyer and has been highly regarded and rated globally across the leading legal directories since 2010.

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Anna-Lise Wisdom is Counsel* at Appleby, specialising in subscription financing and other debt financing for private funds. Anna-Lise regularly works alongside onshore counsel representing leading financial institutions in related credit facilities ranging from tens of millions to billions of dollars of lender commitments. She also has substantial experience in ship finance, corporate and acquisition finance and in capital markets transactions. Prior to joining Appleby, Anna-Lise practised as a corporate attorney in the British Virgin Islands, advising a broad client base of financial institutions, trust companies and investment advisors. Her practice extends to private equity and hedge fund formation, structuring and operation, and she has also advised investment managers on related regulatory and licensing issues in relation to such funds. Anna-Lise is a market leading finance lawyer and has been highly regarded and rated globally across the leading legal directories since 2015.

* *Her promotion to partnership remains subject to immigration approval at the time of publication of this chapter.*

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Summary

<u>What makes a fund finance transaction "English"?</u>

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".

<u>When and why did the English fund finance market develop?</u>

Outside North America, England and 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 fund-level information 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 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 an appropriate user 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 2017 and the market has grown exponentially. Notwithstanding the political and economic uncertainty arising from Brexit, in 2016, Dentons, London advised on "English" fund finance transactions totalling over £15bn 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 £50bn.

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" 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 and Spain) 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, co-invest facilities and facilities used for differing purposes, including end-of-life facilities and re-caps; and
- as allocations to the private markets increase with dry powder sitting at almost $1.5trn 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:

- ***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. In January 2017, more funds are in the market fund-raising than in any previous year and one of the key challenges for investors is determining which GPs to build or maintain relationships with. Whilst fewer funds have closed (*per annum*) since 2014 in Europe, aggregate capital raised has grown from $73bn in 2015 to $81bn in 2016 (YTD/Q3) representing a trend of flight to quality as investor capital has been focused at larger sponsors, resulting in larger average fund sizes.

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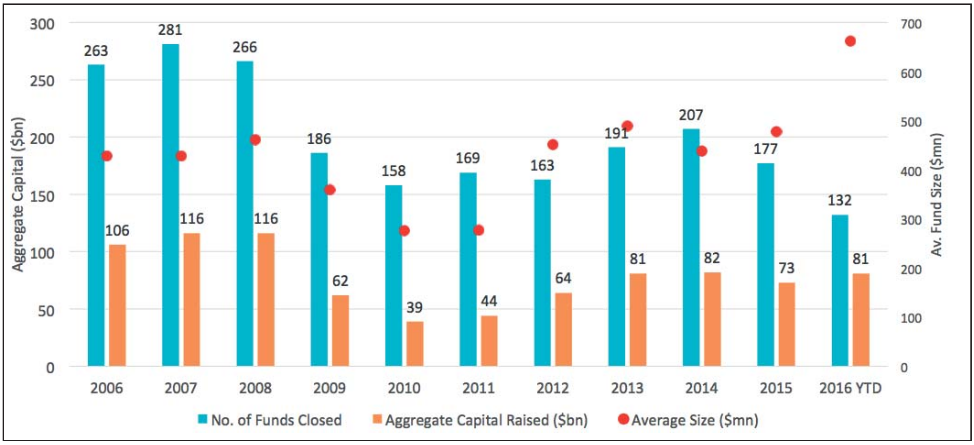

Source: Preqin Private Equity Online

- ***The asset manager's perspective.*** The robust levels of fundraising seen in the UK 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.
- ***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; and/or
  - **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 have recently seen 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 wholly or partially asset-backed 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 asset-backed fund finance products is significantly less than is the case 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 five years we have seen a significant 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 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.*** Traditionally, 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 characteristics, 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 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 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 defaults.
- ***Committed versus uncommitted.*** Historically, many facilities were structured on an uncommitted basis, enabling lenders to benefit from favourable regulatory capital treatment 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 fund and lender side, 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 immunity 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. 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 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 distributions to investors.

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 product and the fact that it is very much a relationship product. In most cases, 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.

Fund domicile in English law fund financings

Whilst Guernsey, Jersey and the Cayman Islands continue to dominate when it comes to fund domiciliation in English law fund financings, over the past three years we have seen funds domiciled in Luxembourg (particularly on the credit fund side), Ireland and Scotland also feature increasingly regularly. 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 the law governing English limited partnerships is considered antiquated: the key statutes, the Limited Partnership Act 1907 and the Partnership Act 1890, have changed little since they were originally introduced.

However, the UK government is now seeking to address this. On 6 April 2017, the Legislative Reform (Private Fund Limited Partnership) Order 2017 is expected to come 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 will introduce the concept of "private fund limited partnership". Some of the usual rules, restrictions and administrative burdens that currently apply to all limited partnerships and their limited partners will not 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 which will 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.

The outlook for 2017 – some crystal ball gazing …

Brexit

The UK's referendum vote on 23 June 2016 to leave the EU was the single biggest political, economic and legal development in the United Kingdom in 2016, with implications far beyond fund finance or even financial services generally. While the predicted immediate slow-down in the UK economy has not materialised, the referendum result did trigger a significant immediate and sustained drop in the value of sterling against both the dollar and the euro. With exchange rate volatility likely to remain high, fund finance lenders are likely to focus even more than in the past on minimising FX exposure with FX hedging likely to become increasingly expensive.

The legal implications of Brexit are less clear, although at the time of writing this article the UK government has now confirmed that it will not seek to keep the UK within the European single market. Although in no way a fund finance-specific issue, this is likely to make it more difficult for UK-based lenders to provide loans to borrowers operating within the EU27 (for example, a Luxembourg-domiciled fund). 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, 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. The potential withdrawal of this EU passport may therefore complicate loans from UK-based syndicates to European funds.

Loss of EU passporting rights is also potentially 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. Many fund finance deals already include either a non-EU manager or fund (or both) and so fall outside the current passporting regime under AIFMD anyway, with the manager marketing in EU jurisdictions if necessary through local private placement rules. In addition, many 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 affiliate 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 to include "designated affiliate" language allowing a lender to designate an authorised affiliate to make loans in its place without a transfer of the loan commitment.

Other developments

Despite the shadow of this large Brexit-shaped elephant being cast over the market, continued growth in capital raising is expected in 2017 in Europe. This expected growth will be aided in the short term by a benign interest rate environment. 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 in which these funds operate and compete for investment/buy opportunities and accordingly demand for these facilities is also expected to continue to grow.

2017 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 a busy secondaries market and managers responding 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 €6.2bn in the first half of 2016 and €9.7bn in 2015, confirming the resurgence of activities recorded since 2012 (€5bn in 2012, €8.2bn in 2013 and €10.1bn in 2014).

The €6.2bn raised in the first half of 2016 will be invested in the economy by 55 management companies,[2] which raised these amounts through 108 vehicles.

During the first half of 2016, 49% of these amounts were raised from foreign investors (against 43% for the first-half of 2015). This proportion rose to 61% for fundraisings greater than €200m.

Olivier Millet, AFIC chairman,[3] says: "In looking at the figures of the first half of 2016, French private equity activity should be very positive in 2016. Investment, exits and fundraising figures are all at their highest levels or breaking new records. Since AFIC's goal is to double the size of the French private equity market over the medium term, we applaud the vigour of the overall sector, whose purpose is to help companies scale up in size. With half of the capital raised, coming from abroad, French private equity is demonstrating its appeal among large, global institutional investors."

This level of fundraising is now in line with the levels seen before the global recession in 2007 and 2008, with aggregate capital commitments around €10bn and an increase of fundraisings in excess of €200 million. They rose from an average of 38% in the period from 2008 to 2012 to around 60% since 2013 (71% in the first half of 2016).[4]

Regarding the type of investors in France, insurance companies and funds of funds appear over recent times to be the main players of such fundraising rebound.

Encouraged 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 its By-Laws 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 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**") 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 three 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 €350,000,000 for funds managed by Antin Infrastructure. In June 2014, PAI Partners put in place equity bridge facilities of €600,000,000 granted by Lloyds Bank for its funds PAI EUROPE VI, refinanced in September 2016 by a second equity bridge financing of €960,000,000 granted by Crédit Agricole Corporate and Investment Banking, and BNP Paribas. 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 2016 in France was over €5bn.

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, "the 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, and subject to the investors' agreement."

The management company has therefore the possibility to grant security, either by way of security *in personam* or security *in rem* over the assets of the FPCI and over the investors' undrawn commitments. In any event, investors cannot be called for an amount higher than their uncalled 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 fund.

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 the 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. 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 constitutional documents. From a tax standpoint, the SLP can benefit from the same tax regime as FPCIs and is therefore in principle exempt from French corporation tax, and its shareholders 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 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.[5] It is usually considered in France that loans with a maximum duration of one year should be considered as temporary, provided that they relate to and are fully covered by, capital 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 all investments and borrowings under the facility for such purposes. 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 special purpose vehicle's obligations under the facility agreement will benefit from: (i) a pledge over the bank account of the fund into which the investors pay the capital calls; (ii) a pledge of the 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 loan, and (b) the management company has not sent drawdown notices to such investors.

So far, we have not seen transactions where security was taken in the form of a pledge over the undrawn commitments of the investors, and 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 to the lender by the fund under the facility. 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 lender is unknown, such *stipulation pour autrui* cannot refer to the name of the lender. However, the lender can rely on the terms of the *stipulation pour autrui* notwithstanding that its 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 the lender. At the time the *stipulation pour autrui* has been accepted, 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 have obtained comfort on this due to: (i) the specific nature of the funds, dedicated to investments, which means that, in principle, the fund should not have other indebtedness and therefore, the fund should not have other competing debt creditors with respect to other outstanding 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 funds. For the avoidance of doubt, 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, we have not seen security *in rem* being granted over the undrawn commitments of the investors, either by way of pledge or transfer of ownership by way of security under the Directive 2002/47/

EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements implemented in France pursuant to articles L. 211-38 and following of the French Financial and Monetary Code. As a technical matter, we note that an assignment by way of security (*cession Dailly*) can only be granted by an SLP (and not an FPCI), since such an assignment by way of security can only be granted by an assignor which has legal personality (and an FPCI does not have legal personality). In practice and to the best of our knowledge, lenders in the French market have relied exclusively on the *stipulation pour autrui*.

A pledge or an assignment of receivables can be enforced by notification to the investor, asking it to pay the pledgee or assignee. 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 or the assignment 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).

French insolvency issues

Neither an FPCI nor an SLP can be subject to insolvency. For the FPCI, this is due to the fact that it does not have legal personality, since it is a co-ownership of assets. For the SLP, the French Monetary and Financial Code has specifically provided that the French insolvency regime does not apply to SLPs.[6] Therefore, there are no restrictions on enforcement due to insolvency.

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 from 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/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*.

Since the French insolvency regime does not apply to French funds, the enforcement regime 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".

Key developments

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 fully funded loan receivables (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.

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 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;[7]
- the loans should have a shorter maturity than the fund's own life,[8] to prevent any maturity transformation;
- the management company must be licensed by the French Financial Market Authority in accordance with the AIFMD and have a programme of operations that allows for the possibility to grant loans.[9] 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 grant loans; and
- the management company must report quarterly to the French Financial Market Authority on all the loans its AIFs have granted.[10]

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.

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 with 20% in the US, according to figures from ICG, an alternative asset manager. It opens the banking monopoly in France, which is very restrictive.[11]

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 now used mainly by upper-mid or large cap funds, whether positioned in the infrastructure or in the private equity sector, and we think that it will gradually expand to smaller funds, encouraged by the competition between banks and the pressure on interest rates.

* * *

Endnotes

1. These data are based on a report entitled "*activité des acteurs français du capital-investissement 1er semestre 2016*" from the AFIC which can be accessed at: http://www.afic.asso.fr/fr/Etudes-Statistiques/Les-statistiques-du-capital-investissement/Activite.html.
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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 2016 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 £247 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 have been introduced to the market in 2016 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).

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).

<u>The typical security package</u>

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:

1. the ability of the LP to incur indebtedness and enter into the transaction;
2. 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
3. that Uncalled Capital may be applied (when called) towards the secured obligations.

<u>Service of notice in respect of security over Capital Call Rights</u>

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).

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 from 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. 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.

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 now 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 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.

<u>Manager Led Product (MLP)</u>

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 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.

<u>Private Investment Fund (PIF)</u>

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

2016 has proved that any attempt to make accurate predictions about market developments is fraught with difficulty. Political developments both in the UK and in the US have yet to play out and it remains to be seen what effect they will have in the medium to long term.

The implications of Brexit are likely to be wide reaching; the UK's present government has made clear its preference for "hard" Brexit and a clean break from the EU. It remains to be seen how the markets both in Guernsey and further afield will react to the forthcoming changes in the regulatory landscape. This is an area which will need to continue to be carefully monitored.

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 2017.

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Overview

From 2001 to 2015, venture capital and private equity investors have invested close to US$ 103bn across 3,100 companies and 12 sectors in India. A significant portion of these investments have been made by global fund managers operating India-focused offshore funds, global fund managers operating in India and Indian fund managers operating offshore funds, investing in the form of foreign direct investment (FDI)[1]. While from 2010 to 2015, venture capital (VC) / private equity (PE) investment doubled to US$ 21bn, in 2016, as of 28th September, investments were up to US$ 12bn. Venture capital investments played a major role in the first nine months of 2016 and supported the growth of start-ups at various stages of their lifecycle. With markets showing positive growth and performance through the year, 2016 was an active year for fund financing in India.

The fundraising and investment environment in India has resulted in a spurt in the efforts being made by Indian regulators and Government alike, to reform foreign exchange laws, laws relating to investments in India, and also as regards taxation to facilitate entry and exit of investors into India. These changes can broadly be classified across three key segments – foreign exchange, securities and taxation.

In terms of foreign exchange laws, the valuation of the company and accordingly, the methodology by which the pricing of shares is being done, have been relaxed from a specific discounted cash flow method to any internationally accepted pricing methodology. Foreign investments into India are subject to specific caps imposed by the Government, based on the sector of investment. In the past year, the Government has been consciously liberalising the applicability and thresholds of these caps across sectors.

The Indian regulators and the government are being proactive in trying to establish a regulatory and tax-efficient climate that is conducive for raising funds from foreign investors. This includes the amendments recently made to the Indo-Mauritius and Indo-Cyprus Double Taxation Avoidance Treaties, along with the removal of Cyprus as a notified jurisdictional area[2].

The securities market regulator in India is the Securities and Exchange Board of India (SEBI). SEBI had constituted a committee – the Alternative Investment Policy Advisory Committee (AIPAC), under the chairmanship of Mr. N.R. Narayana Murthy[3] – in 2015, in order to understand market conditions and develop and increase alternate investment funds (AIFs) in India. The AIF set-up was introduced as a regulation in India in 2012. Since its inception, 253 AIFs have been set up with a total capital commitment of INR 500bn[4]. Reports also suggest that AIFs, as of September 2016, have invested nearly INR 250bn in the Indian markets. Given that AIFs are regulated by SEBI, the AIPAC, in its report, highlighted restrictions in law and relaxations that can be made, or even otherwise generic process-oriented changes from the context of a developing market, to achieve this development. The 2016 annual budget tabled by the Finance Minister adopted certain recommendations of the AIPAC which have been implemented in the last year. The AIPAC has come out with a second report in November 2016 recommending further changes to improve the AIF-linked environment in India.

A positive shift of the regulatory framework in which an investment fund operates requires strict attention to fund documentation and intelligent planning. Fund documentation is crucial to protect the fund managers from limiting their exposures from legal, tax, compliance and regulatory risks. The selection of fund vehicles requires meticulous planning in order to meet the objectives of the key investors and focuses of the fund. In India, a fund can be incorporated in various forms such as trusts, limited liability partnerships, companies, etc. The most popular form of AIF is the trust form, primarily due to the tax benefits available to trusts in India. Having said that, adequate disclosures in the fund documentation are critical for the fund to attract investments from offshore investors, being the potential limited/ general partners (LP/GP). The AIPAC committee reports have extensively deliberated on the nature and extent of disclosures required to be made under the "*private placement memorandum*", which is usually circulated to LPs/GPs for consideration and investment into the AIF. The idea is to bring these disclosures in line with global standards so as to ease investments into India.

Fund formation and finance

Traditional funding sources in India, such as banks and non-bank financial companies, are constrained by risk-aversion, which limits their ability to supply risk capital. Hence, there is a vital need to explore and unlock other domestic pools of capital. The nature of these pools is such that they are well-suited to assuming the risks and rewards of venture capital and private equity at all stages of the entrepreneurial life-cycle. India, as a jurisdiction, is presently dominated by offshore investors / funds putting monies into the country, thereby acting as a catalyst for the country's current growth trajectory. Domestic investors such as banks, insurance companies and high-net-worth individuals have also now commenced creating AIFs and investing monies across sectors. The Government of India itself has set up a fund of funds through the Small Industries Development Bank of India (SIDBI). SIDBI focuses on micro, small and medium-scale enterprises (MSME) in India and has so far set up nearly 88 venture capital funds (VCF), which have invested approximately INR 5,600 crores into about 472 MSMEs[5]. The AIPAC report has recommended unlocking domestic capital pools for providing fund managers an access to domestic pools. In India, a mere 10–15% of equity capital required by start-ups, medium enterprises and large companies is funded from domestic sources. The remaining 85 to 90% is sourced from overseas. This is in contrast to the U.S. and China, where domestic sources fund 90% and 50% respectively, of the venture capital and private equity needs of enterprises[6].

Before the introduction of funds in India, the market mostly saw private placements, IPOs and lending from financial institutions for raising capital. These did not prove an optimal means of raising funds. The introduction of funds in the Indian markets through VCFs and AIFs (including the various varieties within the AIFs) have allowed entrepreneurs to successfully fill the gap between the capital requirements of fast-growing companies such as start-ups, and funding available from traditional sources such as banks, public offerings, etc. Further, this has also provided for risk-adjudicated returns to investors, thereby improving the quality in the capital markets in India. The development of VCFs and AIFs has made the Government realise its potential, and the growth of different sectors such as the internet, technology, etc. AIFs have been classified as Category I AIFs, Category II AIFs and Category III AIFs. An AIF can be established as a trust, a company, an LLP or a body corporate.

- Cat I AIFs are funds which target investment in start-ups or early-stage social ventures or infrastructure, or sectors which the government considers socially or economically viable. Funds such as SME funds, angel funds, venture capital funds, infrastructure funds, etc. are registered with the SEBI as Cat I AIFs.
- Cat II AIFs are funds which are neither registered as Cat I AIFs nor as Cat III AIFs.
- Cat III AIFs are funds which employ diverse or complex trading strategies and may employ leverage, including through investment in listed or unlisted derivatives.

All AIFs can raise funds from Indian or foreign investors or even non-resident Indians issuing units of the AIF to the investors. Every scheme by an AIF is required to have a minimum corpus of INR 250m, with each investor contributing at least INR 10m (subject to certain exemptions in case of managers and sponsors of an AIF). AIFs are permitted to raise monies only through private placement and accordingly, have to make substantial disclosures to their investors.

There are investment restrictions and conditions for all categories of AIFs. Cat I and Cat II AIFs can borrow funds, directly or indirectly or engage in leverage, only to meet temporary funding requirements which do not exceed 30 days. These borrowings cannot be made on more than four occasions in a year, with a cap on borrowing of 10% of the investible funds for the Cat I AIF and 20% of the investible funds for a Cat II AIF. Cat II AIFs are additionally permitted to undertake leverage or borrowings to meet their operational costs. In contrast, Cat III AIFs are permitted to leverage or borrow monies, subject to certain disclosures, consent from the investors of the funds and a specified limit as provided by SEBI.

From 2015, AIFs have been permitted to invest in equity and equity-linked instruments of offshore Venture Capital Undertakings (VCUs), subject to certain conditions mentioned in this circular such as an overall aggregate limit of US$ 500m for all AIFs and VCFs registered under the SEBI (Venture Capital Funds) Regulations, 1996 and the guidelines stipulated by the Reserve Bank of India (RBI) in this respect. Investments would be made only in those companies which have an Indian connection (i.e. company which has a front office overseas, while back office operations are in India) and such investments would be up to 25% of the investible funds of the AIF. The allocation of investment limits would be done on a 'first come, first served' basis, depending on availability in the overall limit of US$ 500m. In case an AIF fails to make the allocated investment within a period of six months from the date of approval, SEBI retains the discretion to allocate such unutilised limits to other applicants.

Fund financing, in terms of attracting investors into India, has been fairly good. Given the global scenarios and specifically, when compared to the remaining BRICS economies, India has been considered a favoured destination for investments. Accordingly, there has been a varied investor appetite, and across sectors. The investors (i.e. LPs/GPs) range from pension funds, with the Canada Pension Plan Investment Board (CPPIB) being one of the leaders amongst them, to hedge funds, and other multi-national private equity funds setting up multiple India-focused funds for investments.

In order for a fund to function efficiently and achieve its ultimate goal of providing returns to its investors, a waterfall mechanism is mandatory. Typically, waterfall involves a return of capital contribution, a preferred return, a GP catch-up and a splitting of the residual proceeds between the LPs and the GP. A number of innovations to the distribution mechanism have evolved to improve fundraising opportunities by differentiating product offerings from one another. Further, distribution of carried interest has been structured on a split basis such that the allocation of carry is proportionate to the returns achieved by the fund. Waterfalls have been structured to facilitate risk diversification by allowing LPs to commit capital both on a deal-to-deal basis as well as on a blind pool basis. In fact, to ease the fund management aspects from an Indian context, SEBI has, as recently as 2nd January 2017, announced a framework for registration of fund managers for overseas funds. This was previously an issue due to tax implications on providing cross-border advice. SEBI has also exempted compliance for such fund managers from specific aspects governing portfolio management in India.

Several kinds of leverage/financing structures are presently 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 Indian assets to repay the LPs, or even for dividend distribution to the LPs.

In India the tax regime follows a source-based taxation on capital gains, and taxes thereon may not be creditable in the home jurisdiction of the offshore investors. Offshore investors are generally pooled in jurisdictions which have a Bilateral Investment Promotion and Protection Agreement (BIPPA) with India, with several reliefs to investors, including fair and equitable treatment, protection against expropriation, reparability of capital, an efficient dispute resolution framework and other rights and reliefs. Further, fund structures based in India with foreign participation which are not Indian managed and sponsored may require regulatory approvals, compliance with pricing norms and may be subject to performance conditions in certain sectors[7].

As regards a domestic fund structure, i.e. an AIF registered with SEBI does not get taxed on any income that is earned from the investment. The income is taxed at the hands of the investor when the fund distributes the income to the investors. If the distributions were to be received in the form of dividend or interest from offshore fund structure, then the investor would have to declare the distribution as income and therefore the same is likely to be taxed in India at the time of receipt.

To add a context on foreign investments into India and the regulations governing them from the context of investments by offshore private equity funds – this is monitored by the RBI, the Foreign Investment Promotion Board (FIPB) and the Department of Industrial Policy and Promotion (DIPP) and Securities and Exchange Board of India (SEBI). The Foreign Exchange Management Act, 1999 (FEMA), and in particular, the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000 (TISPRO Regulations) regulate foreign investment into India.

FDI[8] in India may be made either directly, as a Foreign Venture Capital Investment[9] or as a Foreign Portfolio Investor (FPI)[10]. FDI into Indian companies can be broadly classified in the following manner:

(a) Automatic Route; and

(b) Government Approval Route.

There are certain sectors in which FDI is prohibited – these include lottery business, gambling and betting, including casinos, chit funds, real estate business or construction of farmhouses and even trading in transferable development rights.

FDI into Indian companies may be through direct or indirect means and the FDI regime applies to both direct and indirect foreign investments into an Indian company. FEMA regulates all inbound and outbound foreign exchange-related transactions, in effect regulating the capital inflows coming into the country and moving out of the country. If the percentage of equity holding by non-residents is within certain industry-specific thresholds (sectoral caps) then FDI, generally, does not require prior government approval. Downstream investment essentially deals with an FDI entity, making investments into a step-down entity. The manner of these investments is also regulated under the FDI policy.

SEBI introduced the SEBI (Foreign Venture Capital Investors) Regulations, 2000 (FVCI Regulations) to encourage foreign investment into venture capital undertakings. The FVCI Regulations make it mandatory for an offshore fund to register itself with SEBI if such fund intends to avail of benefits under the FVCI regime. The benefits of FVCI are free pricing, instruments such as optionally convertible redeemable preference shares, optionally convertible debentures, etc. which otherwise are not permitted under FDI or the FPI route. FDI is permitted for equity shares, compulsorily convertible debentures and compulsorily convertible preference shares. Further FVCIs which are registered with SEBI are given qualified institutional buyer ("**QIB**") status and are eligible to subscribe to securities at an IPO through the book building route.

As regards FPIs, similar to AIFs, there are three categories of FPIs – Cat I FPIs, Cat II FPIs and Cat III FPIs.

- Cat I FPIs, *inter alia*, include Government and Government-related investors such as central banks, governmental agencies, sovereign wealth funds, international or multilateral organisations or agencies.
- Cat II FPIs include appropriately regulated broad-based funds, persons such as banks, asset management companies, investment managers and advisers, portfolio managers, university funds and pension funds, etc.
- Cat III FPIs are those FPIs which are not covered in Cat I or Cat II FPIs such as charitable societies and trusts, and foundations, trusts, individuals, family offices, corporate bodies, etc.

Analogous to AIFs, FPIs also do have certain investment conditions and restrictions. FPIs are presently, commonly used for subscribing to security receipts in India given the quantum of stressed assets in the country and urgent need to address them.

Key developments

Amongst the most recent and key developments in the sector has been the submission of the second report of the AIPAC. The report takes into account trends in the industry and, keeping in mind the earlier amendments considered and made to the regulations, and to ease investments and returns, has suggested further reforms in the AIF space. Some of the key reforms are broadly categorised in the following segments:

(a) Disclosures by AIFs: The AIPAC suggests heightened disclosures from AIFs that raise capital from retail investors with ticket sizes of less than INR 100m per investor. These disclosures include: the organisation of the AIF and its decision-making process; track records regarding returns from previous funds; manner of computation of returns;

investment strategy and investment objectives of the funds; key terms for the fund; valuation; investee due diligence and documentation to be followed within the fund; process for transfer of units to facilitate exit of investors during the life of the fund; and dealing with liquidity issues within the fund. The AIPAC also suggests that quarterly reports be submitted to the AIF investors which can provide for the financial statements of the fund, coupled with period-end schedule of the investments and the partners' capital account statement.

(b) Better governance of the AIFs and collating performance to date: In this context, the recommendation is to set up an Investor Advisory Committee which can address issues regarding conflicts of interest and include those arising during the life of the fund and at its closure. As regards the performance date, the AIPAC recommends the creation of a central database for benchmarking purposes. The central database will create reports on the performance of the funds on an aggregate basis using the information already being provided annually by the AIFs to SEBI.

(c) Tax reforms: While the negotiation of some of the DTAAs has provided some clarity on taxation along with the implementation of the earlier recommendations made under the 1st report of the AIPAC to the Government, there is still a lot to be desired. Under their 2nd report, the AIPAC recommends that gains from transfer of unlisted shares held by AIFs be treated as capital gains, irrespective of whether there is a change in control or management. Presently, there is ambiguity on whether these can be treated as business income as well as extending pass-through taxation to Cat III AIFs, as has already been done for Cat I and Cat II AIFs. This will ensure that the tax payable will be in the hands of the investors of the fund and not the funds themselves. The AIPAC also considers the introduction of a "securities transaction tax" on the AIF such that the monies returned to investors is tax-exempt.

(d) An interesting reform proposed is regarding the creation of permanent capital vehicles specifically for the MSME segment in India. The MSME segment contributes significantly towards India's manufacturing outputs and labour force. Given the challenges faced by MSMEs in raising capital through traditional means (e.g. bank finance), the committee has suggested the formation of these permanent capital vehicles so as to ensure sources of funding for the MSME segment.

(e) Another compelling reform is the participation of Cat III AIFs for anchoring initial public offerings (IPOs) irrespective of whether the lead manager of the IPO is a group company. In addition, AIFs can be allocated a specific percentage weightage for subscription in an IPO – within the IPO allocation or outside. This is primarily to provide AIFs with an equal footing with mutual funds in India and to boost investment sentiments in the primary markets at the time of an IPO. In the context of Cat III AIFs, they are not permitted to invest more than 10% of their investible funds in a single investee company. Interestingly, this 10% threshold is linked to the "investible funds", which essentially is the corpus of the fund less its operational expenses. Having this 10% threshold linked to the market value of the fund at the time of making the investment will provide the fund with more flexibility in terms of making such investments.

In addition to the above, SEBI has recently liberalised the regulations dealing with angel funds. The number of investors in an angel fund has now been increased from 49 to 200, and the minimum investment amount by the angel fund in any VCU has been halved from INR 5m to INR 2.5m. Angel funds are now permitted to invest in start-ups which have been incorporated in the preceding five years (as opposed to the earlier timeline of three years) and their investments will be subject to a lock-in of only one year, which has also been reduced from three years. Further, subject to additional guidelines to be issued by the RBI in this regard, angel funds are permitted to invest in securities of companies incorporated outside India. The RBI had issued a consultation paper in respect of the above; however, final norms are yet to be issued by them.

As far as jurisdiction goes, the past year has seen the renegotiation and conclusion of the Mauritius[11], Cyprus DTAAs along with some scrutiny of DTAAs with other jurisdictions. India has a BIPPA with Mauritius as a result of which Mauritius has become a more viable destination for setting up funds. The market has seen some hesitation in accepting the changes; however, this mostly is seen as a welcome move, whereby there is an ease of tax rates in India and also benefits with respect to interest income.

India will now have a source-based right to tax capital gains which arise from alienation of shares of an Indian resident company acquired by a Mauritian/Cypriot tax resident (as opposed to the previous residence-based tax regime under the treaty). For Mauritius, all existing investments up to 31st March 2017 have been grandfathered (second layer) and exits/shares transfers in respect of such investments beyond this date will not be subject to capital gains tax in India. Additionally, the Protocol introduces a limitation of benefits provision, for both Mauritius and Cyprus, which will be advantageous to the funds located in each of these jurisdictions.

The year ahead

A robust governance structure is important for a pooled investment vehicle. The genesis of this obligation (other than as may be required under applicable laws) is in the generally accepted fiduciary responsibilities of managers with respect to the investor's money. An investment manager is actively involved with all the activities of the fund including investment- and divestment-related decisions. There is an active fiduciary responsibility to be considered by the fund directors. The jurisprudence has started to emerge that the threshold for fiduciary responsibility of fund managers and fund directors in Indian markets now makes it important that they are responsible for the situations that the funds are in.

In the year ahead, we anticipate further changes to the regulatory landscape in terms of fund management in India. We expect that the recommendations made by the AIPAC will be taken up by the finance ministry during the upcoming budget session, and it is possible that funds may see further easing of regulations and taxation. Investments in India are on an upward trend and given the market scenarios, this is likely to continue to be so. The impetus given by the Government on the infrastructure, digital and start-up space, in our view, is likely to continue for 2017. We also suppose that the stressed assets situation in India will improve if there are enough funds invested in turning them around – set-up of these turnaround funds seems to have been the flavour of 2016, and investments from these funds are likely to take place through 2017.

* * *

Endnotes

1. http://www.sebi.gov.in/cms/sebi_data/attachdocs/1480591844782.pdf.
2. A notified jurisdictional area, in the context of taxation, refers to the blacklisting of a country, i.e. all payments made to such a country would attract a withholding tax of

30%. In addition, all Indian entities receiving monies from such a country, are required to disclose the source of funds.

3. Mr. N.R. Narayana Murthy is the Co-founder and Chairman Emeritus of Infosys Limited.
4. http://www.sebi.gov.in/cms/sebi_data/attachdocs/1480591844782.pdf.
5. http://venturefund.sidbi.in/Fund.php.
6. http://www.sebi.gov.in/cms/sebi_data/attachdocs/1453278327759.pdf.
7. Any downstream investment by an AIF (which receives foreign contributions) will be regarded as foreign investment if the Sponsor and the Investment Manager of the AIF are not Indian 'owned and controlled'. The ownership and control is determined in accordance with the extant FDI Policy.
8. This refers to investments by way of subscription and/or purchase of securities of an Indian company by a non-resident investor. While the RBI allows capital account transactions, these are subject to the TISPRO Regulations issued by the RBI. Thus, 'direct' investments by the offshore fund vehicles/special purpose vehicle (SPV) would need to comply with the provisions and restrictions stipulated under the TISPRO Regulations.
9. The FVCI regime has been developed to attract venture capitalists, therefore there are certain incentives attached to being recognised as one. This accordingly requires registration and approval from the regulators such as SEBI and RBI. While granting approval to an FVCI, certain restrictions and conditions may be imposed including a restriction on the scope of investments that can be made by the FVCI. Initially, RBI had been prescribing in its approval letter to FVCI applicants that the investments by FVCI entities are restricted to select identified sectors such as infrastructure and IT related to hardware and software development. However, RBI has recently relaxed such sectoral restrictions for investing FVCIs into "startups'. <u>It is also important to note that SEBI-registered FVCIs are specifically exempted from the RBI pricing guidelines</u>.
10. FPI Regulations which repeal the Foreign Institutional Investor Regulations significantly revises the regulation of foreign portfolio investments into India. Under the FPI regime, SEBI has harmonised the FII, sub-account and QFI regimes into a single investor class – foreign portfolio investors – and provided a single window clearance through designated depository participants. The FPI Regulations classify FPIs into three categories based on their perceived risk profile. The FPI route as such is the preferred route for foreign investors who want to make portfolio investments and trade in Indian listed stocks on the floor of the stock exchange.
11. Effective from 1st April 2017.

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Ireland

Kevin Lynch, Kevin Murphy and David O'Shea
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Overview of the Irish funds industry

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 July 2016 there were 6,284 Irish domiciled funds with net assets of over €1.9trn. While the majority of these fund assets are held in UCITS funds[1], Irish-domiciled AIFs[2] had in excess of €460bn in net assets as of July 2016 (representing significant growth in the size of alternative investment funds since the introduction of AIFMD in 2013). The majority of the investment in these regulated investment funds comes from non-Irish institutional investors.

General introduction to the 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.

Common fund structures

Ireland as a domicile provides a variety of potential fund structures, which can be broadly categorised as regulated by the Central Bank or unregulated.

(i) Regulated structures

There are four main types of regulated fund structure in Ireland (as described below): (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 pursuant to the European Communities (Undertakings for Collective Investment in Transferable Securities) Regulations, 2011, as amended (the "UCITS Regulations" [3]) or as an alternative investment fund ("AIF") pursuant to the EU (Alternative Investment Fund Managers) Regulations 2013 (the "AIFMD Regulations")[4]. 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").

- *Investment Companies*

  An Investment Company is established as a public limited company under the Irish Companies Acts. They have a separate legal identity and there is no recourse to the shareholders. There is a requirement to spread risk if the fund is established as an Investment Company. It is typically the board of directors of the Investment Company who will have to approve any decision to borrow, grant security or enter into derivatives, although it will be important in each case to review the Investment Company's constitutional documents including its memorandum and articles of association, prospectus and/or supplement thereto and any management agreements that have the authority to execute the necessary agreements.

- *ICAVs*

  The ICAV is an Irish corporate investment fund which was introduced in 2015 to meet the needs of the global funds industry, pursuant to the Irish Collective Asset Management Act 2015 (the "ICAV Act"). Since its creation, the ICAV has replaced the Investment Company as the most commonly used structure for newly established funds in Ireland. One of the main advantages of the ICAV is that it may be eligible to elect to be treated as a transparent entity for the US federal income tax proposes by "checking the box". This would allow US taxable investors to avoid certain adverse US tax consequences that would normally apply to "passive foreign investment companies". Most Irish funds have historically been authorised as Investment Companies and, as such, are required to comply with many of the rules applicable to Irish companies which may not be relevant or appropriate to an investment fund. The ICAV is a bespoke corporate structure that is specifically designed to give more administrative flexibility than an Investment Company. For example, the ICAV may:

  - amend its constitutional documents without shareholder approval in respect of changes that do not prejudice the interest of shareholders and do not come within certain categories of changes specified by the Central Bank;
  - prepare separate financial statements for sub-funds;
  - issue debenture stock, bonds and any other securities; and
  - allow directors to dispense with the holding of an AGM by giving written notice to all shareholders.

  UCITS and AIFs established in Ireland can convert into an ICAV subject to compliance with the conversion process specified by the Central Bank. However, it is not possible to use the ICAV conversion procedure in respect of an existing UCITS or AIF unit trust, investment limited partnership or common contractual fund. Importantly, it does not affect the legal existence of the fund or any pre-conversion rights or obligations. The ICAV Act contains a mechanism for existing corporate collective investment schemes established in the Cayman Islands, the British Virgin Islands, Bermuda, Jersey, Guernsey and the Isle of Man to migrate or redomicile to Ireland as an ICAV by operation of law. The migration process is the same as the fund redomiciliation process that was introduced in Ireland in 2009, pursuant to which non-Irish funds can move to Ireland and become subject to Ireland's regulatory regime for investment funds. The main difference with the ICAV migration process is that the application for migration is made solely to the Central Bank and not to the Irish Registrar of Companies. The analysis in relation to who has authority to contract e.g. borrow, grant security, enter into derivatives, for an ICAV are the same as for an Investment Company.

- *Unit Trusts*

  Unlike an Investment Company, a Unit Trust is not a separate legal entity but rather a contractual fund structure constituted by a trust deed between a trustee and a management company. In a Unit Trust, the trustee or its appointed nominee acts as legal owner of the fund's assets. As the Unit Trust does not have a separate legal personality, it cannot contract for itself. Managerial authority is exercised by the directors of the management company which, in the context of an AIF, may also perform the role of the so-called alternative investment fund manager (or "AIFM"). While in many cases it is the directors of the management company who execute contracts, the trust deed and other relevant documents such as the management agreement should be carefully reviewed to confirm who has signing authority. For example, if assets are registered in the name of the trustee, the trustee will need to execute security over the assets of the Unit Trust and in some Unit Trusts, the trust deed may, for example, require joint execution by the trustee and the management company.

- *CCFs*

  A CCF, similar to a Unit Trust and investment limited partnership, does not have a separate legal existence. It is a contractual arrangement established under a deed of constitution, giving investors the rights of co-owners of the assets of the CCF. As co-owners, each investor in a CCF is deemed to hold an undivided co-ownership interest in the assets of the CCF as a tenant in common with other investors. A CCF may be treated as transparent for tax purposes, which is a key distinguishing feature from other types of Irish fund structures.

- *Investment Limited Partnership ("ILP")*

  An ILP is established pursuant to the Investment Limited Partnership Act 1994. An ILP is a partnership between one or more general partners and one or more limited partners and is constituted by a partnership agreement. As with a Unit Trust, an ILP does not have an independent legal existence. It has one or more limited partners (which are similar to shareholders in an Investment Company or ICAV, or a unitholder in a Unit Trust) and a general partner who can enter into contracts on behalf of the ILP, which would include any loan agreement or security document. It is proposed to introduce a number of changes to the ILP structure, which should make the ILP more broadly appealing to promoters of venture capital, and private equity funds in particular.

(ii) Unregulated structures

- *Limited partnerships*

  The limited partnership established pursuant to the Limited Partnership Act, 1907 is the favoured structure for unregulated investment funds in Ireland.

  A limited partnership is a partnership between one or more general partners and one or more limited partners, and is constituted by a partnership agreement. To have the benefit of limited liability, the limited partners are not permitted to engage in the management of the business of the partnership or to contractually bind the partnership – these functions are carried out by the general partner.

There is a general limit of 20 partners in a limited partnership, although this limit can be raised to 50 where the limited partnership is formed 'for the purpose of, and whose main business consists of, the provision of investment and loan finance and ancillary facilities and services to persons engaged in industrial or commercial activities'.[5] The analysis in relation to who has authority to contract, e.g. borrow, grant security or enter into derivatives for an unregulated limited partnership, is similar to that for an ILP.

Regulation of Irish funds

Investment funds in Ireland can be established as either UCITS or AIFs.

<u>UCITS</u>

UCITS were first introduced in 1985 in the European Union with the introduction of the UCITS Directive[6]. Although UCITS are regulated retail investment product, subject to various liquidity constraints, investment restrictions (both in terms of permitted investments and required diversification), borrowing and leverage limits, nevertheless UCITS are predominantly held by institutional investors and are firmly established as a global investment fund product (being widely distributed both inside and outside of the EU). Irish UCITS may avail of the UCITS passport regime which allows for UCITS to be marketed publicly across the EU subject to limited registration requirements.

<u>AIFs</u>

AIFs are defined under AIFMD as "any collective investment undertaking [...] which raises capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors", and that does not require an authorisation under the UCITS Directive. Therefore, all non-UCITS funds may be considered AIFs.

Irish AIFs are established pursuant to the AIFMD Regulations which implement AIFMD in Ireland. AIFMD regulates both EU AIFMs who manage AIFs in the EU and Non-EU AIFMs that manage AIFs in the EU or market AIFs in the EU. The main types of AIFs in Ireland are Qualifying Investor Alternative Investment Funds ("QIAIFs") and Retail Investor Alternative Investment Funds ("RIAIFs"). AIFs must also comply with the rules set out in the Central Bank's AIF Rulebook. QIAIFs can be marketed to professional investors and there is a minimum subscription requirement of €100,000 (which may be disapplied in respect of certain categories of investor). They can avail of the right to market across the EU using the AIFMD passport. A QIAIF can be managed by an EU or non-EU AIFM and can also be internally managed (see below). A QIAIF is not subject to any investment or borrowing limit but it is obliged to spread risk if established as an Investment Company.

The RIAIF replaces the previous retail non-UCITS regime and has no minimum subscription requirement, but there is a restriction on it borrowing more than 25% of its net assets. As the RIAIF is a retail fund it cannot use the AIFMD passport which is available to QIAIFs marketing to professional investors. Unlike a QIAIF, RIAIFs cannot be managed by a non-EU AIFM.

AIFs are required to appoint an AIFM which can be either an external manager of the AIF or, where the legal form of the AIF permits, such as in the case of an Investment Company or ICAV, and the AIF chooses not to appoint an external AIFM, the AIF itself.

Recent developments

Loan origination funds

The Central Bank's rules for loan origination funds are set forth in a dedicated chapter of the Central Bank's AIF Rulebook on loan origination QIAIFs ("LO-QIAIF") which represents the first dedicated regulatory regime in the EU for loan origination funds. AIFMs that meet the additional 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 additional conditions applicable to LO-QIAIFs include the requirement that the LO-QIAIF:

- be closed-ended;
- must not have gross assets of more than 200% of its net asset value;
- 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;
- does not lend to certain categories of borrower; and
- 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.

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). The ELTIF is a new type of regulated investment fund that invests in long-term investment opportunities and may be marketed to both professional and retail investors across the EU. ELTIFs have 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. An ELTIF must be an EU AIF and must be authorised by the regulator in its home jurisdiction (the Central Bank having been designated as the competent authority in Ireland). Further, an ELTIF may only be managed by an EU AIFM. ELTIF managers will therefore be required to comply with the requirements under AIFMD as well as the ELTIF Regulations. The ability to market an ELTIF on a passported basis to retail investors across the EU is a significant advantage over other types of AIFs. However, as the ELTIF is subject to significant limitations in terms of the types of assets that it may invest in and the diversification limits that apply, it remains to be seen whether, from a marketing perspective, the potential benefits are considered by promoters to be worth the additional investment constraints and compliance burdens.

Fund financing and security

Overview

Lending to Irish funds is typically structured as either a bilateral or syndicated facility, a note issuance agreement whereby the issuer (the fund) issues a note in favour of the note holder or a derivative contract, typically documented through an ISDA Master Agreement. Lending by AIFs is restricted although (as discussed above) it is possible to establish an AIF which is focused on loan origination, including investing in loans. In the last number of years capital call, subscription and equity bridge facilities have become much more commonplace. Irish fund structures, particularly Investment Companies, ICAVs and ILPs, are also commonly used as property investment vehicles.

The lenders and governing law

At present the majority of deals in the Irish market are being financed by international financial institutions. Reflecting the international nature of the financiers, the relevant loan agreements for such transactions are commonly governed by the laws of New York or England and Wales, although there is no legal reason why they could not be governed by Irish law. The terms of the loan agreement will very much depend on the type of facility being advanced.

While many lenders in Irish fund financings hold a bank licence or have “passport” rights to lend into Ireland, it should be assessed on a case-by-case basis whether a bank licence or passporting rights are required on a particular transaction, particularly where the relevant lender(s) do not have either a banking licence or passporting rights and the transaction involves “banking business” as a matter of Irish law.

Security package

A key consideration in every fund financing is the security package. This will vary depending on the type of financing involved. For example, on many financings, the security package will consist of a fixed charge over the funds rights, title and interest in and to the securities and/or cash account recorded in the books and records of the Depositary (or Trustee in the case of a Unit Trust, as such any references hereafter to a Depositary should be read to include Trustee in the context of a Unit Trust) and an assignment of the funds rights in the Depositary Agreement (or Trust Deed, in the case of a Unit Trust). Such a security package is also commonly coupled with a control agreement which will give the lender or its security agent control over relevant rights or assets either on a “day-one” or more commonly “springing lien” basis on the occurrence of a future enforcement event.

A properly drafted and structured Irish law security document should also be able to obtain the benefits of being considered a “financial collateral arrangement” pursuant to the European Communities (Financial Collateral Arrangements) Regulations 2010 (as amended). Relevant bank mandates should be reviewed and where necessary amended to be consistent with the terms of the control agreement. It is very important in this context to also verify where the account is located, and whose name the account is opened in. In many cases the account holder may be a Depositary or sub-custodian, and the cash account for an Irish fund may not be located in Ireland, particularly where cash is held by a sub-custodian. Equally in structures where the connection with Ireland is only that the Depositary is Irish incorporated, it is not uncommon that one or more cash accounts may also be held by sub-custodians outside Ireland.

As with any financing, there is no “one size fits all”. In this regard, the typical security package for a capital call/subscription facility is quite different, commonly consisting of security over the right to call on investors for further contributions, security over the account into which such subscriptions monies are lodged, and coupled with a robust power of attorney either prepared on a stand-alone basis or forming part of the relevant security document. The fund’s constitutional documents, prospectus, as well as the administrative services agreement and the subscription agreement, need to be carefully reviewed to verify who actually makes the subscription call; for example, in the context of a corporate fund such as an Investment Company or ICAV, most commonly it is the directors of the fund that make the call, but sometimes the constitutional documents also give the manager (where the corporate fund is externally managed) the power to make the call. The Administrator also plays an important role in processing subscriptions, and recording and registering the subscriptions. Depending on the extent of the role performed by the Administrator, consideration could be given to taking specific security over the rights of the fund in and to the administrative services agreement, which would afford the lender "step-in" rights *vis-à-vis* the Administrator in any further enforcement. However, in practice we do not see this, and more usually a side letter addressed to the Lender/Agent is obtained from the Administrator in relation to the performance of their duties under the administrative services agreement.

Over the last number of years we have also seen a steady growth in financings involving Feeder Fund structures. From an Irish law regulatory perspective, this can require careful structuring of the security package. One of the issues which requires consideration in this regard is that an Irish regulated fund cannot give "guarantees" to support the obligations of a third party (which may include another sub-fund within the same umbrella fund structure). Unfortunately, the term "guarantees" is not defined and it would be prudent to take it that this term also captures "security" to support the obligations of a third party. In Feeder Fund structures where, for example, the Feeder Fund is the borrower and the Master Fund is an Irish fund and expected to guarantee the obligations of the Feeder Fund, the rule against giving third party guarantees is very relevant and the structure and security package will need to be carefully considered and tailored to ensure that this rule is not infringed. The use of "cascading pledges" can also, depending on the structure, be a useful tool in the security package.

Governing law of security package

Irish law does not strictly require that the security package be governed by Irish law. We commonly see transactions where security is taken under the laws governing the relevant financing agreement, e.g. New York or England & Wales law. However, where the relevant secured assets are in Ireland, e.g. the securities or cash account or, for a subscription call deal, the governing law of the subscription agreement is Irish law, we would always also take Irish law-governed security. Typically, any control agreement would be governed by the laws of the country where the account is located, however, if this not the case, local law guidance and preferably a legal opinion should be obtained to ensure that the use of a different governing law will be enforceable in the relevant jurisdiction.

Security agent

As a common law jurisdiction, there is no issue as a matter of Irish law with security being granted in favour of a security agent or security trustee and, subject to the bank licensing considerations referred to previously, it is not necessary under Irish law for the security agent to be licensed in Ireland to enforce its rights. A point to note in relation to the enforcement of Irish security is that on enforcement typically it is a receiver appointed by the lender/security agent who will be appointed over the secured assets and realise same on behalf of the secured parties. One advantage of this from a lender/security agent perspective is that the Irish security document will contractually provide that the receiver is the agent of the borrower rather than the lender(s)/security agent, thereby insulating the lender/security agent from potential claims arising from the actions of the receiver as part of any enforcement.

Consents and stamp duty

No Irish governmental consent or stamp duty is generally required/payable in connection with the execution of security in fund financing. However, where a security assignment is being taken over, the funds rights in and to the depositary agreement, the depositary agreement should be carefully reviewed to check that the prior consent of the Depositary and/or the Central Bank is not required. In cases where the assignment is taken by way of security rather than being a true assignment, the consent of the Central Bank will not be required as it permits funds granting such security in connection with its borrowings, and for receivers appointed by the lenders enforcing such security.

Security filings

Once security has been created, lenders will need to ensure that the security, if created by an Irish entity or an entity required to be registered in Ireland as a branch whether governed by Irish law or otherwise, is registered against the correct entity in the appropriate Irish registry. For example, (1) security created by an Investment Company will be registered on the file of the Investment Company in the Irish Companies Registration Office ("CRO"), and (2) security created by a trustee or its nominee as part of a Unit Trust structure will be registered on the file of the trustee/its nominee in the CRO. Importantly, as ICAVs are established under the ICAV Act rather than the Companies Act, registrations for ICAVs are made on the file of the ICAV with the Irish Central Bank rather than the CRO. Particulars of all such security in the form prescribed by the CRO (Form C1) or the Irish Central Bank (Form [CH1]) must be filed within 21 days of the date of creation of the security, and in the absence of such, filing is void against a liquidator and any creditor.

Property fund financing

Irish funds are also popular vehicles for investment in Irish real estate by both Irish and non-Irish investors. In our experience, Investment Companies and ICAVs have been the most popular platforms used by investors, but some investors have also used Unit Trusts due to their familiarity with same in their home jurisdictions. While many investors establish their own fund platforms, it is also possible to establish a sub-fund as part of an existing platform set up by a service provider, a so-called "rent a fund". This can save on the establishment cost. In some deals, ILPs are also set up under the relevant Investment Company or ICAV sub-fund, for finance structuring reasons.

The loan agreement in financings for such funds is typically based on the LMA Real Estate Finance form of loan agreement. This is commonly governed by Irish law but, if necessary, could equally be governed by the laws of England & Wales (adapted as required). There are a number of key modifications that need to be made to the LMA form, including in particular to reflect the role and importance of the relevant service providers in such structures, such as the management company, AIFM and the Depositary, the applicable events of default, regulatory compliance matters, the change of control provisions and the security package.

The security package will always consist of security over the relevant property and related assets and in many, but not all, cases security over the shares/units in the fund/sub-fund. Where the fund/sub-fund has invested in real estate through an ILP, security can also be taken over the sub-fund's interest in the ILP, and security is also taken over the shares held by the shareholder of the general partner of the ILP. This is important as, in an ILP, it is the general partner who contracts for the ILP and, on an enforcement, having security over those shares means that the lender can exercise control over the general partner and its contracting powers.

As with all fund financing structures, it is crucial at an early stage of any property fund financing deal to ascertain who has title to the assets and who has contracting power. An additional point to note in this regard is that the Depositary of the fund investing in real estate is obliged to maintain "control" over the property and related assets, such as rental income. Previously, this was interpreted by Depositaries to mean that title to the property had to be registered in their name. However, as registered owner of the property this potentially exposes the Depositary to claims, for example, in relation to environmental liability, but also to being named in court proceedings if, for example, there is a rent dispute. The practice which has emerged in this regard is that either the Depositary has title registered in the name of a nominee company it establishes or, more commonly, it registers a caution on the relevant property title which restricts future disposals, including on any enforcement. It is crucial in this context to obtain a Control Letter/Deed of Control from the relevant Depositary to regulate the rights and duties of the Depositary on any future enforcement by the lenders but also, for example, to regulate how the Depositary operates the fund's bank accounts to ensure compliance with the account control and waterfall provisions of the facility agreement. Commonly, the rent account in such transactions is opened in the name of the Depositary, and it is Depositary signatories who are named on the bank mandate.

Hotel financing can also be accommodated through a fund structure. Particular issues can arise in relation to this type of structure, where a separate OpCo/PropCo structure is used, and advice should be sought at an early stage to optimise the structure and ensure that financing can be put in place.

* * *

Endnotes

1. Described further below.
2. Described further below.
3. The UCITS Regulations implement the UCITS Directive in Ireland.
4. The AIFM Regulations implement AIFMD in Ireland.
5. Companies (Amendment) Act 1982 (Section 13(2)) Order 2004.
6. Undertakings for Collective Investments in Transferable Securities Directive 2009/65/EC.

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Japan

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Overview

2016 has been an encouraging year for private equity in Japan. On the fundraising front, it is expected to be one of the best years in a decade. Advantage Partners, Ant Capital, CLSA, Integral, J-Star, Polaris and Tokio Marine Capital, together with newcomers such as NSSK and Yukon Capital, are among the sponsors who, according to Reuters, could help Japan-based private equity firms raise as much as US$4bn during the year, a solid increase from the US$2.6bn reported by PEI Research & Analytics to have been raised in 2015 and a far cry from the lean years following the Global Financial Crisis ("GFC"), when total fundraising reportedly averaged less than US$500,000 a year. On the deal-making front, announced M&A deal volume in Japan in the first half of 2016 totalled approximately US$30.7bn, representing a 68% increase as compared to the first half of 2015, according to Mergermarket. In addition, in November 2016, KKR & Co. announced its largest buy-out to date in Asia, a US$4.5bn acquisition of Calsonic Kansei Corporation, an auto parts maker listed on the Tokyo Stock Exchange and affiliated with Nissan Motors.

The resurgence of private equity fundraising in Japan comes after a long period of minimal activity and represents the fruition of significant shifts that began with the election of Shinzo Abe as Prime Minister in December 2012. As the after-effects of the GFC receded and investors were encouraged by signs of success of Prime Minister Abe's economic policies, known as "Abenomics", both Japanese and foreign investors began to find Japanese private equity attractive again. Despite the lack of sustained growth in GDP, the doubling of Japanese equity markets between 2013 and mid-2015 was viewed as possibly signalling that the stimulus and reform policies of Abenomics might be working and that long-entrenched impediments to M&A might be breaking down. This led to a modest rebound in fundraising activity in late 2014 and 2015, with Carlyle closing their third Japan buyout fund with over ¥100bn (US$825m) in commitments and Unison closing their fourth at their cap of ¥70bn (US$578m). That trend accelerated through 2016. As both Japanese investors and sponsors, including Yasufumi Hirao of Alternative Investment Capital and Ryuosuke Iinuma of Ant Capital, remarked to Reuters and PEI, it is a good time to be raising funds in Japan.

Abenomics has represented a shot in the arm for private equity fundraising on multiple levels. The Bank of Japan (BOJ)'s monetary easing and lowering of interest rates, ultimately below zero, stoked inflation and boosted equity markets, at least in the beginning, but its more lasting effect may have been to make Japanese private equity funds more attractive to investors. At the same time that the BOJ was cutting rates, the world's largest pension investor, Japan's Government Pension Investment Fund (GPIF), with approximately ¥132trn (US$1.3trn) AUM (as of Sep. 2016), announced that it was shifting its target allocations from predominantly government bonds to a more growth-oriented strategy, with significantly higher allocations to equities (both foreign and domestic), as well as alternative asset classes including private equity. According to Bloomberg, GPIF is targeting an allocation of up to 5% of its assets (i.e. ¥6.6trn (US$55.8bn)) in alternative investments including private equity. The new allocations made GPIF one of the largest potential alternative asset investors in the world overnight.

Following GPIF, the recently privatised Japan Post Bank, with approximately ¥207trn (US$1.8trn) AUM, and Japan Post Insurance, with approximately ¥80trn (US$676.9bn) AUM (as of Sep. 2016), each announced that they would start allocating similar percentages to alternative investments. PEI reports that together, GPIF, Japan Post Bank and Japan Post Insurance potentially stand to mobilise over US$3trn towards private equity investments.

The benefits to the private equity industry of the wave of capital brought by these three giants are magnified by the fact that these institutions cannot make direct investments by themselves. Rather, they are required by law or policy to invest through third-party asset managers, such as Nissay Asset Management, which in many cases must agree to invest according to a strict set of fiduciary rules not unlike those applicable to ERISA fiduciaries. These shifts have also necessitated the rapid build-up of private equity skills and knowhow at these institutions. GPIF, for example, hired former Coller Capital partner Hiromichi Mizuno in 2015, who now serves as Executive Managing Director and Chief Investment Officer, while Japan Post Bank hired Hideya Sadanaga to be their head of private equity. This new sophistication, knowledge and familiarity is another positive for the industry.

The Japanese pension and savings giants are not the only movers in the market, either. Reuters and FinanceAsia.com report that regional banks, including the likes of Yokohama Bank, Shizuoka Bank and Fukuoka Bank, have also begun investing in private equity, seeking returns as a means to help their local and regional economies. And Japanese mega-banks, who played a central role in the emergence of the home-grown Japanese private equity industry, have begun returning to the market, for somewhat different reasons. In March 2015, after years of uncertainty as to whether foreign banking institutions would be permitted to invest in private funds that were open to U.S. investors,[1] during which time Japanese banks had largely scaled back their investment in, and sponsorship of, private equity funds, the U.S. Federal Reserve Board and other agencies provided an important clarification that effectively made it easier for non-U.S. banks to rely on an exemption to the so-called "Volcker Rule". With that, Japanese banks began reversing course and resuming their private equity programs. As PEI notes, the participation of Japanese banks is particularly significant for the Japanese private equity industry, as they play a unique role in the pipeline of investment opportunities for some Japanese GPs. For some sponsors, the mega-banks account for very substantial portions of their capital. Added to this mix, corporate pensions have also become increasingly active investors in Japanese buyout funds, contributing to a substantial new pool of capital for private equity fund sponsors.

Despite the apparent flood of capital back into the market, these changes represent something other than a return to the domestic Japanese private equity industry's pre-GFC trajectory. The market and the industry have shifted fundamentally since the shock, internalising, rightly or wrongly, lessons of the perceived excesses of the pre-GFC days. The private equity landscape that is now emerging is characterised by a larger number of sponsors raising comparatively smaller funds, generally in the ¥30bn to ¥60bn (US$253.8m to US$507.7m) range, with only one predominantly Japan-focused non-captive fund (Carlyle Japan Partners III, which closed with ¥119bn (US$1.0bn) in commitments in 2015) having closed with more than ¥70bn (US$592.3m) in commitments over the past few years. Even Japan's largest buyout fund sponsors, Unison and Advantage Partners, which each raised over US$1bn in their last pre-Lehman vintages (AP's 2007 Fund IV fund series, with the equivalent of approximately US$2bn in commitments, remains the largest non-captive Japan buyout fund to date), have set their sights in the ¥70bn (US$592.3m) range for their most recent vintages. (The exception that proves the rule may be Japan Industrial Solutions, a mostly captive large-cap sponsor funded by the Japanese mega-banks that held a special closing of their 2010 vintage turn-around fund in 2013 to bring total commitments to ¥100bn (US$1.0bn) and is now reported by Nikkei to be forming a ¥200bn (US$ 1.7bn) Fund II.)

On the regulatory side, amendments to the Japanese Financial Instruments and Exchange Act (the "FIEA")[2] took effect in March, imposing additional restrictions and requirements for fund operators relying on the QII-targeted business exemption (the "QII Exemption"), which has been a popular exemption for non-Japanese general partners placing limited partnership interests with investors in Japan. Additionally, the industry continued adapting to the July 2015 Japan Supreme Court decision holding that Delaware limited partnerships should be considered foreign corporations under Japanese tax law, and thereby putting into question the pass-through tax treatment of interests in Delaware limited partnerships.

On the financing side, Japan's established banking sector, record-low negative interest rates, recent legislative and structural reforms, and improved perception towards private equity investors, have created an attractive market for private equity funds in Japan. In the current environment, with plentiful long-term, low-interest credit, some, including Megumi Kiyozuka of CLSA Capital Partners (quoted by PEI) now boast that the leveraged buyout market in Japan may be "the best in the world". The market's development has also led to Japanese private equity sponsors' increasing interest in entering into fund-level borrowing through capital call facilities (also known as subscription facilities), a type of credit facility made available to a fund typically secured by: (i) the unfunded capital commitments of the fund's investors; (ii) the fund's rights to call capital and receive capital contributions; and (iii) the fund's bank account in which capital contributions are made. Given the relatively small size and number of funds compared to the U.S. and Europe, the Japanese fund finance market remains in a relatively early stage of development.

Fund formation and finance

As the Japanese private equity market has evolved, managers of Japanese private equity funds have shown increasing interest in entering into capital call facilities for their funds. Some of the key reasons for this interest include: (i) the attractiveness of borrowing terms, with effective interest rates hovering just above zero per cent; (ii) the ability to bridge the gap between the investment date and the typical 10–12 business days normally required by a fund to call capital from its limited partners; (iii) the ability to improve the fund's internal rate of return by using low-cost interim financing; (iv) the ability to reduce the spread between gross and net performance metrics with low-cost financing; (v) the ability to more flexibly support obligations of portfolio companies at more attractive rates than those available to the portfolio companies themselves; and (vi) improved competitiveness *vis-à-vis* strategic buyers.

Many Japanese private equity funds have not been able to execute on capital call facilities, however, due in part to the tension between the stringent requirements of the capital call lenders and the resistance by the limited partners to accommodate additional obligations. Also, there are practical challenges imposed by Japanese tax considerations, including the need to avoid causing offshore limited partners to be deemed to have a permanent establishment ("PE") in Japan or increasing their risk of exposure to local taxation under the so-called "25/5 Rule".

Permanent Establishment

Japanese tax advisors commonly advise sponsors of Japan-focused funds that accept both Japanese and non-Japanese investors to structure the funds in a manner that minimises potential PE risk in Japan for non-Japanese LPs. The rules are complex and beyond the scope of this article, but broadly there are several avenues through which a non-Japanese investor in a Japanese private equity fund may be deemed to have a PE in Japan, including by virtue of the general partner conducting its business in Japan, having a Japan-based advisory entity that manages (or appears to manage) the fund (e.g., where the general partner is merely a "rubber stamp" for the Japan-based sponsor) or by having Japanese investors invest in the same vehicles alongside non-Japanese investors.

To help reduce these risks, Japanese buyout funds are sometimes structured as two or more independently managed parallel funds, i.e. one exclusively for Japanese investors and one (or more) exclusively for non-Japanese Investors. In order to minimise the risk of any non-Japanese limited partner being deemed to have a PE in Japan through the general partner, the general partner of each parallel vehicle for non-Japanese investors is typically organised in a jurisdiction outside of Japan and conducts the business of managing the fund outside of Japan. Additionally, local tax counsel often advise the sponsor to ensure that any Japan-based advisor or sub-advisor entity (i.e., typically the sponsor) does not hold itself out to investors or third parties as actually carrying out the business of the general partner, so as to avoid the risk of offshore investors being deemed to have a PE through the Japanese advisor. Direct agreements between the non-Japanese limited partners and any Japanese entities in the fund structure (e.g., a clawback guarantee agreement by a Japanese advisor and the offshore limited partners) may also be seen to create risk that the non-Japanese limited partners may be deemed to have a PE in Japan. The consequences to non-Japanese investors of having a deemed PE in Japan are significant, with potential exposure to the top applicable effective Japanese tax rates for corporations or individuals in Japan, plus penalties and interest.

25/5 Rule

Non-Japanese limited partners in Japanese buyout funds may also risk being subject to Japanese tax with respect to investments in Japanese portfolio companies through the 25/5 Rule if such limited partner, together with "special related parties" (i.e. typically including all the other limited partners in the fund vehicle in which such limited partner invests) owns 25% or more of the shares of any Japanese portfolio company.[3] Some Japan-focused buyout funds that have commercial substance in multiple locations may structure multiple independent fund vehicles that co-invest the fund, with each fund owning less than 25% of any particular underlying investment. Such a structure, if respected, could avoid exposure to Japanese taxation under the 25/5 Rule.

Additional measures may also be used from time to time in order to minimise such exposure, including decoupling of any linked voting among the parallel funds (e.g., voting as "combined limited partners" with respect to general partner removal, exceeding the fund's investment limitations, extending the term of the fund, incurrence of debt obligations). Moreover, local tax advisors often advise against permitting direct agreements between the general partners of the independent parallel funds to act in concert, e.g., with respect to caps on fund size or organisational expenses.[4]

Implications for capital call facilities

Consequently, any capital call facility arrangements between lenders and such private equity funds need to take into consideration the finely tuned tax structure of the funds, so as to avoid increasing the risk that offshore investors might be deemed to have a PE in Japan or become subject to the 25/5 Rule. In other words, a single agreement among the lenders and all of the general partners/managers of the multiple independent parallel funds in the fund structure may materially increase these risks. Further, such an agreement among a lender, a non-Japanese general partner of the parallel fund for non-Japanese investors, and the Japanese general partner of the parallel fund for Japanese investors, could potentially give rise to PE risk for the non-Japanese investors in the offshore parallel fund.

A further consequence of these tax risks is that joint and several liability among borrowers in the various parallel funds of the fund series with respect to obligations under the same credit facility or cross-collateralisation within a credit facility (where the borrowers are liable on a several basis, but the obligations under the credit facility are secured by the uncalled capital of the parallel funds in the fund series) raise the same PE and 25/5 Rule aggregation concerns, effectively limiting the inclusion of cross-defaults among parallel funds in such a fund series in any capital call facility or similar lending arrangement.[5]

Given the complexities of the Japanese tax considerations for private equity buyout funds, it is essential that any sponsor or lender with an interest in entering into lending arrangements with Japanese private equity buyout funds consult their respective tax advisors and weigh their options to determine the optimal capital call facility structure.

"Bankable" limited partnership agreement

Lenders of capital call facilities diligence the limited partnership agreement of the fund borrower to ensure that the partnership agreement permits borrowings, and the pledge by the borrower to the lenders of its right to call capital from the investors. The permission to incur indebtedness could be a highly negotiated provision in the limited partnership agreement between the private equity sponsor and the limited partners. Certain limited partners investing in Japanese funds still frown upon the ability of the fund to incur indebtedness and negotiate to minimise the amount of permitted debt as well as the duration for which such debt can be outstanding, for example, by requiring indebtedness to be repaid within 30 days of borrowing. Realising the utility of capital call facilities, the private equity sponsor and the general partner tend to desire a more flexible borrowing provision where indebtedness may be outstanding up to 180 days or longer. Capital call facilities are considered to be a low-risk credit instrument as lenders are typically over-collateralised, and the availability of borrowing under the credit facility is based on the quality of the investors, each thoroughly vetted by the lenders prior to and during the course of the credit facility.

Lenders also sometimes request investor consent letters in which each limited partner provides a direct confirmation to the lenders that such limited partner agrees for the fund to enter into the capital call facility and to pledge the uncalled capital to the lenders, and that if there is a default under the credit facility and the lenders exercise remedies and make a capital call, such limited partner will fund the capital call. Limited partners typically do not want to be in direct privity with the lenders. Therefore, obtaining investor consent letters from each limited partner requires prolonged negotiation and is very time-consuming and expensive. Funds in the U.S. have managed to avoid investor consent letters, mainly because limited partnership agreements now include many of the same acknowledgments and representations that would otherwise be included in investor consent letters, and the limited partnership agreements provide for third party beneficiary rights to the lenders.

Lenders in the Japanese fund finance market, which is dominated by Japanese financial institutions such as Mizuho Bank, Sumitomo Mitsui Trust Bank and The Bank of Tokyo Mitsubishi UFJ, have generally accepted that investor consent letters are cumbersome for fund sponsors; however, in lieu thereof, they may demand that no amendment, modification or waiver of any partner's obligation under the limited partnership agreement is permitted without the prior written consent of the lenders. Such restriction essentially constrains the fund borrower from negotiating side letters with the limited partners which is an essential component of fundraising, especially disadvantaging funds trying to court non-Japanese investors. For example, certain sovereign wealth fund investors require their investments to remain confidential, and may not agree to provide any information to the lenders. Such arrangement would be included in a side letter between the specific investor and the fund borrower. In the U.S. market, lenders do not have a consent right over side letters, but rather the lenders diligence these side letters and exclude certain investors from the borrowing base. Ineligibility of specific investors in the borrowing base is more favourable than a covenant outright-prohibiting the fund borrowers' or the general partners' ability to accommodate flexibility essential to certain investors. The fund borrowers must ensure, however, that these ineligible investors are limited compared to the overall investor pool supporting the capital call facility, as significant exclusions from the borrowing base would affect the viability of the capital call facility.

It is not unusual for a fund borrower to share, subject to confidentiality, drafts of its limited partnership agreement to potential lenders, in order to ensure that the limited partnership agreement is "bankable" from a fund financing perspective. Understanding what a "bankable" limited partnership agreement needs to look like prior to, or at the early stages of, the fundraising efforts is critical in navigating successful negotiations with the limited partners as well as the lenders, as there is still a gap between what the Japanese lenders consider "bankable" versus the flexibility required by fund borrowers, especially for funds with both Japanese and non-Japanese investors.

Realising that the U.S. and European fund financing markets have adopted a more flexible approach, certain sponsors have started to reach out to non-Japanese financial institutions in hopes of securing financing on terms that would be more acceptable to limited partners in their funds. These non-Japanese financial institutions, however, cannot offer the same low interest rate product as their Japanese competitors. In addition, interest on loans by non-Japanese financial institutions is generally subject to a 20% Japanese withholding tax, further disadvantaging the non-Japanese lenders.

Key developments

Increased receptivity to private equity investment

A subtle but key development in Japan has been the increasing receptivity of the public generally, and the owners and founders of private companies specifically, to investment by private equity firms. Cultural resistance to selling a business to outsiders, and the prevalence of cross-shareholdings among corporate conglomerates, have long been a target of critics lamenting the failure of M&A and private equity to penetrate Japan. But recently, private equity investors including Carlyle's Tamotsu Adachi (quoted by PEI) have touted Japanese small and medium enterprises' desire to partner with firms that have the skills, experience and capabilities to help them expand internationally. Megumi Kiyozuka, managing partner of CLSA Capital Partners, credits intermediaries like investment banks for helping sellers become better informed about the advantages and disadvantages of potential private equity partners, noting for PEI, "[p]reviously they hated seeing us private equity firms, but that negative perception is decreasing."

Differences in domestic and offshore LP investment strategies

One of the interesting aspects shaping development in the Japanese private equity industry has been the different approach to private equity investing taken by Japanese and offshore investors. Non-Japanese investors, particularly those with a long history of investing with private equity general partners, often look at their investments as the establishment of long-term relationships, and therefore tend to be highly selective in choosing the managers with whom they will entrust their money. After conducting broad diligence, they may select their partners from among a basket of many options, and then look to work closely with that partner to help it grow and succeed. Japanese investors, on the other hand, outside of the GPIFs and the Japan Post Banks of the world, seem to be taking a more risk-diversification portfolio approach to investing, choosing to divide their allocations across many sponsors rather than betting on just one or two that they find to be more promising.

The results have been significant in helping to shape the industry. Many domestic sponsors find that they can raise sufficient capital for their funds' investment programs mainly, or even solely, on the basis of commitments from Japanese investors. Although there is a desire to tap into overseas capital, they don't need to do so. Moreover, a strong domestic sponsor that wins commitments from both limited partners with their diversified portfolio approach and the larger, selective domestic investors, finds itself in a strong position *vis-à-vis* offshore investors, with little need to make concessions on terms. Another result has been that a number of sponsors have seen the portion of aggregate commitments to their funds accepted by Japanese investors increase significantly relative to those of non-Japanese investors.

Recent FIEA amendments

As mentioned above, amendments to the FIEA took effect in March, imposing additional regulatory restrictions and requirements for fund operators relying on the QII-targeted business exemption. Under the March amendments, satisfying the QII Exemption has become more difficult and compliance burdens have increased substantially. The new requirements have also made it more difficult for Japanese domestic investors to structure offshore investment vehicles that are outside the application of the FIEA (or that at least do not impose compliance burdens for general partners), while on the off-shore side, what had been a relatively straightforward notification process to accept Japanese investors has become more complex, with compliance requirements that are potentially burdensome and intrusive from the sponsor's perspective.

Impacts of AIFMD for Japanese fundraising

The effects of the implementation of the Alternative Investment Fund Managers Directive (the "AIFMD") in the European Union ("EU") have been felt globally, but particularly in Japan, where funds tend to be smaller and have fewer investors than in the United States and some other jurisdictions. Consequently, the burdens and costs may disproportionately impact Japanese sponsors more than in some other jurisdictions where the fund sizes are large enough to support full compliance efforts, or are small enough that they do not frequently have EU investors. As one might imagine, sponsors therefore seek to rely on reverse solicitation whenever possible, and only infrequently seek to use the national private placement regime route, other than in administratively "easy" jurisdictions such as the United Kingdom and the Netherlands.

The European Securities and Markets Authority ("ESMA") publication in July of its advice on the application of the AIFMD "passport" to several non-EU Alternative Investment Fund Managers ("AIFMs") established in 12 countries, including Japan, was encouraging. The passport refers to the process by which the AIFMD can be extended to non-EU AIFMs in these countries – by choosing to comply fully with the AIFMD, a non-EU AIFM would become authorised, and thus permitted to market alternative investment funds in all member states of the EU under the marketing passport. ESMA's advice with respect to Japan was positive, concluding that there are no significant obstacles impeding the application of the AIFMD passport to Japan. This does not guarantee that the passport will ultimately be extended to Japan, and realistically the next steps in the process are likely to take time, particularly in the wake of Brexit. Challenges remain, but this is an encouraging step that leaves Japan one step closer to becoming a passport country, with the potential for an easier road to reaching EU investors.

Corporate governance reforms under Abenomics

Two key initiatives of the Abe administration have had particularly positive impacts on private equity and investing in Japan: the amendment of the Companies Act, and the introduction of the new Stewardship Code.

The Companies Act amendments, effective May 1, 2015, have effectively put pressure on companies to break with the traditional practice of keeping directorships limited to former senior executives, and instead make increased use of outside independent directors. The notion is that independence would help Japanese companies avoid the strong temptation of "group-think", make them more responsive to outside shareholders, and improve performance. The same amendments also streamlined the process by which minority shareholders can be squeezed out after a successful tender offer, making it easier for buyers which have acquired at least 90% of the total voting rights of the target to then make such target a wholly-owned subsidiary. While the effectiveness of these reforms in improving corporate governance is a matter of some debate, it appears they have in fact made it easier to take Japanese public companies private.

The introduction of the Stewardship Code provides institutional investors with greater opportunities for constructive engagement with management in determining the medium- to long-term growth of the companies in which they invest. The institutional investors are required to disclose their votes at shareholders' meetings, as motivation to end the traditional passivity of Japanese shareholders. A new index, JPX-Nikkei 400, was also launched in the beginning of 2014, comprised of companies which meet global investment standard criteria. Selection criteria include factors such as disclosure of earnings in English and three-year average return on equity. These reforms and initiatives have arguably forced greater accountability on large public companies and encouraged investors to become more active, in an effort to kick-start value creation and improve shareholder return. These changes are driving an uptick in carve-out transactions (i.e., partial divestitures of non-core businesses of larger conglomerates), creating more opportunity for private equity firms. As seen in the ¥665.5bn (US$5.9bn) acquisition of Toshiba Corp's medical equipment unit by Canon in early 2016, multiple challenges remain for private equity firms, including cash-rich strategic bidders whose valuations of target companies are often significantly higher than what private equity investors find reasonable, as well as the pervasive challenge of changing entrenched corporate cultures in which resistance to change is part of their DNA.

The year ahead

While the impact on Japan of certain global events such as the withdrawal of the United Kingdom from the European Union and the new U.S. presidency remain uncertain, interest rates are expected to remain low, and the long-term shifts that have been making private equity attractive to investors are expected to continue. As some observe, the next few years look to be a good time to be a private equity investor in Japan.

Overseas investors' appetite towards Japan should remain steady; however, they may be more susceptible to currency fluctuation. The Japanese yen has fluctuated between US$1 = ¥135 and US$1 = ¥76 since 2001 and if it were to significantly strengthen against the US dollar, Japanese investments would become more expensive for overseas investors and hence less attractive. Recent signs since the U.S. presidential elections, however, point to the yen weakening, which seems to be an encouraging sign for investors and the economy.

On the deal-making front, there is no reason to believe that additional carve-out transactions of non-core assets by large Japanese corporations and other divestitures will cease. Partnership between small to medium-sized companies and private equity firms should continue as the aging and declining Japanese population is not an easily reversible phenomenon.

From the fund financing perspective, it is important to increase awareness among the limited partners, the sponsors and the lenders regarding the benefits of the capital call facilities and the limited risk associated therewith. The tax implication on these capital call facilities will need to continue to be assessed. A better understanding of the flexibility needed by the fund borrowers, and of the protection provided to the lenders, will hopefully lead to more competition, sophistication of the market and expansion of capital call facilities in Japan.

* * *

Acknowledgment

The authors wish to thank Mary Touchstone, Head of the Funds Finance Practice at Simpson Thacher & Bartlett LLP and Julia Kohen, Counsel in the Funds Finance Practice at Simpson Thacher & Bartlett LLP, for their assistance in the preparation of this chapter.

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Endnotes

1. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("*Dodd-Frank*"), enacted in response to the financial crisis, ushered in a new wave of financial and regulatory reform that, among other things, heightened regulation of the private funds industry. A key component of Dodd-Frank was the so-called "Volcker Rule" which, subject to certain limited exceptions, prohibits banking organisations from sponsoring or investing in most private equity funds. Defining and clarifying those exceptions took a period of several years, during which non-U.S. banks with U.S. branches or subsidiaries were left in limbo, not knowing whether they would be required to withdraw from their private fund investments and, if so, how quickly.
2. Kinyu Shōhin Torihiki-hō, Act No. 25 of April 13, 1948.
3. Technically the 25/5 Rule applies where a non-Japanese limited partner without a PE in Japan (i) together with its "specially related parties" sells 5% or more of the shares in a

Japanese company in a fiscal year and (ii) together with specially related parties owns, or has owned, 25% or more of the shares in such Japanese company at any time during the prior three 12-month periods from the last day of the fiscal year of sale. Note that limited partners of a private equity fund are generally, absent an applicable exemption, deemed to be aggregated with each other for purposes of the 25/5 Rule.

4. This does not necessarily mean that fund size and organisational expenses cannot be capped, just that it has to be done in a manner that does not constitute a direct agreement among the general partners of the parallel funds.
5. It should be noted that there are other potential structuring alternatives which could, in theory, make it possible to have cross-default type arrangements and agreements by and among the parallel funds. For example, each of the non-Japanese limited partners could be required to rely on making a so-called "25/5 Rule Exemption" filing. However, there are significant limitations with such an approach (e.g., a minimum one-year holding period for investments does not apply to distressed financial institutions; the limited partners shall not be involved in the management or operation of the fund negating any consent rights and increased regulatory oversight in Japan), which are commercially challenging in most cases.

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Jersey

James Gaudin & Benjamin Bestgen
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Overview

As an international financial centre (**IFC**) of choice for global investments into the UK and Europe, Q3 2016 (30 September) saw Jersey as home to approximately 1,125 funds with an aggregate of net assets under management of £237.3 billion placed in 1,860 separate pools[1]. In comparison, figures of Q1 (30 March) showed a total of 1,326 funds with an aggregate of £228.4 billion of assets under management, placed in 2,157 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 almost £10 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 the Brexit vote in June 2016[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 October 2016 Jersey was named "Best International Financial Centre" at the International Fund and Product awards in London. 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**).

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[3] 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. In the wake of the "Panama Papers", which led to IFCs falling under increased scrutiny once again, Jersey stands in excellent stead, being 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 confirmed in June 2016 that there are no objections to Jersey being granted the AIFMD "passport"[4], allowing Jersey funds to conduct business in all EU member states as soon as the final approvals are granted and the EU hands the passport over (expected in 2017). 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 in funds matters[5]) 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.

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 has taken steps to introduce a manager-led fund product called the JRAIF (see para below, 'JRAIF'). Further, the Jersey Financial Services Commission (**JFSC**) (the island's regulatory body) and Jersey's government recently launched a joint consultation for an overhaul of the existing private fund and unregulated fund landscape[6], which will take place in the course of 2017.

Results and revised proposals from the consultation are expected for Q1 in 2017 and most of the current proposals are clarifications and consolidations of existing laws. In particular, it is proposed to:

- Introduce a JFSC-approved guide for Very Private Placement Funds. It is intended to increase certainty about the regulatory approach taken to eligibility conditions for investors and the authorisation process for the fund.
- The definition of "Professional Investor" will be made universal and based on the definition used for "Expert Investor" in the "Expert Fund Guide", as currently a few slightly different definitions for non-retail investors are still active. The proposed definition can be found in the consultation (see endnote 6) but is too long to repeat for the space of this article.
- Changes will be made to the Control of Borrowing (Jersey) Law 1947 (**COBO Law**) to align COBO with the modern regulatory, supervisory and enforcement powers enjoyed by the JFSC under the Collective Investment Funds (Jersey) Law 1988. A proposal of the exact amendments to COBO Law will be published by the States of Jersey following the consultation.

Taking security over fund assets

Jersey's security regime in respect of intangible securities started with the Security Interests (Jersey) Law 1983, which was superseded on 1 July 2014 by the Security Interest (Jersey) Law 2012. The new regime offers a modern securitisation approach, is flexible and lender-friendly.

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**). 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 or security over bank accounts is perfected by control over the relevant account or investment; or security interests in shares or receivables are registered on the Security Interests Register (**SIR**). The most common form for security perfection is registration.

A registration fee of currently £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:

Security	Market practice comment	Usual perfection method(*)
Call rights SIA	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 account SIA	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.	Control over bank account and/or SIR registration
Shares SIA	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 SIA (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 SIA 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.	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;
- 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 current funds regime, there are no regulatory restrictions on borrowing for Very Private Funds, funds under the Private Placement Funds Regime, and Unregulated Funds. 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]:

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 £5million, 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.

Fund finance market – latest thoughts: Substance

In light of BEPS, AIFMD and the Panama Papers, the funds world (not only in IFCs) sees a increased 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 it is also more important 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 on-shore 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)

As European banks try to comply with Basel II regulations and pass appropriate stress-tests, 2015/16 has seen lending drop. In addition to banks' capitalisation requirements, BEPS aims to discourage the use of debt as a way of reducing tax liabilities[10], with countries like the UK aiming to cap deductions for interest payable on debts at a maximum of 30% of a company's (or group's) EBITDA[11].

This lending gap has been identified by the funds world as an opportunity to launch LOFs which offer to act as third-party lenders and provide alternative sources of capital. 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[12]. Funds do not have the capitalisation issues banks have and can be structured in more flexible ways, provided that the JFSC is satisfied that the fund will not provide capital to people or other financial institutions. As each LOF is likely to be different, the JFSC will assess on a case-by-case basis whether to grant a licence to the fund. Jersey Finance[13] advises that the JFSC will in all likelihood want to see 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;
- 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.

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[14]. 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[15], 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 launched a consultation about the most appropriate ways to understand and regulate the investment and trading in virtual currencies while at the same time considering measures to ensure these currencies cannot be used to facilitate money laundering or terrorist financing[16]. Further concerns about virtual currencies revolve around appropriate consumer protection measures as well as regulating the creation, taxation and trading of such currencies. Jersey will monitor and engage with regulatory developments in Canada, US, UK, Germany, Hong Kong and Australia, all countries who have decided to take a pro-active 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 both require complying 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 AIFMD's compliance. 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 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 2017/18

If 2016 showed the world one thing, 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[17]. 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. Current draft legislation is due to be approved by the States of Jersey[18]. 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 off-shore vehicles and expertise without needing to worry about regulatory or reputational concerns on-shore.

Thirdly, President-elect 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[19]. This would lead to many advisers of private funds no longer being required to register with the Security and Exchange Commission. Further, US banks may regain the ability for proprietary trading in private equity funds, i.e. to invest themselves in funds they promote or manage, which could flush the funds market with extra dollars. It is unclear whether deregulation in the US would have a tangible competition effect on funds in jurisdictions like Jersey, who comply with higher regulatory and compliance standards than Mr 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[20]. 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. The fund landscape may also be somewhat re-shaped if more financial services business 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-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.

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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 appeared in *The Legal 500* UK 2016 recommended lawyer list and *IFLR1000* named James as a "Leading Lawyer" in the 2014, 2015 and 2016 editions. Clients told *IFLR100* 2016 that Appleby as a team is: "focused, dynamic and solution driven", and highlighted James Gaudin specifically. He is included in *Chambers* and *The Legal 500* and has been commended for his "practical advice", "availability" and "excellent responses". *The Legal 500* UK 2013 recognised James for "displaying great knowledge". Most recently James was recommended by clients to *The Legal 500* UK 2015 directory and described as someone who is "easy to deal with and quick at turning things around".

He has contributed to numerous publications, and regularly presents to conferences, seminars and clients. James also participates in numerous industry steering and consultation groups.

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Benjamin Bestgen is an associate in the Corporate department in Jersey.

He joined Appleby in August 2016 having qualified in July 2016 as a solicitor and notary public in Scotland, after having completed his legal traineeship with Brodies LLP, one of Scotland's top tier commercial law firms.

During his traineeship, Ben completed seats in Corporate, Commercial Services as well as Insurance and Risk Litigation. He was also seconded for 10 weeks to the in-house legal team of a major UK retail bank.

Before graduating in law from the University of Edinburgh, Ben also completed a Master of Arts at the institutes of philosophy, psychology and German literature in Frankfurt am Main, Germany.

Ben enjoys writing and has contributed to a variety of professional publications on legal and commercial issues.

He is fluent in English and German and further aims to improve his French.

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Luxembourg

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Overview

Luxembourg has developed into the second-largest fund centre in the world, with €3,626bn of assets under management.[1] This volume has been driven mainly by Luxembourg's success in positioning itself as the leading jurisdiction for retail funds, UCITS (undertakings for collective investment in transferable securities). 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 financing activity, supported by the possibility of implementing efficient security packages in the context of credit facilities for funds. The past year has been particularly active as regards fund financing 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

<u>Legal overview – fund formation</u>

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.

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.

<u>Leverage under the AIFMD and the AIFM Law</u>

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 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 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 by them in the EU.

<u>Structuring the security package</u>

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 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 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/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. Given that investors in Luxembourg funds are generally located in different jurisdictions outside Luxembourg, the lenders and the security takers will need to take this into account when structuring the security package.

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.[5] 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 his 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 has 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 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.

<u>Involvement of depositaries in fund financing transactions</u>

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 financing 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 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 Luxembourg 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 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 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 two years, has been the success of the modernisation of the Luxembourg partnership regime and its increasing use by US 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 will continue and sustain a growing demand from fund managers for financing solutions.

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Endnotes

1. In October 2016.
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.
5. If the AIFM is empowered to make capital calls or enter into borrowing arrangements on behalf of the fund, it must be added as a party to the security interest agreement.

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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 positive growth in 2017 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

<u>Global funds – Overview</u>

The present regulatory framework enables global funds to be structured as companies incorporated under the Companies Act, 2001 (**Companies Act**), as limited partnerships 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.

Despite numerous headwinds, fund finance markets continued their outpaced growth in 2016, 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 not aware of any substantial case law relevant to fund finance in 2016. As indicated above, the funds market in Mauritius currently, and as at 31st August 2016, holds around 972 active global funds as compared to 958 active global funds licensed with the Commission as at 31st December 2015. We expect positive growth in 2017 given that the uncertainties of Treaty amendments are now behind us.

<u>Fund financing</u>

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. Capital call subscription credit facilities continued their positive momentum in 2016 and had an outstanding year as an asset class.

We were not consulted on a single facility payment event of default in 2013 to 2016. 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 are confident based on our experiences, as well as anecdotal reports from multiple facility lenders, that the fund facility market expanded materially from 2010 to 2016. As one available data point, Appleby Mauritius fund finance practice was up 25% in 2015 to 2016 compared to 2014, measured by volume of completed transactions.

<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, 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 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 recommended 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 Government of India has recently signed a protocol amending the Treaty with the aim of preventing double taxation (**Protocol**). Various amendments to the Treaty have been brought, in particular, in respect of capital gains. Thus, under the Protocol, India shall tax capital gains arising from the sale of shares acquired on or after 1st April 2017 in a company resident in India with effect from financial year 2017–18. The tax rate on the capital gains arising between the transition period of 1st April 2017 to 31st March 2019 shall be 50% of the domestic tax rate and after the transition period, the capital tax gains shall be charged at full rate. The reduced rate shall be subject to fulfilment of the Limitation of benefit (**LOB**) Article. However, a Mauritian resident, including a shell/conduit company, shall not benefit from the 50% reduced rate of tax, if such resident fails the main purpose test or *bona fide* business test. For the purpose of the Protocol, a shell/conduit company is one where its total expenditure on operations in Mauritius is less than INR 2,700,000 within 12 months of its existence. The changes brought under the Protocol are not expected to affect 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 is equally estimated to be a minimal one that is unlikely to make a significant dent.

Fund financing

We identified four key trends that were impacting the market: (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

The present regulatory framework, and recent developments in clarifying the uncertainties surrounding the Treaty, will further enhance Mauritius as a fund domicile, thereby bringing added confidence and impetus to Mauritius 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 and Africa. The changes brought under the Protocol are not expected to affect current business environment.

Also, multiple regional US lenders are expanding beyond their historical geographies and middle-market fund roots, often in an effort to keep up with the growth of their fund clients. Many such regional lenders have increased their facility maximum hold positions to levels comparable to that offered by the money centre lenders, at least for certain preferred funds in Mauritius. In fact, several US lenders made substantial progress increasing their relevance in the greater facility market in 2016. 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, variances in facility structure dictate the syndication strategy and prospects for a particular facility, adding additional complexity to a transaction.

We are cautiously optimistic for a robust fund finance market in 2017. In Mauritius, we expect the number of facilities consummated will continue to grow at a solid clip as fundraising improves and 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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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 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 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.

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.

Developments

Brexit & Scottish independence. The vote in the UK referendum in June 2016 to leave the European Union will potentially have significant effects on the financial services industry in Scotland, the rest of the UK, Europe and more widely, depending on the manner of its implementation. The election in November 2016 of Donald Trump as President of the USA may also affect the industry, particularly if it leads to a relaxation in US tax and regulatory requirements or other economic changes. These events do not have immediate legal effects for the funds industry in Scotland, but they do create some need for contingency planning for possible future effects, and some uncertainty in the interim. Initial market reaction has been similar in Scotland to the rest of the UK, with continuing market activity driven by more general market factors.

Continuance of access for funds to both investor and investment markets between the UK and the reconstituted EU following departure of the UK is obviously a concern and more detailed analysis of activities that are regulated or unregulated or requiring intra-EU regulatory passporting or not, continues. Given the distinct possibility that the UK will not continue to be a formal member of the EU single market in financial services, there has also been increasing analysis of the potential application of EU "equivalence" rules to what, initially at least, are likely to be very similar ongoing UK regulatory rules.

These issues do not really affect Scotland differently from the rest of the UK. However, as a significant majority in Scotland voted in the referendum to remain in the EU, contrary to the vote in the UK as a whole, it is possible that a further referendum may be held on Scottish independence from the rest of the UK. A vote for Scottish independence would be likely to lead to Scotland remaining a member of the EU or rejoining (although there is much uncertainty over the exact process and how long it would take). This would preserve or restore current Scottish access to EU investor and investment markets and could promote Scotland as an EU financial services gateway from outside. It would, however, create a regulatory boundary within the currently highly integrated UK market which would need to be addressed in the context of the arrangements ultimately made between the current UK and the EU.

The Scottish National Party, which currently runs the devolved Scottish Government, has indicated that it considers a second Scottish independence referendum likely and is putting preparatory legislation in place. A clear majority voted against Scottish independence in September 2014 and, while support for Scottish independence increased following the referendum vote to leave the EU, at the time of writing polls suggest independence would be rejected at that time by a similar majority as in 2014. In parallel to a possible second independence referendum, the Scottish Government is seeking maximum participation by the UK in the EU single market once the UK leaves the EU, and enhanced status within the EU for Scotland over the rest of the UK if ongoing full single market membership for the UK is not agreed with the EU. This last option raises some difficult technical issues, including boundary issues within the UK similar to those arising if Scotland were to be independent *and* a member of 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. Following consultation, the UK Government intends to introduce a "white list" in 2017 of activities in which limited partners in Scottish and English limited partnerships may become involved without risking their limited liability. To benefit from this more specific protection, it is anticipated that a further registration of a limited partnership as a "private fund limited partnership" with the Companies Registrar will take place.

It is also intended that capital requirements be removed for private fund limited partnerships, with no capital contributions being required of limited partners, permanent capital withdrawal being permitted, and filing of capital information ceasing to be required. This will increase funding flexibility for funds, and increased amounts of capital rather than debt may be provided by limited partners once this change comes into effect.

Trading of limited partnership interests in private fund limited partnerships will also become more straightforward as the requirement to advertise assignments of such interests in the Gazette will cease. This will also make it more straightforward to take fixed security over full limited partner interests in Scottish private fund limited partnerships, as the advertising requirement will also cease for relevant assignments in security.

Persons with significant control regime. In parallel with these proposals to simplify limited partnerships, the UK Government is considering the extension to Scottish partnerships and limited partnerships of the regime recently introduced for UK companies under which they must maintain a register of those "persons with significant control" − intended to assist in tracing beneficial ownership of a company. This is being considered in the context of the implementation by the UK and other EU member states by 26 June 2017 of the EU Fourth Money Laundering Directive. It remains to be seen if this regime will be so extended and how it may be applied to Scottish limited partnerships. Given the element of control central to the "PSC" regime, it seems likely that limited partners will not often fall within the regime, if so extended.

Security interest reform. 2017 is also likely to see publication by the Scottish Law Commission of its report on moveable transactions. This Scottish Law Commission project arose from practical problems in transferring and constituting fixed security over moveable property in Scots law, such as contractual rights and financial instruments. The reform proposals contained in the previous consultation on this project were generally well received and it is likely that there will be support for taking forward the legislation likely to be proposed in the report. There is therefore a reasonable prospect that some of the slightly more 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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Introduction

The use of Singapore-domiciled fund entities for fund-raising should be regarded as a relatively recent trend. While unheralded 10 years ago, a few key factors, namely, the introduction of a tax exemption scheme for Singapore tax-resident fund entities, a progressive regulatory regime for regulation of Singapore-based fund managers, and the availability of Singapore's wide network of tax treaties have made Singapore a more widely used jurisdiction to establish investment funds.

Anecdotally, although there are a score or more Singapore-domiciled fund companies that have been set up and are actively investing, the sponsors of the funds have not actively raised debt financing for the Singapore fund companies. Just as fund sponsors have taken a while to become comfortable with the concept of a Singapore-domiciled fund entity, institutional debt financiers probably are still in the early stages of coming to terms with the legal issues encountered where a borrower is governed by Singapore laws.

In light of the fact that the fund financing market is still not well developed in Singapore, this chapter will not address the market developments or future outlook. The following discussion will canvas the legal issues encountered under the Singapore Companies Act, where a Singapore company assumes the obligations of a borrower or security provider, which may be *de novo* to institutional players operating largely in London and New York funding markets.

Historically, the Singapore Companies Act is modelled after the UK Companies Act of 1948, but recent law reforms have seen Singapore adopting provisions inspired by the Australian Corporations Act and the New Zealand Companies Act, while monitoring developments in Hong Kong, Canada and other English common law-based jurisdictions. Thus, it could be said that the Singapore Companies Act is no longer a carbon copy of the UK Companies Act and there are *de novo* legal issues which may be practice pit-falls to the uninitiated, especially as regards company capitalisation and administration.

The capital call facility

The defining characteristic of fund financing is the security package, being comprised primarily of the unfunded commitments of investors to make capital contributions when called from time to time by the fund company. These obligations are typically set out in a subscription agreement between the fund entity and each investor. As such, financiers will seek an assignment of the fund entity's rights under the subscription agreement as part of the security package. In addition, financiers typically require the company to undertake to pay any proceeds of capital calls into a specified bank account, which is in turn charged in favour of the financier as well. A facility secured on these unfunded capital commitments is also known as a "capital call facility".

As noted above, the capital call facility in the Singapore market is still not that well developed, but it does not differ greatly from facilities seen in London and New York funding markets. Consequently, the typical structures, documentation, covenants and their associated issues remain applicable when entering into a Singapore law governed capital call facility. However, slight differences in statutory law and market practice do give rise to practical concerns peculiar to the Singapore context, especially in the realm of assignments and the registration of security interests.

Assignment of subscription agreement – Notice of assignment

Under Singapore law, like most common law jurisdictions, it is possible for a contracting party to assign his contractual rights to a third party by way of legal or equitable assignment. An assignment is effective if: (1) it is an absolute assignment, (2) made in writing under the hand of the assignor, and (3) express notice in writing has been given to the counterparty.

The most pertinent issue in the context of an assignment is typically the giving of express notice in writing of the assignment to the investors, which is a perfection requirement under Singapore law. No particular form of notice is required; it is sufficient that the notice makes clear that the debt has been assigned. Strictly speaking, acknowledgment by the investor is not a security perfection requirement, but it is often requested by financiers for the following reasons. These acknowledgments commonly include undertakings by the investor directly in favour of the financier. Such provisions usually include: (1) undertaking to pay the financier instead of the fund company upon the financier's request; (2) representing that no prior notices of assignment were received by the investor; and (3) an undertaking that the investor will not assert any set-off or other rights that may exist between it and the fund company against the financier. In the context of a capital call facility, financiers may additionally require that the investors give certain information confirmations, such as the unfunded portion of the investor's capital commitment. However, it is noted that where there is a large number of investor entities, giving express notice in writing to each party and/or obtaining such acknowledgment may be difficult, especially if they prefer to keep their identities confidential. Some deals are structured on the basis that the amount available for borrowing is pegged to the unfunded capital commitments of investors who meet certain financial criteria and/or give such acknowledgment.

Assignment of subscription agreement – Registration of charge

Under section 131 of the Companies Act (Chapter 50 of Singapore), certain charges granted by a company over its assets are to be registered with the Accounting and Corporate Regulatory Authority ("ACRA") within 30 days of the date of creation of the charge. Such categories include charges over book debts, floating charges and charges over uncalled share capital. An unregistered registrable charge will be void against the liquidator and any creditor of the company, such that the creditor would effectively be an unsecured creditor in a liquidation. Moreover, a failure to register a registrable charge would mean that the chargor company and every officer of the chargor company is guilty of an offence and liable on conviction to a fine and default penalty.

An absolute assignment of a chose in action (such as the right to make capital calls and to receive the proceeds of a capital call) by way of security is typically registered as a charge over book debts under section 131(3)(f) of the Companies Act. The test of whether something is a book debt is a rather factual enquiry, being whether the practice in well-kept books is to enter the debt in question in the ordinary course of business. Given that the fund company is essentially a holding company, it is arguable that the obligation to pay monies owed by the investors to the fund company constitutes the fund company's book debts, and consequently an assignment by way of security is registrable as a charge over book debts.

Even if not strictly a book debt, there is an argument that an assignment of the right to make a capital call pursuant to a subscription agreement falls within section 131(3)(b) of the Companies Act as a charge over uncalled share capital. One counter-argument rests on the basis that the requirement to register such charges was meant for charges over the unpaid portion of the par value of shares, and therefore does not extend to a charge over an obligation to contribute capital to the company in connection with an allotment of fresh, fully paid shares. However, this was never tested in a Singapore Court. Nevertheless, if the uncalled commitments were structured as the unpaid portion of the fund company's share capital (such that the investor holds unpaid shares, as opposed to a contingent contractual obligation separate from the allotment of new fully-paid shares in the investor's favour), then arguably there is a strong case that the assignment is registrable under section 131(3)(b) of the Companies Act.

Given the consequences of non-registration, and the fact that it is often not immediately clear whether or not a particular charge would fall within section 131(3) of the Companies Act, it is common practice for Singapore financiers to routinely require registration of each charge created in their favour even if they may not fall strictly within a section 131(3) category.

The Courts do have the power, on the application of the company or any person interested, to grant an extension of time for registration on the grounds that the failure to register was (1) accidental, (2) due to inadvertence, (3) not of a nature to prejudice the position of creditors or shareholders, or (4) where it is just and equitable to grant relief. However, this will involve costs, the time taken for the hearing date and the wide discretion of the court in hearing such an application, and this means that such a procedure should not be routinely relied upon.

It must be noted that the charge registration regime essentially serves a public notice function. As such, the very fact of registration means that the nature of the security, and hence the fact of the fund company having obtained financing, would become public knowledge. In addition, a copy of the charge document must be kept available at the company's place of business for its creditors' inspection without fee, and any person may, upon application to the company and payment of a nominal fee, be furnished with a copy of such instrument.

Note that the registration requirements only apply to companies incorporated under the Companies Act and non-Singapore companies registered as foreign companies in Singapore under the Companies Act. The position may differ if the fund was organised as a limited partnership under the Limited Partnerships Act (Chapter 163B of Singapore). However, where the general partner who acts for the fund is a company incorporated or registered under the Companies Act, charges made on behalf of the fund may be registered as against that general partner.

Charge over shares in subsidiaries

While it is recognised that any downstream security taken over the fund company's portfolio entities would likely rank behind the respective portfolio entity's senior creditors, financiers may nevertheless seek to take security over all of the fund company's assets and undertaking under an all-assets debenture (a security allowed under Singapore law and not uncommon). A typical Singapore law debenture will seek to take a fixed charge over as many present assets as the nature of the property allows (e.g. existing real property, tangible moveable property, insurances, contractual rights and shares), and a floating charge over the whole of the fund company's undertaking and other assets, present and future. Financiers may also require a specific charge over the equity in specific subsidiaries of the fund company. Such charges will be registrable under section 131(3)(g) of the Companies Act as a floating charge, and possibly, for charges over equity in specific subsidiaries, under section 131(3)(c).

Where the shares charged are not that of a subsidiary within the definition given in section 5 of the Companies Act, the charge may still be registrable as a charge over book debts. A typical form of share charge would also include a charge over all rights and dividends received, receivable, attaching to, deriving from or exercisable by virtue of the ownership of such shares. As above, it is commonly accepted practice to treat these rights as book debts and registrable as such. For listed shares which are held as scripless securities (shares within the meaning of "book-entry securities" as defined in section 81SF of the Securities and Futures Act (Chapter 289 of Singapore); typically including shares traded on the SGX) and deposited in The Central Depository, a statutory interest must be created in favour of the financier in the manner prescribed by the Securities and Futures Act and the Companies (Central Depository System) Regulations 1993.

A share charge or pledge given by a fund company would typically be governed by the law of the place of incorporation of the portfolio entity, and it attracts Singapore stamp duty of S$500. The liabilities for stamp duty and its registrability are not affected by the governing law of the charge instrument.

Conclusion

Although very much a developing phenomenon, capital call facilities are becoming more widespread in the Singapore private equity landscape. While foreign investors may feel very much familiar with the usual forms of documentation adopted by domestic financiers in such facilities, there are nevertheless important domestic law issues to bear in mind, especially in relation to the perfection of security. Given the impact these concerns may have on both the fund and its financier, it is important that they be given due consideration.

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Information in this chapter accurate as of 12th Jan 2017

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Spain

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Overview

During the last few years, the private equity industry in Spain has undergone a consolidation process as a consequence of changes made to Spanish law and a turnaround in the market trend following the economic downturn.

If we look at the level of capital raised by the Spanish funds in the last few years, it is clear that there has been a significant turnaround in the private equity industry in Spain, despite the number of transactions involving private equity funds remaining lower than pre-crisis numbers. In 2015, Spanish funds raised a total amount of €3,359m, representing a year-on-year increase and matching the pre-crisis levels. Although the official data has not yet been released, 2016 is expected to be similarly impressive.

One of the important drivers behind this turnaround was 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 offered to private management companies with a presence in Spain an aggregate amount of €154m for investment in 2016. The amount offered by this public fund for year 2017 has reached €190m as a result of the positive performance of the fund and its significant contribution to revitalising the venture capital sector in Spain[1].

From a legal standpoint, the last few years have also been positive for the private equity industry in Spain. 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 implements 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. This new act has played 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 new Private Equity Act indirectly creates 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 recognises 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*).

In our recent experience, we have seen that many 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. Whether this trend stems from the aforementioned change brought about by the Private Equity Act, if it is the outcome of importing a trend from the United States and the United Kingdom or – why not raise it – if this 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, it is 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.

Financing and collateral structure

As regards the financing structure for fund financing transactions, the pattern followed in the few transactions closed in the Spanish market as of today has been the following: a committed revolving credit facility – *subscription facility* – governed by 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 a collateral governed by Spanish law, limited or related to 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* – and 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 seen any 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 it 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 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 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, 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 any future acquirer is notified of the pledge, because without this any such investor can freely discharge its obligations to 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 chargor 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.

<u>Specific documentation issues</u>

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 you 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.

Key developments

Two legal elements have been essential in the emergence and development of fund finance.

The first element, as previously mentioned, is that 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.

The second element relates to the simplification of the pledging process of credit rights resulting from the latest changes to the Act 22/2003, dated July 9 and as amended (the "**Spanish Bankruptcy Act**") – *please remember that the main collateral for fund finance in Spain is the pledge over credit rights resulting from unfunded commitment and bank accounts*. Historically, there was considerable debate amongst Spanish legal scholars as to the ranking of pledges over credit rights from a bankruptcy standpoint, depending on whether the same were constituted or not as pledge with possessory transfer, and registered or not with the Registry of Chattels (*Registro de Bienes Muebles*). As a consequence of these latest legal changes, the debate among legal scholars in relation to this has disappeared. Indeed, the new language of section 90.1.6 of the Spanish Bankruptcy Act following the enactment of Act 40/2015, dated October 1, *on legal regime sector*, sets out specifically that pledges over receivables will be deemed to be privileged credits when having true date (i.e. when being notarised), and that there is no need to register the same with the Registry of Chattels in order to consider the same as privileged credits from a Spanish bankruptcy standpoint as anticipated above.

The clarification of the bankruptcy status of ordinary pledges has undoubtedly enhanced the design and use of facilities that are secured by pledges over receivables, due to simplification and cost reduction, as these pledge agreements do not need to be registered as mentioned above (and consequently, no registration fees have to be paid), which makes such transactions considerably more desirable.

Notwithstanding the aforementioned, it is worth noting that as regards private equity funds (but not private equity companies), 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 the 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 (the International Monetary Fund has forecast a 2.2% growth in GDP, while the Bank of Spain expects growth of 2.3%) which, in our view, should reflect continued growth in the private equity industry and therefore continued growth in fund finance. The general consensus in the private equity industry in Spain is that 2017 may turn into a bumper year in Spain, given the large amount of capital raised last year compared to the number of private equity transactions closed. In addition, given the ECB does not intend to increase the interest rate in the Eurozone in the next couple of years and the existing new 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 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. Time will tell.

* * *

Endnotes

1. Source. *Spanish Association of Capital, Growth and Investment* – Ascri.

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Overview of the subscription credit facility and fund finance market

The subscription credit facility (each, a "Facility") and related fund finance market in the United States (the "US") is at perhaps its most robust position ever. Despite a myriad of challenges coming on the heels of the financial crisis, the US Facility market (the "US Market") has grown by a significant margin (and in many cases, by double digits year-over-year). At Cadwalader, Wickersham & Taft LLP ("Cadwalader"), 2016 will undoubtedly be a record-setting year, both in terms of deal volume and growth of our global practice. While there is no tracking service to accurately measure the size of the US Market, we conservatively estimate, via an analysis of our own deal portfolio and anecdotal evidence from Lenders and other US Market participants, that the US Market is approaching $200bn in size based on Lender commitments.[1] This comprises by far the largest Facility market globally. The outpaced growth of the last half decade has been fuelled by many factors, including robust fundraising and an ever-evolving fund formation environment, sustained positive fund performance, and deep penetration of Facility offerings into the US private equity fund market. Facility usage is now the norm in the US Market, and yet there is still plenty of room for continued growth. This chapter summarizes the current state of the US Market, highlights key trends and challenges impacting the market, and forecasts notable developments for the coming year.

State of the market

<u>Credit performance</u>

Throughout 2016, US Facility credit performance has remained pristine with zero known loan losses or write-downs. To our knowledge, no institutional limited partner (each limited partner, an "Investor") funding defaults have occurred in the US Market thus far in 2016. None of the major lending participants (each, a "Lender") from the 50+ financial institutions in attendance at either of the 6th Annual Global Fund Finance Symposium hosted by the Fund Finance Association on March 2, 2016 in New York (the "2016 Global Conference") or the 2nd Annual European Fund Finance Symposium hosted by the Fund Finance Association on October 20, 2016 in London (the "2016 European Conference") reported a loss or payment event of default in the last 12 months. Similar to prior years, we have not consulted on any Investor capital call ("Capital Call") funding delinquencies, with the exception of a few by high net worth and family office Investors ("HNW Investors") that were subsequently remedied. While this positive credit performance is no surprise given recent history and data points in the US Market, it is worth noting that this perfect credit performance has once again extended to our hybrid and asset-level facilities, which are underwritten at significantly higher risk profiles.

However, many Lenders have grappled with a significant rise in technical defaults caused by covenant breaches, predominantly related to borrower reporting obligations. We think this trend is simply a function of portfolio growth and the increase of newer private equity and investment funds (each, a "Fund") borrowing under their first Facility. Several active Lenders in the market are adding post-closing compliance checklists or training sessions with Funds in hopes of reducing these occurrences. Additionally, US Lender staffing constraints have been stressed by the outpaced growth of Facility portfolios (which, for some US Lenders, has been in the 10–30% range over the past 12–18 months). These portfolios have quite often churned out a steady (and increasing stream) of Facility amendments, joinders and collateral maintenance work. As a result, a number of mature Lenders have recently sought new hires, expanded portfolio management teams, completed internal reorganizations, instituted additional training sessions or a combination thereof to keep pace with the growth of the business.

New entrants and recent market development

New entrants (Lenders, law firms, etc.) have for some time tried to establish themselves in the US Market, each with different tactics. Beginning around 2012, certain new entrant movements occurred or accelerated that had the potential to be disruptive to the historical competitive dynamics, at least at the fringes. For example, multiple non-US Lenders were investing in and building their capabilities in the US. Similarly, and in reverse, many of the dominant US Lenders became increasingly attentive to Europe and Asia, recognizing the potential opportunities in those submarkets. Unlike some of their new-entrant predecessors, the non-US Lenders had real, demonstrable execution capabilities, even if primarily in a different submarket. As Lenders migrated in both directions, they brought their historical Facility structures and underwriting guidelines to the new submarket. As a result, Funds found themselves with an increased diversity in Facility offerings. Today, Funds are more often weighing significant structural variation (a traditional US Facility borrowing base (each, a "Borrowing Base") *vs*. a coverage ratio, as a simple example) in their Facility proposals.

Along a somewhat parallel path, multiple US regional Lenders have expanded beyond their historical coverage geographies and middle-market roots. This movement has been in an effort to better serve and grow with certain Fund clients. It is also a response to the near-perfect historical credit performance of US Facilities. As a result, many US regional Lenders have recently increased their Facility maximum-hold positions to levels comparable to that offered by some of the financial center Lenders, at least for certain preferred Fund sponsors. With increased relevance in the greater US Market, these regional Lenders have altered the competitive landscape. The Facility structures and underwriting parameters at these institutions often differ from those of a traditional Facility Lender. Such variances in structure may dictate the syndication strategy and prospects for a particular Facility, sometimes adding additional complexity to a transaction. For example, we have previously written about the interesting trend of "shadow borrowing bases" – where traditional US Facility Lenders, in order to participate in deals led by regional Lenders that employ coverage ratio style borrowing bases, underwrite the Investor pool according to the more traditional included Investor/designated Investor/concentration limit formula, but do it on a shadow basis, not conscripted in the credit documentation.

Given the competitive landscape in the US Market, Lenders are increasingly willing to move further down the risk continuum. Five or six years ago, we saw a strong movement away from historical requirements to deliver investor letters and legal opinions in the US, and we now continue to see a greater acceptance of less than ideal Fund limited partnership agreements ("LPAs").[2] Similarly, Lenders have developed concepts to lend against the uncalled capital commitments of Investors that have historically been excluded from Borrowing Bases. This includes lending against the commitments of sovereign wealth funds ("SWFs"), Texas state investors and other historically challenging Investors via the "hurdle" or "skin in the game" type concepts we have previously noted. Another recent trend has been the expansion, both in terms of frequency and size, of "HNW Facilities" – traditional subscription-style facilities made available to Funds comprised solely or almost entirely of HNW Investor commitments. These structural evolutions have also extended Borrowing Base availability later into a Fund's life cycle, further extending the market. Most notably over the past few years, we have seen a relatively significant expansion in the underwriting consideration of Fund assets, both in terms of supporting more aggressive Borrowing Bases and as a means of mitigating other perceived credit weaknesses in a particular Facility, such as a tight overcall limitation or similar Investor cease funding risk.

Taking this a step further, certain Lenders in the US Market are now actively considering net asset value-based facilities (each, a "NAV Facility") or hybrid variations. We anticipate this will continue as Lenders seek higher-yielding opportunities and aging Funds look for continued liquidity and/or leverage later in their lifespans, as Investor commitment-backed Borrowing Bases reduce. In fact, given some of the challenges present in the post-crisis investment/exit environment,[3] many Funds have expanded their tenors. The average lifespan of a private equity Fund is currently 13.2 years and increasing, up from 11.5 years in 2008[4] − a trend that will likely increase demand for later-term Fund financings. While each of these facilities is unique, we are seeing more consistent structures and increased frequency of the offerings. As more Lenders gain comfort with underwriting the particular Fund's assets, we expect this market to grow steadily, albeit continuing at a fraction of the size of the Facility market.

Fund performance

Fund performance throughout 2016 has continued to be a key factor driving overall US Facility growth. It should be no surprise that satisfied Investors seek to invest additional capital into new Funds. The most telling trend is that Investors continue to reap the benefit of hefty distributions at record rates. 2016 will mark the sixth consecutive year that Investors received more from Fund distributions than they funded via Capital Calls.[5] The net cash flows to Investors over the last five years alone have exceeded $300bn − equal to more than one-and-a-half years' worth of fund-raising during that same period.[6] In fact, according to data from Preqin, 98% of all Investors today have a generally positive view of Fund investment.[7] At each of the 2016 Global Conference and the 2016 European Conference, a Preqin presenter noted the excellent health of the Fund industry, as evidenced by respectable-to-exceptional returns, positive Investor sentiment and continued Fund growth, as fundraising has been in part driven by these increased net cash flows.

Fund formation and finance

Fund formation

We are seeing slightly decreased fund formation activity globally, including in the US. However, based on past experience and a strong US Fund market supported by record distributions, we are optimistic that fundraising activity will remain steady (and perhaps increase) into 2017. According to Preqin data, the first three quarters of 2016 saw 864 Funds raise a combined $425bn in Investor commitments.[8] This is the first time since

2013 that fewer than 1,000 Funds have closed in the first three quarters of the year, and represents a 9% decline in aggregate capital raised compared to the first three quarters of 2015.[9] In fact, the third quarter of 2016 had 69 fewer Fund closings, with nearly $1bn less capital raised, than in the second quarter of 2016.[10] Most experts attribute some of this interim decline to uncertainty created by macro events, such as Brexit and the 2016 US presidential election. However, there is room for optimism, albeit in a crowded market. At the end of the third quarter in 2016, 2,935 Funds were seeking a total of $983bn in Investor capital compared with 2,798 Funds seeking a combined $938bn in the prior quarter.[11] Additionally, Preqin surveys show that 87% of Investor respondents expect to commit more or the same amount of capital to Funds in the next 12 months, with 43% expecting to increase commitments over the same time period.[12] Thus, our expectation is that even a moderate to healthy increase in consummated Funds and Investor commitments will lead to continued expansion of the US Market in 2017, perhaps with the most notable growth occurring outside of the traditional US Market with hybrids, NAV Facilities, and bespoke separately managed accounts ("SMAs") and other Investor-driven structures.

Fundraising delays are an additional challenge we are seeing impact the US Market. Depending on asset class, Preqin reports that the time to first close for many Funds has now reached or exceeded 20 months. As Facilities are often discussed in the early stages of Fundraising and many times even structured and documented to coincide with a Fund's initial Investor closing, this is creating some noticeable delays in Facility closings. The deals are eventually closing, but these timing delays present some challenges as Lender credit approvals expire and/or final Borrowing Base composition (and other terms) change based on final Investor makeup at Facility closing compared to the indicative list initially provided by the Fund. We anticipate these delays may continue into 2017 given the competitive and crowded fundraising market and the increased Investor sophistication and appetite for bespoke structures and terms.

Investor influence on structuring

Today's Investor influence is a frequent driver of US Facility structures. Over the past few years, Investor recognition and consideration of Facilities has increased dramatically, and many Investors now pay close attention to how Facilities are structured and the related delivery and reporting obligations. Investors even negotiate Facility-related provisions into their side letters with the Fund. These often express a desire to limit their obligations to deliver financial statements or other information to Lenders. Some tax-exempt Investors may also insist on several liability, borrowing clean-down periods and/or certain limits on cross-collateralization with respect to the individual parallel funds or SMAs they invest through, in order to preserve a more favorable tax structuring analysis, such as limiting unrelated business-taxable income. Whether facilitated via efforts of the Institutional Limited Partners Association or simply via greater investing experience, Investors are more sophisticated and more aware of the Facilities their Funds are entering than ever before.

One key example of the direct impact Investor influence is having on US Facilities is the growing use of SMAs. Investor preference for an SMA investing structure is driven primarily by the desire for more control and lower management fees with the Fund. Typically only Investors with the highest commitment levels (such as US state pensions or SWFs) currently employ SMAs in their investing strategy. In 2013, we predicted steady growth in the volume and frequency of commitments to Funds by SWFs, and in the use of SMAs generally by Investors. At that time, Preqin estimates showed that SWFs had just surpassed the $5trn mark for total assets under management. That number has grown to $6.51trn through March of 2016, increasing by nearly $1.5trn in less than a three-year period alone.[13] Also, according to 2013 data, only 19% of Investors surveyed by Preqin indicated that they used and/or were planning to use SMAs. Today, that number has increased to 32% of Investors.[14] Additionally, 30% of Investors expect to increase their level of SMA activity in the long term.[15] Thus, including SWFs in Borrowing Bases and single Investor exposure when setting up Facilities for SMAs has become a permanent fixture in the US Market. Three years ago, we closed only approximately three SMA Facilities in the entire year. Through the first three quarters of 2016, Cadwalader has closed 12 SMA Facilities, with another three in progress.

Security structures

- *Traditional subscription facilities*

A traditional US Facility is defined by its collateral package, which will typically include a pledge by the Fund and its general partner (each, a "GP") of all rights, titles and interests in and to: (i) the unfunded capital commitments of the Investors; (ii) the right to make Capital Calls upon the Investors; (iii) the right to collect the proceeds of, and enforce the making of, such Capital Calls; and (iv) the deposit account (the "Collateral Account") into which Investors will fund their capital contributions when called (collectively, the "Facility Collateral").

The Facility Collateral is characterized as a "general intangible" or "payment intangible" under Article 9 of the Uniform Commercial Code (the "UCC"). A security agreement and/or series of pledges and security agreements are used to create the Lender's security interest in the Facility Collateral. With respect to each pledging Fund and its GP, a UCC filing pursuant to Article 9 of the UCC is the method by which Lenders perfect such security interest. The applicable filing office is dependent upon the jurisdiction of formation of such pledging Fund or its GP, as applicable. The Collateral Account is perfected via an account control agreement entered into by and among the pledging Fund, the depository bank holding such account and the Lender. These accounts are typically "springing" whereby the Lender will obtain exclusive control by way of presenting the depository bank with notice upon the occurrence of a certain event under the Facility (typically, Borrowing Base deficiencies, pending defaults and ripened events of default). In addition to pledging the Facility Collateral, the GP also grants the Lender a power of attorney to issue Capital Calls in the GP's name during a default.

For most US Facilities, New York law will govern the loan and related security documentation. If one or more Funds are formed or secured accounts are held in non-US jurisdictions, then local counsel should be consulted regarding any local law requirements for perfecting security and recognition of a US judgment.

Facilities are full recourse to the Fund, and typically underwritten with borrowers on a joint and several basis. This is to provide full cross-collateralization across any parallel funds and alternative investment vehicles in the structure, which is a necessity in deals with a single Borrowing Base comprised of Investors that commit to multiple Funds within the structure. Sometimes, due to US law concerns under ERISA or the tax code, Facilities will be structured via "cascade" pledges that utilize a series of security grants to indirectly pledge certain Fund interests to the Lender. Where several liability is an option, cross-secured or cross-collateralized structures may be used to effectively link the ability to call from all Investors in each Fund during an enforcement scenario. Additionally, Facilities may be structured via separate "Onshore" and "Offshore" facilities or "umbrella" style silos (the former being utilized where no cross-security or linkage across parallel funds is permitted, and the latter for efficiency's sake where it makes sense to document multiple Facilities, each for a separate vintage or fund series with respect to a single sponsor, in one set of transaction documents). Whether or not a particular approach will work for a Lender will ultimately depend upon its underwriting criteria as applied to the given Fund, including, but not limited to, the composition of the Fund's Investors and whether one or multiple Borrowing Bases is feasible to achieve the desired Facility size and usage.

- *NAV and hybrid facilities*

While some Lenders may consider NAV Facilities on an unsecured basis (where the assets are high-quality and fairly liquid in an enforcement scenario), most US Lenders will require security over some assets of the Fund. NAV Facilities are not typically secured by all underlying investments of the Fund. Such an "all asset" arrangement is quite often commercially challenging given potential transfer restrictions, third-party consent rights, change of control triggers and/or other perfection or foreclosure issues. The collateral varies widely from deal to deal and generally includes some combination of: (a) cash distributions and liquidation proceeds from Fund investments; (b) equity interests of special purpose vehicles or holding companies via which the Fund owns the "eligible investments"; and/or (iii) less frequently, direct equity interests in such investments. The idea being that, in a default scenario, the Lender will have the right to foreclose on the collateral, and either take direct ownership control of the equity interests or sell such interests and apply the sale proceeds to satisfy any remaining Facility debt.

The method of perfecting the security interest in cash distributions and liquidation proceeds is akin to a traditional US Facility. Such distributions and proceeds are directed and/or swept into an account that is pledged to the Lender and subject to related withdrawal restrictions. The account or accounts will be subject to account control agreements in favor of the Lender. The pledged equity will either be perfected via Lender control of certificated securities or over a securities account, in each case, pursuant to Article 8 of the UCC or by way of UCC filings where such interests are characterized as "general intangibles" under Article 9 of the UCC (which is generally the case where the interests are issued by holding companies formed as limited liability companies or partnerships unless such company elects to "opt into" Article 8 of the UCC). In less common situations where the collateral package includes a direct lien on the Fund's investments, control over a securities account or custodial arrangements may be used by the Lender. If non-US entities or non-US accounts are present in the collateral, then additional non-US security documentation and means of local law perfection may be required.

Hybrid facilities are generally considered to be some combination of a traditional US Facility and a NAV Facility, whereby the Lender acquires a security interest over certain assets of the Fund as well as remaining uncalled capital of (and related Capital Call and enforcement rights with respect to) the Fund's Investors. The means of perfecting each component of the collateral will require a legal analysis under the UCC, but will generally be subject to the aforementioned methods.

Key legal developments

New margin regulations

A popular feature of US Facilities over the past few years has been the inclusion of a secured hedging facility. Under such arrangement, the Fund may enter into swaps with the Lender that are secured by Facility Collateral pursuant to the Facility documents (subject to agreed trade allocation thresholds, which amounts, when utilized for trades, are subtracted from Borrowing Base availability). From March 1, 2017, all uncleared "swaps" entered into by swap dealers are subject to margin requirements that will generally require counterparties to post cash or similar highly rated "eligible collateral".[16] Lenders that are swap dealers will be subject to the new rules.[17] However, these requirements are generally not applicable to "foreign exchange forwards" and "foreign exchange swaps", as those terms are defined under the US Commodity Exchange Act (collectively, "Excluded Swaps").[18] Going forward, it will be prudent for Lenders to include language that "the Borrower understands and agrees that applicable law may require the Lender to impose independent collateral requirements on lender hedging agreements." While this is likely to have some impact on the utility of such secured hedging facilities (and maybe no impact, to the extent hedging activity is limited to Excluded Swaps), access to a Facility will certainly be beneficial to Funds that need to post cash or letters of credit to satisfy the requirements for non-Excluded Swaps.

Heightened sanctions / AML focus

On September 1, 2016, the Loan Syndications & Trading Association ("LSTA") published new guidance on the inclusion of sanctions and anti-money laundering provisions in US loan transactions.[19] While the market has slowly started to settle on standards similar to the LSTA recommendations, a number of Lenders have policy guidelines that differ slightly. Also, some gaps do exist for fund finance transactions given that the LSTA provisions were drafted generally with non-Fund borrowers in mind. As a result, knowledge qualifiers on certain reps and warranties, the scope of sanctions authorities (including non-US authorities in US Facilities), and reps and warranties regarding Investors as sanctioned persons are frequently negotiated in US Facilities. The issues are extremely sensitive to Lenders since they could face potential civil or criminal liability, commercial risk relating to possible non-repayment by Funds facing sanctions liability, and also franchise and reputational risk associated with engaging in business with Funds or Investors who are associated with sanctions targets. While many of these issues should be addressed on a case-by-case basis, they do present interesting syndication challenges especially where non-US Lenders or Funds are party to a US Facility led by a US Lender. As a result, we are frequently seeing a prudent expansion of the scope of sanctions-related provisions in US Facilities, and expect this trend to continue into 2017.

Case law update

There have been no material updates during the prior year in US case law relevant to enforcing Investor capital commitments.[20] In fact, the often cited *In re LJM2 Co-Investment, L.P.* and *Iridium* cases remain good law in Delaware, and continue to stand for the proposition that capital commitment funding obligations by Investors are enforceable for debt repayment in spite of a Fund bankruptcy or bad faith modification of Investor funding obligations.[21]

Bail-in

As part of the continuing measures by national authorities in the European Union ("EU") and the EU itself to avoid a repeat of the taxpayer bail-outs of financial institutions required after the 2008 financial crisis and as part of an EU-wide directive (the Banking Regulation Recoveries Directive (the "Directive")) introduced as part of the measures to deal with this issue, compulsory "Bail-in" provisions were introduced across the EU covering European Credit Institutions and Investment Firms in January 2016. The intended effect of a "Bail-in" is to allow the write-down or conversion of unsecured debt of a relevant institution, where that institution is failing or likely to fail. In effect, it enables such write-downs or conversions to be imposed prior to an actual insolvency of that institution so that (along with other measures) systemically important parts of that institution or its business can be continued.

These provisions (referred to in the Directive as the "Bail-in tool") apply automatically to any obligations of an EU/European Economic Area ("EEA") incorporated relevant institution in any contract governed by the laws of an EU or EEA country involving such institutions. For contracts governed by laws other than those of an EU or EEA country involving such institutions (e.g. the US), Article 55 of the Directive ("Article 55") requires that specific "Bail-in" language is included in the relevant contract. A number of industry bodies, including the Loan Market Association in the United Kingdom, the International Swaps and Derivatives Association, Inc. and the LSTA in the US, have drafted relevant language for inclusion in contracts. The relevant institutions are subject to penalties (fines and/or restrictions on and/or removal of licensing) if the language is not included where it should be. For subscription finance transactions, the primary areas of documentation where such language may be required to be included are the credit and security documents, but inclusion may also be required (and should be considered) in Fund documentation (e.g. subscription agreements and potentially, LPAs and/or side letters) where relevant institutions (or their subsidiaries or associates) are or may be parties to those arrangements.

Following industry pressure, some exceptions to the compulsory "writing in" of the Bail-in terms under Article 55 have been allowed (in the UK effected by the Prudential Regulation Authority as of August 1, 2016). These exceptions generally relate to situations in which the inclusion of the specific language would be prohibited or contradictory to law or regulation, and not simply commercially "inconvenient". So in general, and unless one of the limited exceptions can be applied, Bail-in language should be included in all new contracts and/or material amendments to existing contracts made or effective after January 1, 2016. Notably throughout 2016, we have already experienced a large push by EU Lenders in US syndicated Facilities to include the new prescribed Bail-in language and we expect this will be a permanent fixture moving forward.

Brexit

To the surprise of almost everybody, in June 2016, the UK voted in a referendum to exit the EU. Since the vote, there has been a great deal of political and legal confusion and argument about exactly what the vote means and how that vote will be or can be implemented.

The latest indications are that the UK Government will, subject (as per a recent decision of the High Court in the UK and currently being appealed to the UK Supreme Court) to UK Parliamentary approval, trigger a two-year period of negotiation on the terms of the UK exiting the EU under Article 50 of the EU Constitution, some time around February/March 2017, which (if the two-year timetable was adhered to) would mean an actual exit on terms in 2019, although there are some relatively persuasive views that the process may take a great deal longer than that. There is, as of yet, not a great deal of clarity on the likely terms of that exit. The latest indications are that it will be a relatively "hard" exit (but with a likelihood of building in some protection for various significant industries, for example the automobile and financial services industry), but this is subject to significant change depending on the political and commercial climate.

For Funds and the fund finance market (as with any other industry) it is really "too early to tell" in terms of the precise impact of Brexit. For Lenders and Funds, by far the most significant "macro" impact of the Brexit vote and negotiations will be the preservation (or not) of "passporting" rights between the UK and the rest of the EU (by which currently institutions situated in one EU country can effectively carry on business and/or market to commercial investors in any other EU country). Should that or equivalent no longer be available (or even be called into question), then both Lenders and Funds are likely to move at least some of their deal making and other resources and focus "out" of the UK and into a continuing "EU" country or countries. In terms of the "micro" impact (e.g. on credit documentation), the impact currently is minimal, since until the conclusion of the Article 50 process the UK remains part of the EU and contractual provisions currently are based on that premise. That may change as the exit negotiations continue and matters become clearer, at which point (a) there could be some impact (particularly if there was a "hard" Brexit) on the more "technical" side of contractual terms relating, for example, to jurisdiction and enforcement and/or matters relating to sanctions, increased costs or "Bail-in", and (b) some more substantive impact on commercial terms (covenants, etc.) to the extent that the Brexit terms started to have a real impact on the commercial and credit aspects of credit or Fund documentation. At a minimum, the uncertainty has been interesting to the US Market at large and is likely to be somewhat impactful, given that Brexit has real implications on fundraising, formation and investment strategy for Funds with UK touch points and commercial implications for UK Lenders, that in each case, participate in US-based Facilities.

The year ahead

To date, 2016 has included a number of challenges to the US Market: continued global macro-economic and political uncertainty (including Brexit and the US presidential election), reported declines in fundraising, increased delays with initial Investor closings and increased Investor preference for SMAs, which are more challenging to lend to than traditional commingled fund vehicles. Yet, US Facility deal volume remains robust and will likely finish above 2015's pace. While we expect 2016 deal volume to ultimately finish at or ahead of the 10% growth that we forecasted at the end of 2015, a strong finish to the year will be necessary. However, the pipeline of both large syndicated transactions and bilateral deals forecasts well for the remainder of the year and into the first quarter of 2017.

This growth is being driven by the same factors that have been driving the US market for some time. There are still Funds being introduced to the Facility product, and market penetration has been and remains a primary growth driver, especially in the middle market buyout space. Further, many Lenders continue to adjust their maximum hold positions, leading to larger availability for the larger Funds currently being formed. Finally, asset-based lending to fund-of-funds and secondary Funds secured only or primarily by their underlying fund interest investments has increased considerably (at possibly the highest rate in recent years), and we think this growth will continue into 2017. We also expect the recent fundraising declines of the third quarter 2016 to reverse course. All told, we forecast continued growth in the US Market to be in upper single digit range (6–9%).

There are simply too many factors to support a more pessimistic view. With a record number of Funds actively fundraising and record levels of cash distributions year-over-year since 2010, we are hard pressed to forecast a meaningful decline in 2017 Fund formation. Even assuming some macro-level economic and political volatility, we think the US Market has plenty of headroom for uncorrelated growth given Fund volume and unprecedented levels of dry powder relative to actual US Market size.[22] While US Facility structures have been trending moderately in favor of Fund borrowers for years, we continue to believe that the credit profile of market-structured US Facility transactions forecasts well for US Facility performance in the year ahead, and we do not forecast any systematic or wide-spread default or loss occurrences. Thus, the state of the US Market should remain strong in 2017.

Acknowledgment

Special thanks to Danyeale Chung and Trey Sessoms, associates in the Cadwalader Charlotte office, for their assistance with this Chapter.

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Endnotes

1. We estimate the global market is approximately $300bn in Lender commitments.
2. We should note that this trend has been somewhat more muted in 2016 compared to prior years. The increasing concentration of Funds with the top tier Fund formation law firms has been a significant positive for the US Market, as these firms are intimately familiar with lending requirements and tend to produce bankable Fund LPAs from the outset. This positive trend on the collateral side of US Facility structures has somewhat reduced the prevalence of asset-level mitigants, such as net asset value covenants, periodic clean-downs and covenants to call capital.
3. According to the *Preqin Investor & Fund Manager Surveys – June 2016*, 65% of Investors listed Pricing/Valuations as the biggest challenge for the next 12 months.
4. Source: Palico as reported by Law360, *PE's Rising Enchantment with Unconventional Fund Terms* by Benjamin Horney, October 24, 2016.
5. $475bn was returned to Investors in 2015 alone according to data presented by Preqin at the 2016 Global Conference.
6. See, *2016 Preqin Report*, p. 43.
7. See, *Preqin Investor Interviews*, *June 2013-June 2016* ("Preqin Investor Interviews"); the Preqin Investor Interviews also noted that 89% of Investors feel that their private equity Fund investments have lived up to expectations over the past 12 months; also 63% of Investors surveyed believe that Fund manager and Investor interests are currently aligned.
8. See, *Preqin Q3 2016 Fundraising Update* (the "Preqin Fundraising Update"), p. 1.
9. *Id.*
10. *Id.*
11. *Id.*
12. See, *Preqin Investor Outlook: Alternative Assets H2 2016*.
13. See, *The 2016 Preqin Sovereign Wealth Fund Review*.
14. *Preqin Investor Interviews, June 2016*.
15. *Id.*
16. See, Commodity Exchange Act ("CEA") Section 4s(e).
17. See, 80 Fed. Reg. 74839 (Nov. 30, 2015).
18. See, Sections 1a(24) and 1a(25) of the CEA.
19. See, "*LSTA Guidance Regarding US Sanctions Issues in Lending Transactions*".
20. We should note that there have been some recent disputes between Investors and GPs that have led to litigation in the US. See *Wibbert Investment Co. v. New Silk Route*

PE Asia Fund LP et al., case number 650437/2013, in the Supreme Court of the State of New York, County of New York. Wibbert sought to avoid making a Capital Call seven times alleging fraud on the part of New Silk, but, according to the last publicly available reports, ultimately funded its capital commitment in order to preserve its status as a limited partner in the Fund.

21. See *In re LJM2 Co.-Investment, L.P.*, 866A. 2d 762 (Del. Super. Ct. 2004) and *Chase Manhattan Bank v. Iridium*, 307 F.Supp 2d 608, 612-13 (D. Del. 2004); local counsel should be consulted for non-Delaware jurisdictions, which often have similar case law: see *Advantage Capital v. Adair* [02 Jun 2010] (QBD) Claim no. HQ10X01837 (Order for breach of contract granted in favor of private equity fund that sued a limited partner for repudiation under English law).

22. With a reported $1.43trn in dry powder available globally (see *Preqin Fundraising Update*) and assuming a global Facility market size of $300bn in Lender commitments, this still only yields a global advance rate of approximately 21%. Most Lenders have an average blended advance rate of closer to 30% across their portfolios, which suggests there is still ample room for growth via penetration into new Funds (with the US Market capturing a large proportion).

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Wes has served as lead counsel on many of the largest and most sophisticated fund financings ever consummated, notably having assisted more than 35 banks as lead or syndicate lender during the past two years with transaction values totalling in excess of $25bn. Many of the transactions he advises on are precedent-setting, carrying unique structures and complex international components – whether that be foreign limited partners or funds, multi-currency advances or foreign asset investment.

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