Fund Finance Compendium 2011 - 2018

Mayer Brown

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INTRODUCTION

We started working with you on subscription credit facilities nearly 20 years ago. Initially, the product was utilized by private equity real estate funds for a wide variety of purposes—everything from pure capital call bridging to an alternative to asset-level leverage. The documentation was altogether different then and sometimes included items such as a pledge of the limited partners' equity interest and/or limited partner investor acknowledgements. With no "market standard" credit agreements existing for these arrangements in the early 2000s, market players negotiated bespoke facility documents to address the competing interests of lenders and private equity funds alike.

Mayer Brown, through no intent or design, happened to be well-positioned to assist in this burgeoning market's growth given the firm's capabilities in sophisticated, secured lending transactions as well as its experience in private investment fund formation and representation. And the ensuing two decades have seen global events and product developments beyond anything we could have imagined back then.

Among other things, the subscription credit facility product not only survived but thrived through the Great Recession. These facilities proved to be essential to many funds by permitting them to preserve their assets' values by allowing follow-on and other necessary asset maintenance investments during that challenging period. Also, many limited partners faced their own temporary liquidity issues and, as a result, requested that sponsors fund these investments via the subscription credit line. Although the recession posed many practical tests for market participants, the strength and integrity of the subscription credit facility's legal structure allowed the product to pass with flying colors and, as a result, experience tremendous growth.

Since then, the broader "fund finance" market has grown rapidly in size and scope. This growth can be seen in the increasingly global market for subscription credit facilities as well as in innovations in product type, such as the introductions of hybrid and net asset value facilities that serve a variety of private equity and hedge funds at varying stages in their life cycles. The market also has expanded to provide liquidity at various levels of the sponsor structure, with credit lines now available to management companies and general partners.

Eight years ago, we realized that we had stumbled into a vibrant market overflowing with creative, intelligent and responsible participants and thus thought it made good sense to begin writing about some of the trends impacting our industry. This also coincided with our wish to connect market participants through the Mayer Brown Fund Finance Symposium, which has since become an anticipated industry event, a global conference connecting market participants in the United States, Europe and Asia.

We are both proud and fortunate to have collaborated with many of you on these efforts and on many of these articles. Hopefully, this dialogue has improved the fund finance transactions we work on together and the market as a whole. We are so very grateful for your partnership with us, and, as a small token of our gratitude, we've decided to compile all of our articles into one volume for your ease of reference.

Whether it be new developments in fund structuring, regulatory updates impacting our industry or the latest financial products in response thereto, we look forward to drawing on our prior experience while continuing to learn from you as we collaborate on creative solutions for future fund financings.

~ THE MAYER BROWN FUND FINANCE TEAM

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SUMMER 2011

Enforceability of Capital Commitments in a Subscription Credit Facility

A subscription credit facility (a "Facility"), also frequently referred to as a capital call facility, is a loan made by a bank or other credit institution to a closed end real estate or private equity fund secured by the capital commitments of the fund's investors. As the number of new funds in formation appears to be up markedly from the recent past, interest in Facilities from funds and potential creditors is up dramatically.

Introduction

A subscription credit facility (a "Facility"), also frequently referred to as a capital call facility, is a loan made by a bank or other credit institution (the "Creditor") to a closed end real estate or private equity fund (the "Fund"). The defining characteristic of a Facility is the collateral package: the obligations are typically not secured by the underlying assets of the Fund, but instead are secured by the unfunded commitments (the "Capital Commitments") of the limited partners of the Fund (the "Investors") to fund capital contributions ("Capital Contributions") when called from time to time by the Fund or the Fund's general partner. The loan documents for the Facility contain provisions securing the rights of the Creditor, including a pledge of (i) the Capital Commitments of the Investors, (ii) the right of the Fund to make a call (each, a "Capital Call") upon the Capital Commitments of the Investors after an event of default and to enforce the payment thereof, and (iii) the account into which the Investors fund Capital Contributions in response to a Capital Call.

As we come out of the recent financial crisis, Investors appear willing to again make Capital Commitments to Funds, and the number of Funds in formation and seeking Capital Commitments appears to be up markedly from the recent past. Correspondingly, Fund inquiries for Facilities are also on the rise. As Creditors evaluate these lending opportunities, they naturally inquire into the enforceability of Investors' Capital Commitments in the event of a default under a Facility. This Legal Update seeks to address the current state of the law on point.

Enforceability of Capital Commitments

Although the subscription credit facility product has been around for many years, the volume of published case law precedent on point is limited. Creditors typically see this as a good thing: few Facilities have defaulted and thus there has been little need for litigation against Investors seeking to compel the funding of Capital Contributions. Anecdotal evidence during the financial crisis certainly supports this positive performance, as very few Investor defaults,

let alone Facility defaults, have been reported by active Creditors in the market.

There is, however, published legal precedent supporting Creditors' enforcement rights, and it is generally accepted that a Creditor can enforce the Capital Contributions of the Investors under two separate theories of liability: state statutory law and general contract law. We examine each in turn below. Additionally, a Creditor's rights to the Capital Commitments of the Investors should not be materially impaired by a Fund's bankruptcy proceeding. While there is not definitive legal authority negating all possible defenses an Investor could raise, there is sufficient law on point to give Creditors' ample comfort that the collateral supporting a Facility is enforceable.

STATE STATUTORY RIGHT OF CREDITORS TO CAPITAL COMMITMENTS

Delaware Statutory Law. Most Funds are formed as either limited partnerships or limited liability companies, and the vast majority of stateside Funds are organized under Delaware law. Delaware statutory law contains specific provisions addressing the obligations of an Investor to a Fund: "Except as provided in the partnership agreement, *a partner is obligated to the limited partnership to perform any promise to contribute cash or property or to perform services*, even if that partner is unable to perform because of death, disability or any other reason."[1] In addition, an Investor's obligation to honor its promise to make Capital Contributions explicitly extends for the benefit of Creditors, and although an Investor's obligations to the Fund can be "compromised" by consent of the other Investors, this compromise will not excuse the liability or obligations of the Investor in question to Creditors of the Fund. Title 6, Section 17-502 (b)(1) of the Delaware Code provides:

> Unless otherwise provided in the partnership agreement, the obligation of a partner to make a contribution or return money or other property paid or distributed in violation of this chapter may be compromised only by consent of all the partners. Notwithstanding the compromise, a creditor of a limited partnership who extends credit, after the entering into of a partnership agreement or an amendment thereto which, in either case, reflects the obligation, and before the amendment thereof to reflect the compromise, may enforce the original obligation to the extent that, in extending credit, the creditor reasonably relied on the obligation of a partner to make a contribution or return.[2]

The Revised Uniform Partnership Law, adopted by most states, contains similar provisions allowing a Creditor to enforce its rights against an Investor, even if the Investor's obligations to the Fund have been compromised.[3] The Delaware LLC statutory framework provides similar protections for Creditors.[4]

A Delaware Superior Court has confirmed a Creditor's cause of action against an Investor to compel the funding of its Capital Commitment under Delaware statutory law. In *In re LJM2 Co-Investment, L.P.*, a Delaware limited partnership was formed by Andrew Fastow, the then-CFO of Enron, for the purpose of making investments in energy and communications businesses related to Enron. The Fund secured nearly $400 million in Capital Commitments and entered into a $120 million syndicated Facility, in what appears to have been a "No Investor Letter" transaction.

The Facility included an "Undertaking" pursuant to which, if the Fund defaulted, the Creditors could issue Capital Calls to cure any payment default. When Enron went bankrupt, the Fund defaulted and the Investors declined to fund Capital Calls issued by both the general partner and subsequently by the Creditors. Instead, the Investors amended the Partnership Agreement, in violation of the Facility provisions, to compromise and rescind the Capital Calls. Without additional Capital Contributions, the Fund could not

meet its obligations and filed for bankruptcy. The bankruptcy trustee issued an additional Capital Call—which the Investors again declined to fund—and then commenced litigation against the Investors.

The Investors moved to dismiss the statutory cause of action under Title 6, Section 17-502(b)(1) of the Delaware Code based on a variety of arguments, including that the Creditors could not demonstrate "reliance" on their Capital Commitments as required by the statute. The court ruled in favor of the Creditors, holding that they stated a claim for relief under Section 17-502(b)(1) and that the Creditors adequately alleged reliance on the Capital Commitments.[5] While not an ultimate ruling, the framework set forth by the court looked quite favorable for the Creditors, and the case appears to have been resolved prior to the issuance of any subsequent opinions.

New York Statutory Law. New York law imposes a similar duty on Investors for "unpaid contributions" to the Fund, and this obligation extends for the benefit of the Fund's Creditors.[6] Additionally, an Investor may be liable with respect to its unfunded Capital Commitment even after exiting the Fund. In *In re Securities Group 1980*, the trustee of the Fund's bankruptcy estate brought an action seeking to enforce the Investors' Capital Commitments, which they had declined to fund after principals of the Fund sponsor were convicted of tax fraud. The Federal Court of Appeals, affirming the Federal Bankruptcy Court, held that the Investors were obligated to fund their Capital Contributions irrespective of the alleged fraud committed by the Fund Sponsor: "Under the statutory provision [of New York law], even if a debt to a partnership creditor 'arises' after the limited partner's withdrawal, the withdrawn limited partner is nevertheless liable for the debt if the creditor 'extended credit' before the amendment of the limited partnership certificate."[7] The court went on to uphold the liability of the Investors to the Fund's Creditors reasoning that "the limited partners should bear the risk that the partnership's assets could become worthless."[8]

CONTRACTUAL RIGHT TO CAPITAL COMMITMENTS

Breach of Contract. Under a theory of contract liability, an Investor's obligation to fund its Capital Commitment is an enforceable contractual obligation pursuant to the terms of the partnership agreement (the "Partnership Agreement"). An Investor is held accountable for its Capital Commitments on the ground that it has entered into a contractual relationship with the other partners to make Capital Contributions or contribute other property to further the Fund's financial growth. Accordingly, the failure of an Investor to honor its obligations would constitute a breach of contract, and the Investor would be liable for such a breach.[9]

To rely on a theory of contractual liability, the Creditor needs to have standing to assert the claim for breach. To help establish standing, the Partnership Agreement and the Facility documents should contain affirmative language evidencing: (i) the right of the Fund or general partner to make Capital Calls on the Investors and their obligation to fund their related Capital Contributions and (ii) a pledge by the Fund of its right with respect to such Capital Calls and the enforcement thereof to Creditors. If the Partnership Agreement provisions create the contractual obligation and the Facility documents contain the requisite pledge, the Creditors will be well-positioned legally to enforce the Investor's Capital Commitments.[10]

Iridium. A federal district court's ruling in *Chase Manhattan Bank v. Iridium Africa Corporation* illustrates the importance of the Partnership Agreement in protecting the rights of Creditors. In this case, the Creditor entered into a $800 million Facility with Iridium LLC based on provisions in the Iridium LLC agreement (the "LLC Agreement")

that the Creditor had the right to call on Iridium's members' Reserve Capital Call obligations ("RCC Obligations"), and a certificate from the secretary of Iridium LLC certifying that the LLC Agreement was "true and correct." Under the terms of the Facility, the Creditor was assigned Iridium's RCC Obligations. When Iridium defaulted on its loan, the Creditor sought to enforce the assignment of the RCC Obligations. In resolving the dispute, the district court reviewed the language of the LLC Agreement, which contained provisions stating that a member's duty to perform its RCC Obligations was "absolute and unconditional" and that each member "waived in favor of [the Creditor] any defense it may have or acquire with respect to its obligations under the [RCC]." Therefore, the court granted summary judgment in favor of the Creditor on its breach of contract claim against the Investors.[11]

Material Breach. An Investor may argue, under contract law, that it should be excused from further performance of its obligations to a Fund in instances where there has been a material breach by the Fund or its General Partner. This is a relatively well-established general legal principle.[12] However, this release of an Investor's liability has been held not to extend to the obligations the Investor owes to Fund Creditors. In distinguishing the relationship between an Investor's duty to the Fund and other parties contracting with the Fund, a Massachusetts Court of Appeals held that "relations of a limited partner to the partnership … are more complex in that other limited partners and third parties *rely on an expressed obligation*, made public by filing, *to contribute resources to the partnership*."[13] The court further noted that the Uniform Partnership Law places an emphasis on protecting the rights of outside parties that rely on the commitments of limited partners in extending credit to the partnership, because, without this guarantee, Creditors would be unlikely to enter into the loan with the limited partnership.[14] In fact, in a different case, even where the Fund's principals were convicted of fraud in relation to the Fund, a court has held that the obligation to pay Capital Commitments to Creditors was not excused.[15] These case precedents provide strong authority supporting the enforceability of Capital Commitments—even in the case of a material breach by the Fund. However, it is still advisable to require language in the Partnership Agreement and, if applicable, the Investor Letter, that Capital Contributions will be funded by the Investor "without set-off, counterclaim or defense" to further weaken any material breach defense.

ENFORCEABILITY OF CAPITAL COMMITMENTS IN BANKRUPTCY PROCEEDINGS

In the event of the bankruptcy of the Fund, the causes of action entitling the Creditor to relief will not change—they will still be based on the same statutory and contractual theories. But the context of the proceedings, and the potential defenses asserted by the Investors, will likely change. A Creditor's rights will be subject to the applicable provisions of the U.S. Bankruptcy Code (the "Code") and will likely be represented by the Fund itself, as debtor-in-possession ("DIP") or a bankruptcy trustee (the "Trustee"). Within a bankruptcy, the DIP or the Trustee acts on behalf of the Fund and seeks to maximize the value of the Fund's estate to pay off its obligations to its creditors. As such, the Trustee typically seeks to marshal Fund assets by making a Capital Call and bringing litigation against the Investors if necessary.[16]

In a Fund bankruptcy, an Investor's primary argument is likely to be that its remaining Capital Commitment is an "executory contract" under Section 365(c)(2) of the Code, rendering the obligation voidable. An "executory contract," although not specifically defined in the Code, is generally considered to be a contract where both counterparties have material, unperformed obligations. Generally, in bankruptcy, the DIP or the Trustee gets to decide whether to assume an

executory contract (and be bound thereunder) or to reject it and thereby effectively disaffirm any such continuing obligations. However, under Section 365(c)(2) of the Code, a DIP or Trustee is prohibited from assuming an executory contract if it is by a third party to "make a loan, or extend other debt financing or financial accommodations to or for the benefit of the debtor, or to issue a security of the debtor."[17]

In *Iridium*, the Investors argued that the LLC agreement containing their RCC Obligations was a financial accommodation contract that the Code prohibited from being assumed. The court rejected this argument, noting that the purpose of Section 365(c)(2) of the Code is to protect parties from extending additional credit or funding whose repayment relies on the fiscal strength of an already bankrupt debtor. The court held that the RCC Obligations, in contrast, were not "new" obligations, having long since been committed by the members: "In these circumstances, the Court concludes that the [members] are not within the class of creditors Congress intended to protect under Section 365(c)(2) of the Bankruptcy Code."[18]

This ruling leaves an important consideration from a practitioner's perspective, as tax considerations have caused some Funds to allow for Capital Contributions to be funded in the form of loans instead of equity. While we would be hopeful a court would look through this phraseology to the substance of what an Investor's Capital Contributions are, the "loan" language might give an Investor a stronger basis to argue that the applicable agreement was one to extend a loan or financial accommodation, and thus non-assumable under Section 365(c)(2). To help better protect the Creditor against this possibility, we prefer to see explicit language in the applicable Partnership Agreement and, if applicable, in the Investor Letter, substantially to the effect that, in the event that any loans funded in lieu of Capital Contributions under the Partnership Agreement would be deemed to be an executory contract or financial accommodation in connection with a bankruptcy or insolvency proceeding, each Investor irrevocably commits to cause any amounts that would otherwise be funded as loans to be made as a Capital Contribution to the Fund.

Conclusion

While there is not a definitive case fully vetting and dismissing every argument Investors could potentially assert in attempting to avoid honoring their Capital Commitments, the existing statutory and case law provide significant comfort that Investors' Capital Commitments are enforceable obligations, even in a Fund bankruptcy context. ◆

Endnotes

1 DEL. CODE ANN. tit. 6, § 17-502(a)(1) (2010) (emphasis added).

2 DEL. CODE ANN. tit. 6 § 17-502(b)(i) (2010).

3 *See* UNIF. P'SHIP LAW § 502(c) (provisions allowing a Creditor to enforce its rights against a limited partner, even if a limited partner's obligations to the limited partnership have been compromised).

4 *See* DEL. CODE ANN. tit. 6, § 18-502 (2010).

5 *See* In re LJM2 Co.-Investment, L.P., 866A. 2d 762 (Del. Super. Ct. 2004).

6 N.Y. P'SHIP LAW § 106(1)(b) (limited partner liable for "any unpaid contributions which he agreed in the certificate to make in the future at the time and on the conditions stated in the certificate"); *see also* § 106(3) ("[T]he liabilities of a limited partner ... can be waived or compromised only by the consent of all members; but a waiver or compromise shall not affect the right of a creditor of a partnership, who extended credit ... to enforce such liabilities.").

7 *In re Sec. Group 1980*, 74 F.3d 1103, 1110 (11th Cir. 1996); *see also Int'l Investors v. Bus. Park Fund*, 991 P.2d 219 (Alaska 1999) (limited partners liable to creditors who extend credit based on limited partners' capital commitments).

8 *Id.* at 1111 (citing *Kittredge v. Langley*, 252 N.Y. 405, 169 N.E. 626 (1930)).

9 Each case cited hereunder was decided under Delaware or other U.S. law. While applicable local counsel should be consulted in connection with funds that have parallel or feeder vehicles formed in other jurisdictions, other jurisdictions do have precedent consistent with these holdings. For example, Appleby has confirmed that, assuming that the New York law Facility documentation creates a valid and enforceable security interest over the Capital Commitments, Creditors will be well placed legally to enforce the Investor's Capital Commitments in a Fund governed by the laws of the

Cayman Islands (Mayer Brown LLP does not opine on the laws of the Cayman Islands). *See also 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).

10 *See NAMA Holdings, LLC v. Related World Mkt. Ctr., LLC*, 922 A.2d 417, 434 (Del. Ch. 2007) ("As a general rule, only parties to a contract and intended third-party beneficiaries may enforce an agreement's provisions."); *see also Insituform of N. Am., Inc. v. Chandler*, 534 A.2d 257, 268 (Del. Ch. 1987) ("It is universally recognized that where it is the intention of the promisee to secure performance of the promised act for the benefit of another, either as a gift or in satisfaction or partial satisfaction of an obligation to that person, and the promisee makes a valid contract to do so, then such third person has an enforceable right under that contract to require the promisor to perform or respond in damages.").

11 *Chase Manhattan Bank v. Iridium*, 307 F.Supp 2d 608, 612-13 (D. Del. 2004). Similarly, the Bankruptcy Court in *In re Securities Group 1980* held that the Investors were liable under a contractual theory of liability under the applicable Partnership Agreement. See 74 F.3d at 1108.

12 *Partnership Equities, Inc. v. Marten*, 15 Mass. App. Ct. 42, 45, 443 N.E.2d 134, 136 (Mass. App. Ct. 1982) ("If [limited partner's] enrollment were merely a bilateral agreement between the defendants and the general partners, the principle of contact law upon which the defendants rely, that a material breach excuses nonperformance might well apply.").

13 *Id.* (emphasis added).

14 *Id.* at 45.

15 *In re Securities Group 1980*, 74 F.3d at 1109 ("[A] material breach of the partnership agreement ... would not excuse a limited partner's commitment to contribute additional capital on the conditions stated in the certificate [of limited partnership].").

16 *See Lowin v. Dayton Sec. Assoc.*, 124 B.R. 875, 892-93 (M.D. Fla. Bankr. 1991); *see also In re LJM2 Co-Investment, L.P.*, 866A.2d 762, 781 (Del. Super. Ct. 2004).

17 11 U.S.C. § 365(c)(2).

18 *Chase Manhattan Bank v. Iridium Africa Corp.*, 2004 WL 323178 at *4 (D. Del. 2004); *see also Lowin*, 124 B.R. at 901 (stating that a Trustee's enforcement of the limited partners' Capital Commitments "is not the equivalent of requiring the limited partner defendants to extend new credit to the debtors in the form of loans, lease financing or purchase of discount notes").

WINTER 2012

Sovereign Immunity Analysis in Subscription Credit Facilities

Subscription credit facilities have become a popular form of financing for private equity and real estate funds. Governmental pension plans, state endowment funds, sovereign wealth funds and other instrumentalities of foreign and domestic governments are frequent Investors that may possess certain sovereign immunity rights against enforcement proceedings rooted in the common law concept that "the King can do no wrong." Governmental Investors must be evaluated on a case-by-case basis to ascertain if any sovereign rights apply and, if so, whether such Investor has effectively waived its immunity. This Legal Update seeks to set forth the basic legal framework of sovereign immunity in the United States relevant to subscription credit facilities.

Credit Facilities

Subscription credit facilities (a Facility) have become a popular form of financing for private equity and real estate funds (Funds). The Facility's lenders (the Lenders) are granted a security interest in the uncalled capital commitments of the Fund's limited partners (the Investors) and the Lenders rely on the Investors' obligations to fund capital contributions as the primary source of repayment. Governmental pension plans, state endowment funds, sovereign wealth funds and other instrumentalities of foreign and domestic governments are frequent Investors that may possess certain sovereign immunity rights against enforcement proceedings rooted in the common law concept that "the King can do no wrong."[1]

Sovereign immunity in its purist form could shield a governmental entity from all liability—e.g., enforcement by a Lender seeking to collect uncalled capital commitments contractually owed by the Investor to the Fund. Thus, as Lenders evaluate the creditworthiness of governmental Investors for inclusion in a Facility's borrowing base, they naturally inquire into how sovereign immunity may impact the enforceability of such Investors' capital commitments.

Governmental Investors must be evaluated on a case-by-case basis to ascertain if any sovereign rights apply and, if so, whether such Investor has effectively waived its immunity. Given the financial troubles facing many governmental Investors as a result of the ongoing economic crisis and sovereign debt concerns, Lenders are increasing their scrutiny of the credit wherewithal of such Investors and their potential ability to raise sovereign immunity as a defense in subsequent litigation. This Legal Update seeks to set forth the basic legal framework of sovereign immunity in the United States relevant to a Facility.

Basis of Immunity

At its most basic level, the doctrine of sovereign immunity states that the government cannot be sued in its own courts unless it has otherwise consented to waive its sovereign immunity. As it relates to governmental Investors organized under the laws of the United States or a political subdivision thereof (a US governmental Investor), the doctrine of sovereign

immunity comes in two flavors: (i) sovereign immunity of the federal government[2] and (ii) sovereign immunity of state governments and their instrumentalities pursuant to the Eleventh Amendment of the US Constitution, and in some states, through the state's Constitution.

Sovereign immunity of the US federal government is a concept that has existed in US jurisprudence since the country's founding.[3] Through the Tucker Act,[4] however, it is well settled that the US federal government has waived sovereign immunity with respect to any express or implied contract. With respect to state governments, the Eleventh Amendment, along with US Supreme Court jurisprudence on the issue, provides that states generally are immune from being sued in federal or state court without their consent.[5] Recognizing the inequities of such a rule in the commercial context however, many state constitutions, legislatures and high courts have eroded the sovereign immunity of state governments to permit actions based on contractual claims.

The doctrine of sovereign immunity also protects certain foreign governments and international organizations of a quasi-governmental nature, such as the United Nations, against claims in US courts. The Foreign Sovereign Immunities Act of 1976 (the FSIA) generally shields such Investors, but provides an exclusive basis and means to bring a lawsuit against a foreign sovereign in the US for certain commercial claims.[6]

Waivers of Immunity—US Investors

There are three ways that sovereign immunity is generally waived by US governmental Investors: (i) an Investor expressly and unequivocally waiving such immunity in a writing that can be relied upon by the Lender (i.e., an "Investor Letter" delivered to the Lenders in connection with the Facility or a side letter provision running to the benefit of the Lenders), (ii) a statute enacted by the applicable governing legislature that explicitly waives immunity for contract claims in commercial transactions, such as the Tucker Act[7] in the case of the US federal government, or (iii) controlling case law, typically from a federal or the applicable state's highest court, that precludes governmental Investors from effectively raising sovereign immunity as a defense to contractual claims.

WRITTEN WAIVERS FROM INVESTORS

The best case scenario for the Lenders is an explicit waiver from the Investor or an express statement that sovereign immunity does not apply. Often in an Investor Letter, the subject Investor: (i) acknowledges and agrees that, to the extent it is entitled to sovereign immunity now or at any time in the future, it irrevocably waives such immunity to the fullest extent permitted by law and/or (ii) represents that it is not subject to, or cannot claim, immunity from suit in respect of contractual claims to enforce its obligations under the applicable partnership agreement and subscription agreement.

A second variety of waiver is an implicit waiver. With an implicit waiver, the Lenders are provided with an affirmative representation that the Investor is subject to commercial law and that its performance under the partnership agreement, the subscription agreement and the Investor Letter (if applicable), constitutes private and commercial acts, not governmental acts. While this form of waiver is not as strong as the explicit waiver, it puts the Investor at a severe disadvantage when distinguishing itself from a private actor in the marketplace and when attempting to argue that it should be entitled to immunity as a governmental actor (note: the comfort afforded by this waiver to a Lender certainly pivots on whether applicable law has abrogated immunity for commercial transactions).

In transactions where Lenders receive Investor Letters and Investor opinions as a condition to

including a particular Investor in the borrowing base, it is best practice that the Investor's counsel opine, among other things, that the Investor has effectively waived immunity or that such Investor does not enjoy sovereign immunity in connection with its obligation to fund capital contributions to the Fund.

A third variation of waiver language common in the Facility market involves neither an explicit nor an implicit waiver, but rather a statement by the governmental Investor that despite the Investor's sovereign immunity and its express reservation thereof, such immunity does not in any way limit the Investor's obligations to make capital contributions under the partnership agreement. While this seemingly contradictory language is not really a waiver at all, it provides some comfort to the Lenders that the Investor has agreed to fund its capital contributions. The Facility market seems to accept this language cautiously, and then only after a careful review of the underlying law to determine whether the applicable Investor could potentially raise a successful immunity defense in the context of a Facility.

STATUTORY WAIVERS

While it is ideal for Lenders to receive a written waiver as discussed above, Investors often are unwilling to provide such a waiver, or the Facility does not permit Lenders to request and rely on Investor Letters. US governmental Investors will frequently reserve their Eleventh Amendment rights in a side letter; hence, it is very important to carefully review and vet governmental immunity provisions in side letters against applicable law. Many states, however, have waived sovereign immunity for commercial contract claims by constitution, statute or case law.

Several states, including California and New York, have passed statutes explicitly waiving sovereign immunity with respect to contractual claims.[8] In these states, a plaintiff may proceed against the state government just as if it were proceeding against a private citizen. If obtainable, Lenders should seek an explicit statement from the Investor acknowledging that the Facility qualifies under the applicable sovereign immunity waiver statute of that state. An example of such language would be: "Each of the Partnership Agreement, the Subscription Agreement and the Investor Letter constitute a contract within the meaning of [insert applicable state statute (e.g., Cal. Gov. Code Section 814, New York Court of Claims Act §8 (L. 1939, c 860), Section 12-201, State Gov. Article, Ann. Code of Maryland and ORS Section 30.320)]."

These state statutes often contain a specific set of requirements and procedures that must be complied with in order to bring suit and obtain a judgment. For example, statutes that waive sovereign immunity for contractual claims often require that a claimant show that the contract was validly authorized and entered into by the governmental Investor.[9] Additionally, it is not uncommon for such statutes to require that a claimant bring the claim within a certain period of time and in a particular venue, often a certain county or an administrative law court within the applicable state.[10]

Given the variations among statutes with respect to waivers of sovereign immunity, it is prudent for Funds, Lenders and their respective counsel to examine each individual state's statute on a case-by-case basis.

COMMON LAW WAIVERS

Some state high courts have rendered decisions eliminating sovereign immunity with respect to contractual claims. For example, the South Carolina Supreme Court held that when the state enters into a contract, the state implicitly consents to be sued and waives its sovereign immunity to the extent of its contractual obligations.[11] Similarly, in 2006, the Missouri Supreme Court held that sovereign immunity does not apply to breach of contract claims against state agencies.[12] State courts are continuing to follow such decisions. In

2010, the Virginia Supreme Court reaffirmed its prior ruling that sovereign immunity is not a defense to a valid contract entered into by a duly authorized agent of the state.[13] State courts, like state legislatures, have taken varying approaches with respect to the procedures and timelines that must be followed for a claimant to bring an action based on a contractual claim.[14]

We note, however, that a minority of states have bucked the trend to waive immunity for contract and thus leave Lenders at risk of enforcement uncertainty if the state defaults. While not entirely clear, the general rule in Texas may still be that state government entities cannot be sued for a breach of contract, even with evidence of a waiver to the contrary.[15] At least one appellate court in Texas has attempted to reverse course, holding that there is a waiver-by-conduct exception to sovereign immunity in breach of contract cases against state entities.[16] However, the Texas Supreme Court denied review of this holding, leaving the viability of such an exception unsettled.

Waivers of Immunity—Non-US Investors

Foreign governments and their instrumentalities are also frequent Investors, often with sizable capital commitments. Lenders should carefully review such Investor's credit, as well as the procedural requirements for enforcement of their capital commitments, including with respect to immunities.

The general premise of the FSIA is that a foreign government has immunity and cannot be sued in the United States. There are, however, three exceptions to this rule. First, waivers where the Investor has expressly waived immunity by contract, including any such waivers that arise from language in applicable international agreements.[17] Second, implied waivers where the Investor (i) agrees in a choice of law provision to be "governed by" US law,[18] (ii) agrees to arbitration with the expectation of enforcement of an award in the United States,[19] (iii) affirmatively files a suit or responds to a pleading without raising an immunity defense[20] or (iv) has signed an international convention permitting the enforcement of an award in the United States.[21] Third, the "commercial activity" exception.[22]

Under the commercial activity exception, a claimant may sue a foreign government in a US court when the claim is based on (i) a commercial activity carried on in the United States by the foreign government, (ii) an act by a foreign government that is performed in the United States in connection with a commercial activity outside the United States or (iii) an act by a foreign government that is performed outside the United States in connection with commercial activity that occurs outside the United States, if such action "causes a direct effect" in the United States.[23]

Absent an express written waiver, a valid submission to jurisdiction in the United States or an agreement to binding arbitration,[24] non-US governmental Investors in the context of a Facility should fall into the commercial activity exception. In Republic of Argentina v. Weltover Inc.,[25] bond holders sued the Government of Argentina for breach of contract. The US Supreme Court articulated the applicable legal standard: "[w]hen a foreign government acts, not as a regulator of a market, but in the manner of a private player within it, the foreign sovereign's actions are 'commercial' within the meaning of the FSIA."

Argentina argued that that the commercial activity exception did not apply because (i) the issuance of sovereign debt should not constitute commercial activity and (ii) the alleged breach did not have a "direct effect" on the United States. The Court disagreed on both counts. First, the Court concluded that the issuance of the bonds was of sufficient commercial character. Second, the Court rejected the argument that the FSIA required the direct effect to be "substantial" or "foreseeable," instead concluding that it need only follow "as

an immediate consequence" of the sovereign's activity. Despite the fact that none of the bondholders were situated in New York, the Court held that the effect was direct because New York was the designated place for payment.[26] This is certainly helpful precedent for Facility Lenders. For a more in-depth review of the "commercial activity" exception, please see Mayer Brown's White Paper, "Sovereign Immunity and Enforcement of Arbitral Awards: Navigating International Boundaries," available at http://www.mayerbrown.com/publications/detail.aspx?publication=5048.

Satisfaction of a Judgment Against a Sovereign Entity

While a governmental Investor may have waived sovereign immunity by one of the means identified above, enforcing a judgment against a governmental Investor merits additional discussion.

First, side letter provisions may prescribe a particular jurisdiction (other than New York or Delaware) or a means of alternative dispute resolution (e.g., binding arbitration by the International Chamber of Commerce or similar body), and such provisions will affect how a Lender should pursue the Investor.

Further, once a judgment is obtained from the proper tribunal, satisfying a judgment against a governmental Investor may differ from satisfying a judgment against a private person. Due to public policy concerns, some government entities that do not enjoy immunity from suit may nonetheless argue they are effectively exempt from monetary judgments.[27] In these cases, a Lender can initiate enforcement proceedings but may not be able to collect on a judgment. In other cases, payment of the judgment may require that a specific appropriation be made by the appropriate legislative body of the governmental Investor, or statutory limits may exist on the amount of the judgment that may be satisfied.

For example, in Kentucky, while the state has waived its sovereign immunity with respect to contract claims, damages are capped at twice the amount of the original contract.[28] Certain states, including West Virginia, Louisiana and Connecticut, require the special approval of the legislature or some other administrative body before paying a claim.[29] Obviously, a Lender needs to be familiar with these particularities.

Seeking satisfaction of a judgment against a foreign governmental Investor that has defaulted on its capital commitment poses an additional set of issues, including whether or not such Investor has any commercial assets in the United States upon which a Lender can levy in the event the governmental Investor does not voluntarily settle a judgment awarded. In the event that the foreign governmental Investor does not have any commercial assets within the United States, a Lender may need to go abroad to seek enforcement of a judgment. Enforcing a US judgment abroad requires an analysis of whether or not the applicable foreign court will respect the judgment of the US court and if not, how such foreign court will rule if contractual liability needs to be re-litigated.

PRACTICAL CONSIDERATIONS

The good news is that Facilities have been around for many years and anecdotal evidence from active Lenders in the market during the financial crisis indicates that there have been no material governmental Investor defaults, despite significant budget issues faced by many governmental Investors. Additionally, there are practical reasons mitigating the likelihood that a state pension fund or other governmental Investor would renege on its commitment to fund capital contributions. These include the often severe default penalties found in partnership agreements, the bad publicity such Investor would likely receive and the damage the default might cause to the Investor's credit rating and reputation in the market. Thus, while the potential for such an Investor to claim immunity when a Lender exercises default remedies is nonetheless real

and must be considered in connection with formulating each Facility's borrowing base, the practical likelihood of this happening with frequency in practice may be remote.

Conclusion

There are numerous avenues by which governmental Investors have waived sovereign immunity with respect to commercial contracts. While there are complex legal issues surrounding the interplay between the doctrine of sovereign immunity and the capital commitments of governmental Investors, Funds, Lenders and their respective counsel have vetted many of these issues in connection with prior investments and often have the analysis readily available. Accordingly, after careful review, Lenders are typically getting the comfort they need to include the majority of such Investors in the borrowing base. As no two jurisdictions are the same and the law continues to evolve, it is important for both Funds and Lenders to evaluate governmental Investors individually and stay current on sovereign immunity analysis. ◆

Endnotes

1 *See* 5 Kenneth Culp Davis, Administrative Law Treatise 6-7 (2d. ed. 1984) (quoting William Blackstone's Commentaries Book III, Chapter 17 (1765-1769)).

2 *Gray v. Bell*, 712 F.2d 490, 507 (D.C. Cir. 1983).

3 *See Cohens v. Virginia*, 19 U.S. 264 (1821).

4 28 U.S.C. §1491.

5 *See Hans v. Louisiana*, 134 U.S. 1 (1890), *Blatchford v. Native Village of Noatak*, 501 U.S. 775 (1991) and *Alden v. Maine*, 527 U.S. 706 (1999) (establishing that the immunity extends to state court).

6 28 U.S.C. §§ 1330, 1332, 1391(f), 1441(d), and 1602-1611.

7 28 U.S.C. §1491.

8 NY Ct of Claims Act §8 (L. 1939, c 860); *Cal. Gov. Code* §814.

9 *See* Or. Rev. Stat. §30.320, which requires a government agency to be "acting within the scope of its authority".

10 For example, New York has vested exclusive jurisdiction in the New York Court of Claims for actions brought against the state of New York (*See* NY Ct. of Claims Act §8 (L. 1939, c 860)), Michigan, Pennsylvania, West Virginia, Ohio and Connecticut are among other states that have established judicial bodies to hear claims against the state (*See* Mich. Comp. Laws. Ann.. 600.605; 62 Pa. Consol. Stat. §§1721-1726; W. Va. Code §14-2-1; Ohio Rev. Code §2744.01 et seq.; and Ct. Gen. Stat. §4.142). In order to bring an action against the state of New Mexico under its statutory waiver of contractual immunity (N.M. Stat. Ann. §37-1-23), a plaintiff must (i) bring the claim within two years from the time of accrual, (ii) show that the contract is legally enforceable by pleading the basic elements of contract claims—offer, acceptance, consideration and mutual assent (*See Hartbarger v. Frank Paxton Co.*, 115 N.M. 665, 669 (1993))—and (ii) show that the governmental entity was not acting outside of its designated authority or power (*See Spray v. City of Albuquerque*, 94 N.M. 199, 201 (N.M. 1980)).

11 *Hodges v. Rainey*, 533 S.E. 2d 578, 585 (S.C. 2000).

12 *Kunzie v. Olivette*, 184 S.W. 3d 570 (Mo. 2006).

13 *Commonwealth v. AMEC Civil*, LLC, 699 S.E. 2d 499, 516 (Va. 2010).

14 *Supra* note 11.

15 *See Tooke v. City of Mexia*, 197 S.W.3d 325 (Tex. 2006), which held that a public entity does not waive immunity despite a statutory provision permitting such entity to "sue and be sued."

16 *TSU v. State Street Bank and Trust Company*, 212 S.W.3d 893 (Tex. App. 1st Dist. Jan. 11, 2007).

17 *Harris Corp. v. Nat'l Iranian Radio & Television*, 691 F.2d 1344 (11th Cir. 1982).

18 *Marlowe v. Argentine Naval Commission*, 1985 WL 8258 (D.D.C. 1985).

19 *Creighton v. Qatar*, 181 F.3d 118 (D.C. Cir. 1999).

20 *See*, e.g., *Drexel Burnham Lambert v. Committee of Receivers*, 12 F.3d 317 (2d Cir. 1993).

21 *Seetransport Wiking Trader v. Navimpex Centrala Navala*, 989 F.2d 572 (2d Cir. 1993).

22 28 U.S.C. §1605(a)(2).

23 *Id.*

24 In order to limit its exposure to the US courts, it has been our experience that a number of foreign sovereigns will submit to binding arbitration with the Fund or a Lender.

25 504 U.S. 607 (1992).

26 *Id.* at 619.

27 *See* Section 31452 of the California County Employees Retirement Law (*Cal. Gov. Code* §31450 *et seq.*), which

suggests that the assets of a California county retirement system are generally exempt from levy, execution, assignment, and any other collection process. Notwithstanding the express language of Section 31452 and a lack of certainty related thereto, we think there are good arguments that Section 31452 was intended to protect the pension benefits of the underlying beneficiaries from garnishment and not to shield a California county pension fund from liability for breach of contract.

28 Ky. Rev. Stat. Ann. 45A.245 *et seq.*

29 *See* W. Va. Code § 14-2-3 (An award by the Court of Claims is a recommendation by the court to the legislature, and is not binding); La. Const Art. XII, §10 (provides for the appropriation of funds by the legislature); and Ct. Gen. Stat. §4.158-160 (for claims in excess of $7,500, the Claims Commissioner may either (i) grant the claimant permission to sue the state agency, in which case the state has waived sovereign immunity or (ii) recommend payment of the claim to the General Assembly, in which case the Assembly may accept, modify or reject the recommendation. Upon rejection, the Assembly may authorize the claimant to sue, or it may reject the claim altogether.).

SUMMER 2013

In this Summer 2013 edition of our *Fund Finance Market Review* we discuss some of the more noteworthy developments and trends in the subscription credit facility and fund finance markets, including a review of the current challenges and opportunities being driven in large part by the difficult fundraising environment. We also explore the evolution of fund terms and structures and the resulting impact on credit facilities, as well as some of the new and returning financing products surfacing in the market.

Summer 2013 Market Review

Despite continued challenges in the fundraising market for sponsors of real estate, private equity and other investment funds (each, a "Fund"), the positive momentum capital call subscription credit facilities (each, a "Facility") experienced in 2012 has continued and perhaps accelerated in early 2013. And for good reason: on all the panels at the Subscription Credit Facility and Fund Finance Symposium in January of 2013 in New York City (the "SCF Conference"), mention by panelists of institutional investor funding delinquencies could be counted on one hand.

This type of historical investor (each, an "Investor") funding performance of course translated to near perfect Facility performance through and coming out of the financial crisis. Yet despite the excellent Facility performance and the measured growth of the Facility market generally, there is growing recognition that certain trends in the market are creating very real challenges. Below we set out our views on the Facility market's key trends, where they intersect and the resulting challenges and opportunities we see on the horizon.

Key Trends

There are four key trends in the market we see creating material impact: (i) the general maturation of the Facility product and market; (ii) the continuing expansion of Facilities from their real estate Fund roots into other 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 ("Capital Commitments"). We analyze each below.

The Maturing Facility Market

Many Facility lenders (each, a "Lender"), Funds and other Facility market participants have for a long time benefited from the under-the-radar nature of the Facility market. While the market was certainly sizeable—for example, in 2011 Mayer Brown LLP alone worked on Facilities with Lender commitments in excess of $16 billion—it remained a niche in which only a subset of Lenders participated and was largely unknown to the greater financial community. That has certainly changed. The Facility product and its market recognition have matured and are continuing to grow rapidly for a variety of reasons, not the least of which was the publicity created by the sale of the WestLB AG, New York Branch Facility platform to Wells Fargo Bank, N.A. in 2012. Five years ago, the Facility market was operating in virtual obscurity; today it is a common staple familiar to nearly the entire finance community. DBRS has published rating criteria, an insurance company has approached Lenders offering to write credit enhancement on transactions or even individual Investor Capital Commitments and 400 people registered for the SCF Conference, up from 60 in 2010.

There are certainly benefits to being in a more recognized market, but there are also growing challenges. On the plus side, management now fully understands the product, and has context when considering requests for resource allocations. A Fund sponsor's (each, a "Sponsor") CFO no longer needs to explain the product to his partners; they now understand the timing and internal rate of return benefits. Credit personnel analyzing Facilities now have a better grasp of both the embedded risks and the practical performance, leading to better structured and more accurately priced Facilities. But challenges abound. New entrants (Lenders, law firms, etc.) are eager to join the market, some with extensive understanding from lateral hiring and others with more limited degrees of experience. This creates pricing pressure (a positive or negative, depending on your side of the aisle), as new entrants are often forced to compete on price when they cannot credibly demonstrate execution capabilities. It also tends to lead to Facilities being consummated with security structures and collateral enforceability issues that are different or weaker than what has traditionally been deemed "market," as newer participants are less tied to historical structures. Further, as the product matures and garners increased managerial attention, the inherent channel conflict at certain Lenders as to where within the institution to house the product often surfaces. Such channel conflict often leads to centralization of execution, as management realizes the disparities of credit standards and structures in different areas within the institution. Centralization of course leads to challenges, as both Fund relationships and execution experience are critical to a successful overall platform. Finally, a number of Lenders have become quite adept at providing Facilities, and have amassed impressive portfolios. In connection with these increasing exposures, these Lenders have rightfully garnered increased attention from the credit and risk management departments within their institutions. This increased attention often results in the creation of policies and procedures setting guidelines for what a Lender is able to do for the product and what items are outside of policy and require special considerations. Not surprisingly, these types of policies are being tested by the next several material trends.

Continued Expansion into Private Equity

Facilities are sometimes seen as a commodity product in the real estate Fund space, as some real estate Sponsors have been using the product for many years. This extensive experience has lead to provisions in limited partnership agreements ("Partnership Agreements") that tend to adequately contemplate a potential Facility and incorporate the Investor acknowledgments and agreements that a Lender would like to see for a Facility. As real estate Fund Sponsors form new Funds, the precedent Partnership Agreement typically already has these provisions, they carry forward, and the new Fund is ready for a Facility upon its initial Investor closing. But other asset classes are different. As private equity, mezzanine, infrastructure, energy, venture and other Funds (and especially buyout Funds) have traditionally enhanced returns with asset level leverage and less so with Fund level debt (if they used leverage in the first instance), their predecessor Fund Partnership Agreements are frequently less explicit or developed with respect to a Facility. And, of course, when the next Fund is to be formed, Sponsors naturally want to keep revisions to the precedent Partnership Agreement as limited as possible so as to minimize the changes that need to be presented to prospective (and in many instances recurring) Investors. This often leads to a minimal language insertion authorizing the incurrence of debt and the pledge of Capital Commitments; language far less robust compared to what Lenders are traditionally used to seeing and relying on from real estate Funds. Further, Sponsors outside of real

estate have more frequently included overcall limitations and other structural complexities, which prove challenging for Lenders.[1] Thus, as Lenders continue to expand Facilities into Funds focused on private equity and other asset classes, they are increasingly challenged by Partnership Agreements that are less conducive to the Facility structure Lenders have grown to expect. This challenge is presenting almost weekly and standard setting for acceptability is going to be a key element for any Lender in the near future.

Fund Structural Evolution

Depending on your data source and region, 2012 fundraising was between flat globally and at best up just incrementally, especially in the United States. And while our fund formation practices have certainly seen some robust activity in early 2013, we remain guarded as to whether 2013 fundraising will materially outpace last year. The increased negotiation leverage of Investors derived from a difficult fundraising environment and their increased coordination facilitated in material part by the formation and advocacy of the Institutional Limited Partners Association is resulting in significant structural evolutions for Funds (especially outside of the real estate space, where traditional structures seem to be holding more firmly). Funds are increasingly structuring more tailored options for particular Investors (often to accommodate their particular tax or regulatory needs), leading to more Fund entities and more complicated Fund structures. We continue to see Investors making larger commitments to fewer, more seasoned Funds, increased use of separate accounts, sidecars and other co-investment vehicles, Investors committing through special purpose vehicles (each, an "SPV"), formation of Funds as open-ended or evergreen, and extensive concessions provided to material Investors. We have seen structures where certain parallel funds are "funds of one" that cannot be cross-collateralized, where Investors have cease-funding rights in the event the Sponsor fails to fund a capital call (a "Capital Call"), and where an Investor invests directly into a separate, newly formed SPV, created specifically for such Investor on a deal-by-deal basis. These are just a few examples of some of the trends.

To a Facility Lender, of course, "fund structural evolution" means: "Your collateral package is changing." And, when you have a Lender-led trend toward the centralization of the product and the establishment of policies and guidelines, combined with a Fund trend of increased structural complexity designed to accommodate Investors (i.e., not accommodate Lenders), you have a natural tension. Thus, Lenders are working on getting their arms around things like the credit linkage between an SPV and the actual creditworthy Investor, how to efficiently add alternative investment vehicles as borrowers, and how to handle withdrawal rights related to violations of placement agent regulations. So an emerging challenge—and opportunity—is how to best manage this natural tension. How do Lenders develop policies that incorporate optionality into their product suite to accommodate a rapidly evolving Fund structural environment? For example, how does a securitization group tackle a Facility with a parallel fund of one that cannot be joint and severally liable but which has an investment grade Investor? How do Facilities with tight overcall limitations price compared to standard Funds without overcalls? How do you structure a Facility to an open-ended fund?[3] And while these issues are certainly challenging, they clearly trend away from a commodity product, and, thereby, create opportunity. Bespoke structures require customized solutions, and because customized solutions cannot be provided by all, they afford the potential for attractive returns.

New Sources of Capital

As Sponsors have sought to expand their sources of capital, the private wealth divisions of the major banks have not missed a beat and have created a variety of product offerings to bridge the gap between high net worth

individual Investors ("HNWs") and Funds. Many major banks have created or are creating feeder funds ("Aggregator Vehicles") whereby a large number of HNWs can commit directly to the Aggregator Vehicle (or make an upfront one-time investment in the Aggregator Vehicle) and the Aggregator Vehicle in turn commits to the Fund.[2] This enables the HNWs to obtain exposure to Funds whose minimum Capital Commitment threshold they could not otherwise meet. In certain circumstances Aggregator Vehicles can even offer more liquidity than a traditional investment in a Fund by including redemption and transfer rights that would be atypical at the Fund itself. The banks sponsoring Aggregator Vehicles customize the opportunity to the wishes of the Sponsor and the HNWs, and Aggregator Vehicles may be structured to facilitate participation by the HNWs in a single Fund, in a series of Funds sponsored by the same Sponsor, or in multiple Funds sponsored by unrelated Sponsors. There are Aggregator Vehicles being marketed with minimums as low as $50,000. The Aggregator Vehicles often make material Capital Commitments to Funds, and hence their inclusion or exclusion from a Facility's borrowing base can have a material impact on Facility availability. While Aggregator Vehicles are not rated institutions and can be challenging for traditional Facility underwriting guidelines with respect to Investors (including for those Lenders that advance against HNWs that commit directly), they clearly have inherent value worthy of some level of advance or overcollateralization benefit. In fact, it could be argued that in some ways they could be more creditworthy than a traditional institutional Investor, as their source of funds comes from a diversified pool, typically with overcall rights to cover shortfalls created by any particular HNW's failure to fund. Figuring out the right level of advance rate and concentration limit for Aggregator Vehicles is clearly an emerging challenge and opportunity. And the development of similar vehicles and concepts that deliver HNW Investor Capital Commitments to Funds is likely to continue and increase.

Along similar lines, we expect that the continuing shift from defined benefit plans to defined contribution plans will ultimately lead Sponsors and their advisors to create products that allow defined contribution plans and related individual investor savings accounts access to Funds. While the challenges are real: the lack of redemptions does not sync well with the portability of 401(k)s, the accredited investor standard, etc., we believe the challenges are not insurmountable. And while we do not anticipate a sudden change anytime soon to open access to this source of funds, it does seem that the historically favorable rate of return provided by Funds, combined with the sheer size of long-horizon assets invested in IRAs and 401(k)s, makes their eventual connection somewhat inevitable over the long term. Whether the ultimate vehicles and structures formed to facilitate this source of funding involve Capital Commitments or something similar that would enable application for a Facility remains to be seen.

Conclusion

The Facility market is maturing and evolving in ways that create challenges and significant opportunities. We expect that the Facility market will continue to grow at a solid clip as fundraising improves, Fund formation increases and the product further penetrates the various private equity and other asset classes. But we expect that the evolution of Fund structures and new sources of Capital Commitments will challenge the historical Facility structures, leading to more customized and tailored and less standardized Facility constructs. Those Lenders nimble enough to move with these tides will have significant opportunities. ◆

Endnotes

[1] For an in-depth review of overcall limitations, please see Mayer Brown's Legal Update, *"Subscription Facilities: Analyzing Overcall Limitations Linked to Fund Concentration Limits."* on page 24.

[2] Sponsors tend to refer to these HNW vehicles as "feeder funds." We prefer to refer to them as "Aggregator Vehicles" to avoid confusion with traditional feeder funds formed by a Sponsor itself.

[3] For further information about open-ended funds, please see Mayer Brown's Legal Update, *"Structuring a Subscription Facility for Open-Ended Funds."* on page 31.

Subscription Facilities: Analyzing Overcall Limitations Linked to Fund Concentration Limits

As the subscription credit facility (each, a "Facility") market has evolved further from its real estate fund roots and deeper into the buyout fund and private equity world, lenders (each, a "Lender") active in the space have increasingly found overcall limitations ("Overcall Limitations") in the partnership agreements or other governing documents (collectively, "Fund Documentation") of their prospective fund borrowers (each, a "Fund").

These Overcall Limitations take various forms, but in each case limit the ability of the Fund to call capital (each, a "Capital Call") from its limited partners (each, an "Investor") to make up for shortfalls created by other Investors' failure to fund their Capital Calls (each, a "Defaulting Investor"). Such Overcall Limitations fundamentally conflict with a Lender's general expectation in a Facility that each Investor is jointly and severally obligated to fund Capital Calls up to the full amount of its unfunded capital commitment ("Unfunded Commitment"). Therefore, Lenders have naturally taken a skeptical view of such Overcall Limitations due to the credit implications of such provisions. As described below, there are three primary forms of Overcall Limitations and one particular form that is linked to a Fund's investment diversification or concentration limits (a "Concentration-Linked Overcall") that has proved especially troubling for Lenders. This is because the application of such limit means that the degree of overcollateralization afforded to the Lender varies with the size of any particular Fund investment (each, an "Investment"). This variation in the overcollateralization cushion complicates the credit analysis, adding another variable required to be modeled in order to assess the actual credit impact of the Overcall Limitation on a Facility. This Legal Update provides background on Overcall Limitations generally and proposes structural solutions to address some of the issues presented with certain Concentration-Linked Overcalls.

Background

The collateral for and expected source of repayment of a Facility is the Unfunded Commitments of the Investors. As described below, Facilities are underwritten based on an analysis of selected high credit-quality Investors that comprise a borrowing base (the "Borrowing Base") as well as upon an analysis of the likelihood of Defaulting Investors. Analyzing these issues turns, in part, on the contractual provisions governing payment of Unfunded Commitments in the Fund Documentation. Funds have historically taken a two-pronged approach in their Fund Documentation to mitigate the risk and impact of Defaulting Investors, providing for:

(1) severe and almost draconian default remedies (e.g., Fund Documentation often provides, for example, that the Fund may sell a Defaulting Investor's equity interest at a significant discount, oftentimes 50% or more, to a third-party Investor) and (2) the ability of the Fund to make additional Capital Calls on any non-Defaulting Investors up to the amount of their Unfunded Commitment to compensate for any shortfall created by a Defaulting Investor's failure to fund (such subsequent Capital Call, an "Overcall").[1] The first prong aims to discourage any Investor from defaulting on its obligations in the first instance, whereas the second prong is designed to permit the Fund to continue to conduct its business (consummate Investments, repay debt, etc.) despite the existence of a Defaulting Investor. This approach has worked extremely well historically as very few Investor defaults have been reported, even at the height of the financial crisis.

The typical Fund approach to mitigate Investor defaults described above and the resulting high quality of Investor funding performance has led to a robust Facility market, as Lenders favorably view the asset-class on a risk-adjusted basis. Facilities, therefore, have been structured on the premise that Funds will employ the above approaches. That is, as with virtually all asset-based credit facilities, Facilities are typically structured assuming the ability of one receivable (here, an Investor's Unfunded Commitment) to overcollateralize any other defaulting receivable (here, a Defaulting Investor's Unfunded Commitment). To buffer defaults, Facilities employ Investor eligibility criteria for inclusion in the Borrowing Base and often use tiered advance rates for various types of Investors, including, in some cases, Investor concentration limits. The eligibility criteria for an Investor to be included in a Borrowing Base is intended to ensure that the Lender only advances against Investors of a sufficient credit quality; the Borrowing Base and its components provide structural mitigants to allow for a certain predicted percentage or number of Defaulting Investors (times a stress factor) to be absorbed while still permitting the Lender to be repaid in full from the proceeds of Capital Calls from remaining Investors. Thus, in a standard Facility, the structure provides that the Lender only takes the payment risk of the Investors that meet the applicable eligibility criteria (the "Included Investors"), so that if there is a Defaulting Investor, the Fund (or if necessary the Lender) could issue Overcalls on the non-Defaulting Investors to repay the resulting shortfall up to their then-Unfunded Commitments. As described below, Overcall Limits in the Fund Documentation cut against these traditional asset-based lending constructs, as they create both a contractual limitation on the Investors' funding obligation as well as potential credit exposure for the Lender to non-Included Investors.

Overcall Limitation Formats

While Overcall Limitations are still relatively rare in the Fund Documentation of Funds who typically use Facilities, there are several varieties that are commonly seen. Three of the most common formulations are detailed below.[2]

1) PERCENTAGE OF PRIOR CAPITAL CALL.

One form of Overcall Limitation caps an Investor's obligation to fund an Overcall at a predetermined percentage of the initial Capital Call (a "Percentage of Prior Call Overcall"). The limitation is often styled as follows:

> If any Investor defaults on its obligations to fund any Capital Call hereunder, the General Partner shall be authorized to make a subsequent Capital Call on the non-Defaulting Investors for the resulting shortfall, *provided that no such non-Defaulting Investor shall be obligated to fund such a subsequent Capital Call in an amount in excess of [50]% of the amount it initially funded pursuant to the original Capital Call.*

In practice, this means that if an Investor contributed $1,000,000 with respect to an initial Capital Call, that Investor would only be obligated to contribute up to $500,000 pursuant to an Overcall to make up any shortfall created by a Defaulting Investor, even if its Unfunded Commitment was far in excess of $500,000. The percentage restriction in Fund Documentation is sometimes as low as 15% or 20%.[3]

2) PERCENTAGE OF CAPITAL COMMITMENT.

Another type of Overcall Limitation formulation caps an Investor's obligation to fund an Overcall at a predetermined percentage of the Investor's Capital Commitment. This limitation is typically styled as follows:

> If any Investor defaults on its obligations to fund any Capital Call hereunder, the General Partner shall be authorized to make a subsequent Capital Call on the non-Defaulting Investors for the resulting shortfall, *provided that no such non-Defaulting Investor shall be obligated to fund such a subsequent Capital Call in an amount in excess of [15]% of its Capital Commitment.*

Under this type of Overcall Limitation, if an Investor has a capital commitment (its "Capital Commitment") of $10,000,000, such Investor is only obligated to contribute up to $1,500,000 to make up any shortfall created by a Defaulting Investor. Care should be taken in reviewing the applicable Fund Documentation to determine if this form of Overcall Limitation applies to each Overcall or all Overalls in the aggregate.

3) CONCENTRATION-LINKED OVERCALLS.

Funds often have individual and aggregate concentration limits on their Investments ("Concentration Limits") built into their Fund Documentation to ensure that the Fund invests in a reasonably diversified portfolio of Investments. These Concentration Limits may restrict the Fund from investing, for example, greater than [15]% of the aggregate Capital Commitments of the Investors in any single Investment or greater than [25]% of the aggregate Capital Commitments in Investments in a particular geographic region or in any particular industry sector. These Concentrations Limits of course vary across Investment asset classes and are individually tailored in connection with a particular Fund's investing objectives. Concentration-Linked Overcalls cap a non-Defaulting Investor's obligation to fund an Overcall at the amount that would be the most such Investor would have to fund if the applicable Concentration Limit were applied on an individual basis, as opposed to an aggregate basis. Thus, they seek to keep any particular Investor's exposure to a particular Investment from exceeding the Concentration Limit. The limitation has been styled as follows:

> If any Investor defaults on its obligations to fund any Capital Call hereunder, the General Partner shall be authorized to make a subsequent Capital Call on the non-Defaulting Investors for the resulting shortfall, *provided that no such non-Defaulting Investor shall be obligated to fund such a subsequent Capital Call if it would result in such Investor exceeding the concentration limits set forth in Section [X] as to its individual Capital Commitment.*[4]

This formulation means that if the Fund Documentation includes a Concentration Limit that no single Investment may comprise more than 15% of the Fund's aggregate Capital Commitments, no Investor would have to make Capital Contributions with respect to such Investment (i.e., the original Capital Call plus the Overcall) in excess of 15% of its own Capital Commitment. Thus, at the extreme, if an Investment was acquired that required each Investor to fund 15% of its

Capital Commitment originally, and any Investor defaulted, there would be no contractual obligation remaining on the non-Defaulting Investors to fund any Overcall to make up the shortfall.

Implications for Lenders

LIMITATION ON OVERCOLLATERALIZATION

The implications of Overcall Limitations for Lenders are material in several obvious ways. First, the Lender may not have the full benefit of the entire pool of Unfunded Commitments to support repayment. For example, let us assume the following hypothetical at the maturity of a Facility:

Hypothetical

- $200 million of Unfunded Commitments
- $50 million Borrowing Base
- $20 million Loans outstanding
- $20 million initial Capital Call to repay Loans
- a Percentage of Prior Call Overcall set at 50%

If 25% of the Investors (by Capital Commitments) default on the initial $20 million Capital Call, it would result in capital contributions ("Capital Contributions") received of $15 million, leaving $5 million of Loans due and owing. If the Overcall is issued to the non-Defaulting Investors, they are obligated to fund up to $7.5 million (50% of their funded $15 million), and hence the Lender is covered.[5] However, if 50% of the Investors default on the initial $20 million Capital Call, only $10 million would be collected, leaving $10 million of Loans due and owing. The Overcall would only produce $5 million (50% of $10 million), leaving the Lender uncovered for the final $5 million, despite ample Unfunded Commitments.[6] With a Percentage of Prior Call Overcall set at 50%, the percentage of Investors (by Capital Commitments) that must default in order for the Loans not to be repaid in full by Unfunded Commitments (the "Inflection Point") is 33.3%. If the Percentage of Prior Call Overcall is 25%, the Inflection Point is 20%.

EXPOSURE TO NON-INCLUDED INVESTORS

Second, an Overcall Limitation greatly shifts credit risk from just Included Investors to all Investors, which means additional reliance on the creditworthiness of those Investors that the Lender excluded from the Borrowing Base in the first instance. For example, in the above hypothetical, a majority of the 50% of Investors that default on the initial Capital Call could all be excluded Investors, thereby triggering the Overcall Limitation on the obligation of the Included Investors to fund the Overcall. That is, the actual advance rate against the Unfunded Commitments of the Included Investors is materially higher from what the Lender contemplated for the Facility as a result of the Overcall Limitation. And the repayment proceeds are still insufficient, despite ample Unfunded Commitments from Included Investors, a Borrowing Base far in excess of the Loans outstanding and an all-in implied advance rate of only 25%. The Borrowing Base, its structured advance rate and concentration limits, simply do not completely protect against Overcall Limitation risk, even when structured tightly.

MARKET RESPONSE

Lenders in the Facility market of course have taken a concerned view of Overcall Limitations. Fortunately, they present infrequently and when they do, Funds and Investors have been relatively amenable to comments from the Lender to explicitly carve the Facility out from their restrictions. However, there are from time to time situations where a particular Fund sponsor (a "Sponsor") has a fully closed Fund with Overcall Limitations and amending the Fund Documentation is not commercially feasible. In these cases, Lenders often have to make a determination as to whether they can get comfortable with the Overcall Limitations or if they are unable to proceed with the Facility.

Evaluating and Mitigating Overcall Limitations Generally

It is extremely difficult for a Lender to craft an overarching policy position as to which Overcall Limitations are acceptable and which are not, as the impact of Overcall Limitations requires case-by-case analysis and cannot be viewed in a vacuum. For one thing, they are articulated slightly different in each Fund's Fund Documentation, so their actual application can differ. Additionally, the ramifications of such limits differ extensively based on the constituency of the overall Investor pool in a Fund. An Overcall Limitation's potential impact is of greater concern to a Lender where a Fund is comprised of only three Investors versus a Fund with a very granular pool of Investors. Similarly, where a Fund is comprised of 50% high net worth individual Investors compared to one that has all rated, institutional Investors, such concerns may be heightened. At a minimum, a Lender must determine the Fund's Inflection Point to better understand the implications of a particular Overcall Limitation and the practical risk presented. For example, with a Percentage of Prior Call Overcall set at 50%, and hence an Inflection Point of 33.3%, a Lender would want to evaluate both the largest Investors (to see how many and which individual Investors could default before exceeding 33.3%) as well as the credit wherewithal and granularity of the bottom 33.3% (based on credit risk) of the Investor pool (to evaluate the likelihood of defaults exceeding the Inflection Point). Some Funds may have a single Investor whose Capital Commitment as a percentage of the whole is itself in excess of the Inflection Point, in effect creating the potential for single counterparty exposure risk. Additionally, the analysis is often clouded when a Fund has had its first but not its final Investor close, as the Lender is forced to try to perform a credit analysis without the full information required to accurately analyze the actual Investor pool.

Structuring for Concentration-Linked Overcalls

CHALLENGES ANALYZING CONCENTRATION-LINKED OVERCALLS

Concentration-Linked Overcalls are particularly difficult to analyze because they turn on the size of the Investment as a percentage of the aggregate Capital Commitments, and hence, they can either be a virtual non-factor or a complete contractual prohibition on Overcalls, depending on the size of the Investment at issue. For example, if the linked Concentration Limit is 15%, and the Investment at issue is only 3% of the aggregate Capital Commitments, the Concentration-Linked Overcall is of almost no practical effect whatsoever. Of course, if the Investment is 14.5% of the aggregate Capital Commitments, there is precious little overcollateralization or margin for error.

The concept is further complicated in several additional ways. First, Concentration Limits are not typically a simple test of Investment acquisition cost to aggregate Capital Commitments, they are normally a test of Capital Contributions called or to be called with respect to an Investment to the aggregate Capital Commitments. So, for example, if a portion of the Investment acquisition cost is to be financed with asset-level leverage, that portion is only relevant to the extent the financing is subsequently replaced with Capital Contributions (which, of course, can be challenging to forecast perfectly at the time of acquisition of the Investment). Further, Investments often include "Follow-on Investments," and Fund Documentation is often not explicit as to whether Capital Calls to fund "Follow-on Investments" should be bundled with Capital Calls for the initial Investment for purposes of a Concentration-Linked Overcall. Additionally, Funds often have multiple categories of aggregate Concentration Limits, each of which has to be calculated, tracked and abided by. These aggregate Concentration Limits and the related tracking are less transparent to a Lender, as a Lender cannot perfectly determine whether any particular Investment fits within a Concentration Limit with certainty and must largely rely on the Sponsor's categorization.

And finally, there is timing mismatch between the moment in time when the Fund borrows under the Facility to finance an Investment and the subsequent time when the Fund actually makes the Capital Call. In this circumstance, at the time of funding, the Lender in effect has to rely on a Fund's good faith belief as to how much capital it will be calling in the future with respect to the Investment.

USE OF LOAN PROCEEDS LIMITATION

If a particular Concentration-Linked Overcall applies to Capital Calls to repay debt (and not just to Capital Calls to fund Investments), to get comfortable with the limitation Lenders may want to consider structuring limitations on the use of Facility proceeds. For example, if a Fund has a Concentration Limit for individual Investments of 15%, a Lender may want to prohibit the use of Loan proceeds to acquire large Investments that come close in size to the 15% level to ensure that the Lender will have an adequate cushion of Overcalls on non-Defaulting Investors. So, for example, the Lender could set a percentage (the "Maximum Percentage") at the threshold of its comfort level under the circumstances to always ensure an available Overcall cushion between the Maximum Percentage and the 15%, and restrict the use of Loan proceeds with respect to Investments that are in excess of the Maximum Percentage.

Setting the Maximum Percentage will depend on the particular Fund, Sponsor and Investor pool, but suppose, for example, that the Lender would be comfortable under the circumstances with a 33.3% Inflection Point (as if there was a Percentage of Prior Call Overcall framework set at 50%). In such a case, the Lender could set the Maximum Percentage as the mathematical equivalent of the 50% Percentage of the Prior Call Overcall for each Concentration Limit. For a 15% Concentration Limit, the math is simple and the Maximum Percentage would be 10%. Hence, the Fund could use Loan proceeds under the Facility for Investments in which less than 10% of the aggregate Capital Commitments would be called, but would be prohibited from using Loan proceeds for Investments in excess of 10% of aggregate Capital Commitments. For the Fund's aggregate Concentration Limits, the Maximum Percentage would float such that each level was set at the 33.3% Inflection Point.

ADDITIONAL MITIGANTS

Setting the Maximum Percentage requires care and consideration of all the relevant criteria for the particular Fund. It also requires a high degree of confidence in the Sponsor, as the Lender will be relying on the Fund to accurately predict anticipated Capital Call amounts for Investments, accurately classify Investments for purposes of aggregate Concentration Limits, and accurately address the potential impact of subsequent Follow-on Investments. These reliances may, in certain circumstances, require increased due diligence on Sponsors, thus potentially limiting the use of this structure to only highly-experienced, trusted Sponsors with demonstrated track records. Additionally, in certain circumstances, additional asset-level mitigants and "skin in the game" requirements may be appropriate to bring a particular Facility with a Concentration-Linked Overcall back to the intended credit profile. Examples include (i) covenants to periodically call capital to ensure the earlier detection of Defaulting Investors and because Investors periodically investing fresh equity are less likely to be willing to forfeit such equity by defaulting, (ii) minimum net asset value requirements to buffer the secondary source of repayment, and (iii) asset-level leverage limitations to reduce volatility with respect to the equity position of the Fund. In addition, Lenders may want to exercise greater control over transfers by non-Included Investors since the Lenders have exposure to all Investors when Overcall Limitations are applicable.

IN PRACTICE

In practice, many Funds do not actually acquire a large number of Investments that bump up against their Concentration Limits, and therefore, the use of proceeds limitation

has been an acceptable work-around for both Lenders and Funds in certain Facilities. Further, to the extent the Fund wants to acquire an Investment in excess of the applicable Maximum Percentage, it would not be prohibited from doing so with equity; rather, it is only prohibited from doing so with Facility proceeds. Similarly, if a Fund desires to make additional Investments which would put it above the Maximum Percentage with respect to a particular aggregate Concentration Limit, it can do so by simply paying down the Loan related to the initial Investment prior to consummating such additional Investment.

Conclusion

While Overcall Limitations are still relatively rare in Fund Documentation, when applicable they become an important focus of the underwriting analysis for Lenders considering a Facility. Lenders must evaluate not just the Borrowing Base for such Facility, but the Sponsor, the Fund and the Investors as a whole, to adequately understand the risks of Investor defaults exceeding the Inflection Point. Fortunately, Investor default numbers have historically been many multiples shy of even the tightest Inflection Points and with structural mitigants many Lenders are able to find solutions to enable Funds (at least those formed by well-established Sponsors) to benefit from Facilities. Funds considering the possibility of a Facility should, whenever possible, avoid or narrowly tailor Overcall Limitations to scope out Capital Calls to repay a Facility, as their inclusion, even when accommodated, results in greater due diligence time, expense and legal costs and, most importantly, less favorable Facility terms and pricing. ◆

Endnotes

[1] In this Legal Update, we discuss Overcall Limitations in the context of Defaulting Investors, but the concept is also often equally applicable with respect to any Investors that are excused from participating in any particular Investment under the terms of the applicable Fund Documentation.

[2] An Overcall Limitation in any Fund Documentation must be examined individually, as there are many slight variations to the examples provided herein, any of which could impact its prospective applicability to, or impact on, a Facility.

[3] From time to time, we have seen Overcall Limitations surface in side letters of individual Investors as well. While not as dramatic as a Fund-wide Overcall Limitation, individual Investor Overcall Limitations present interesting wrinkles for Lenders as well.

[4] Some Concentration-Linked Overcalls apply only with respect to Capital Calls to make an Investment and not with respect to Capital Calls to repay indebtedness. Some formulations can be ambiguous as to whether they would apply with respect to a Capital Call to repay loans under a Facility (“Loans”) if the Loans were used to acquire an Investment. Hence, again, any particular Overcall Limitation must be analyzed individually.

[5] We assume all non-Defaulting Investors fully fund the Overcall. It is of course theoretically possible that certain non-Defaulting Investors fail to fund the Overcall leading to successive Overcalls.

[6] Note that we are by no means saying that the Lender will definitively take a loss in this circumstance. Facilities are full-recourse obligations of the Fund and the Fund very well may be able to satisfy its payment obligation by the liquidation of Investments. Additionally, the Fund and ultimately the Lender will have claims against the Defaulting Investors which may also result in repayment proceeds and transfers of Defaulting Investors’ positions may produce creditworthy substitute Investors.

Structuring a Subscription Credit Facility for Open-End Funds

A subscription credit facility (a "Facility"), also frequently referred to as a capital call facility, is a loan made by a bank or other credit institution (the "Lender") to a private equity fund (the "Fund"). The defining characteristic of such Facilities is the collateral package, which is composed not of the underlying investment assets of the Fund, but instead by the unfunded commitments (the "Capital Commitments") of the limited partners in the Fund (the "Investors") to make capital contributions ("Capital Contributions") when called from time to time by the Fund's general partner.

The loan documents for the Facility contain provisions securing the rights of the Lender, including a pledge of (i) the Capital Commitments of the Investors, (ii) the right of the Fund's general partner to make a call (each, a "Capital Call") upon the Capital Commitments of the Investors after an event of default accompanied by the right to enforce the payment thereof, and (iii) the account into which the Investors fund Capital Contributions in response to a Capital Call.

The number of Facilities is rapidly growing due to the flexibility they provide to Funds (in terms of liquidity and consolidating Capital Calls made to Investors) and the reliability of the Capital Commitment collateral from the Lender's perspective. As the Facility market continues to grow and evolve, both Lenders and Fund sponsors seek to put in place Facilities for fund structures that vary from the typical closed-end Funds that have historically dominated the Facility market. As recovery from the financial crisis continues, Investors are increasingly investing in open-end Funds due to the Investors' interest in increased liquidity due to the availability of voluntary Investor redemptions in open-end Funds. Historically, Lenders have not pursued open-end Funds for Facilities because of concerns surrounding the transient nature of the Capital Commitments in those Funds. As discussed below, however, with a few structural tweaks, Facilities can be provided to open-end Funds, offering Lenders the same comforts of a traditional Facility while providing Funds convenient and cost-effective fund-level financing. Such financing can be used for leveraging investments, liquidity and bridging Capital Calls. This newsletter provides background on how open-end Funds generally differ from a typical closed-end Fund, and proposes solutions for structuring a Facility for open-end Funds.

Background

While there are many types of open-end Funds, there are a number of common characteristics that generally distinguish an open-end Fund from a typical closed-end Fund. These include: the long-term fund-raising period during which it can accept additional Capital Commitments and close in new Investors, the extended or perpetual investment period during which it can make Capital Calls, and

most important and potentially concerning for purposes of Facilities, the increased flexibility for Investors to redeem their interests. Unlike a closed-end Fund, where redemption and withdrawal rights are generally not available to Investors, or, to the extent that they are available to Investors, are generally limited to specific legal or regulatory issues, Investors in an open-end Fund are generally free, subject to notice and timing restrictions, to redeem their interests in the Fund. True open-end Funds by their nature permit redemption of equity at the election of the Investor (and, in some circumstances, the remaining unfunded Capital Commitment of the redeeming Investor may be cancelled). It is important to note that some open-end Funds require Investors to fully fund all Capital Contributions concurrently with closing into the fund and, thus, do not retain the concept of an unfunded Capital Commitment. A traditional Facility would not be feasible for such a Fund. For purposes of this newsletter we will focus on structuring issues related to the expanded redemption and withdrawal rights of Investors in open-end Funds that retain unfunded Capital Commitments.

Structuring and Documentation Concerns

A Facility for an open-end Fund should contain a representation, warranty, covenant and an event of default package that is generally consistent with that seen in Facility documentation for a closed-end Fund. The collateral package would also be similar, if not identical, to that for a closed-end Fund. As a gating issue, it is important to review the constituent documents of the open-end Fund to ensure that the timing of requests for redemption and the timing for satisfying redemptions allows for Capital Calls to be made and the proceeds thereof applied to make any mandatory prepayment that would result from any such redemption. Notwithstanding the generality of the foregoing, there are a few structural changes that should be noted in a Facility for an open-end Fund.

COLLATERAL ISSUES

As discussed above, the collateral and expected source of repayment in a Facility is the Capital Commitments of the Investors. Given the nature of open-end Funds, the potential fluidity with respect to the Investors and, therefore, the collateral for the Facility raise potential concerns. Notwithstanding the issues related to a changing pool of Investors, with a careful review of the Fund's constituent documentation and attention to the redemption timing and mechanics, a Facility could be structured to address a Lender's concerns while still providing flexibility (in terms of liquidity and consolidating Capital Calls made to Investors) to an open-end Fund. As described in more detail below, the Facility documentation can address the foregoing concerns with some minor changes, including additional exclusion events, mandatory clean-up calls, additional events of defaults and/or additional covenants.

An exclusion event tied to any request by an Investor to redeem its interest in the Fund must be structured so as to remove any such requesting Investor from the borrowing base while also allowing sufficient time to make a Capital Call to cure any resulting borrowing base mismatch in the time period between receipt of such request from an Investor to the time the Investor has been redeemed from the Fund. Tying the exclusion event to a request for redemption, rather than to an actual redemption, is important not only for timing concerns, but also because an Investor that has redeemed its equity in a Fund, even if it is not also seeking to cancel its unfunded Capital Commitment, may not be as concerned by the defaulting investor penalties in the constituent documents of the open-end Fund as an Investor that still has equity at stake. Additional Lender protection can be obtained by requiring cleanup calls (to reduce amounts outstanding under a Facility) in advance of each regularly occurring redemption window under the constituent documents of the open-end Fund. An event of default can be

added that is triggered upon a threshold percentage of Investors requesting redemption of their interests in the Fund. Such event of default can be structured to be cumulative or with respect to any redemption window. A net asset value covenant can be inserted to provide additional early warning of any Fund problems.

ADDITIONAL REPORTING

Because of the potential for changes in the Investor base and the collateral package associated with an open-end Fund, Facilities should be structured to provide additional reporting as to borrowing bases and Investor events, including notice of redemption requests, cues of Investors seeking admission to the Fund and net asset values. Additional delivery of borrowing base certificates and notices of redemption requests should coincide with the time periods under the constituent documents of the open-end Fund such that the Lender can properly monitor borrowing base changes and anticipate any necessary mandatory prepayments resulting from Investor redemptions, while maintaining time to issue any necessary Capital Calls before the effectiveness of any requested redemptions. Tracking redemption requests and Investor cues should provide a Lender with an early indication of underlying problems with a Fund.

We note that reporting and documentation required in connection with a Facility for an open-end Fund may be more administratively burdensome than a Facility in a typical closed-end Fund. Beyond the additional reporting with respect to borrowing bases and Investor redemptions discussed above, deliverables (such as constituent document changes, new side letters and subscription agreements) with respect to additional Investors can continue for a longer period than in a typical closed-end Fund. Moreover, given the increased potential for Investor turnover, it may be burdensome for both Lenders and Fund sponsors to negotiate and obtain investor letters and opinions from Investors. Lenders may want to consider addressing any additional administrative burden related to an open-end Fund Facility by increasing the administrative fees under the Facility. Even with an incremental increase in fees or the interest rate, a Facility still likely provides cheaper liquidity than many asset-level financings.

FACILITY TENOR

Because of its long-term nature, there are a number of options to structure the tenor of a Facility for an open-end Fund. Since open-end Funds typically are not subject to limited investment periods during which they may make Capital Calls for investments and repay Facility obligations, there are more options available to Lenders and Fund sponsors in terms of the tenor of the Facility. Some open-end Funds prohibit initial Investors from redeeming their interests and/or withdrawing from the Fund for a predetermined period of time (often one or two years). Such lock-out periods help the Fund achieve and maintain a critical size during its ramp-up period. During the early stages of such an open-end Fund, a Facility could be structured with a tenor equal to any applicable redemption lock-out period for the Investors. A Facility of this type would look very similar to a Facility for a typical closed-end Fund. Secondly, a Facility could have a longer tenor, even in excess of five years or more, to match the long-term investment period and life-span of an open-end Fund. Although rare in this market, such a long-term tenor is regularly seen in other leveraged lending products. Lastly, a Facility could be structured with a 364-day tenor, subject to any number of one-year extensions, allowing the Lender and Fund sponsor to re-evaluate their respective needs on an ongoing basis during the life of the Fund.

Conclusion

While Facilities for true open-end Funds have to date been relatively rare, the opportunity is ripe for new market entrants. With a careful review of an open-end Fund's constituent documentation and some modifications to the

Facility documentation, a Facility can be structured to provide the traditional benefits of a Facility for an open-end Fund while still addressing a Lender's standard Facility credit criteria. Please contact any of the authors with questions regarding open-end Funds and the various structures for effectively establishing Facilities for such entities. ◆

Separate Accounts vs. Commingled Funds: Similarities and Differences in the Context of Credit Facilities

The use of managed accounts as an investment vehicle has been widely publicized of late with institutional investors such as the California State Teachers' Retirement System and the New York State Common Retirement Fund (referring to such vehicles as "separate accounts"), and the Teacher Retirement System of Texas and the New Jersey Division of Investment (referring to such vehicles as "strategic partnerships") making sizeable investments with high-profile private equity firms such as Apollo Global Management, LLC, Kohlberg Kravis Roberts & Co. and the Blackstone Group.[1]

Regardless of name, these tailored investment vehicles represent a significant trend, with 32% of surveyed fund managers indicating they were intending to invest more from separate accounts during 2013.[2] And although structurally divergent from commingled real estate or private equity funds ("Funds"), these separate accounts share a common objective with Funds: to produce strong returns with respect to invested capital in the most efficient manner possible.

In many situations, accessing a credit facility can facilitate achieving investment objectives. This is quite clear in the context of Funds establishing subscription credit facilities, also frequently referred to as a capital call facility (a "Facility"). These Facilities are popular for Funds because of the flexibility they provide to the general partner of the Fund in terms of liquidity and the efficiency associated with consolidating the number of capital calls made upon limited partners. These benefits would equally apply to institutional investors establishing separate accounts with private equity firms and, despite fundamental differences between separate accounts and Funds, a separate account may be structured to take advantage of the flexibility afforded by a similar credit facility.

Definition of "Separate Account"

The term "separate account" has been used generically to describe an arrangement whereby a single investor provides virtually all of the necessary equity capital for accomplishing a specified investment objective. It is important, however, to distinguish a "separate account" from a joint venture or partnership in which there is an additional party (frequently the investment manager) with an equity interest in the owner of the investment. The equity provided (or earned) by the investment manager may be slight in comparison to the equity capital provided by the institutional investor. However, despite the imbalance of economic interests, these joint ventures and partnerships involve two or more equity stakeholders and generally require careful consideration with respect to many of the same issues which arise in the context of Funds (whether such Fund includes just a few, or a few hundred, investors). And confusion arises when these joint ventures and partnerships are incorrectly referred to as a "separate account."

In fact, a separate account ("Separate Account") is an investment vehicle with only one (1) commonly

institutional investor ("Investor") willing to commit significant capital to a manager (which may also simultaneously manage a Fund or Funds ("Manager")) subject to the terms set forth in a two (2) party agreement (commonly referred to as an Investment Management Agreement or the "IMA"). The IMA is structured to meet specific goals of the Investor, which may be strategic, tax-driven or relate to specific needs (such as excluding investments in a particular type of asset or market). As a result, it is not atypical for a Separate Account to be non-discretionary in terms of investment decisions made by the Manager (with Investor approval being required on a deal-by-deal basis). Separate Accounts can also be tailored to match the specific investment policies and reporting requirements of the Investor.

Separate Accounts vs. Commingled Funds

Aside from fundamental differences such as the number of investors and the potential lack of Manager discretion in making investment decisions (described above), several key distinctions exist between Separate Accounts and Funds. Notably, fees paid to the Manager under Separate Account arrangements are typically lower than those paid to a Manager operating a Fund (in part because of the leverage maintained by an Investor willing to commit significant capital to a Separate Account), and any performance fees must be carefully structured to ensure they do not violate applicable law relating to conflicts of interest.

The popularity of Separate Accounts may be attributable to the greater flexibility they provide to the Investor. In addition to Investor input related to investment decisions, IMAs are sometimes structured to be terminable at will upon advance notice to the Manager (although there may be penalties associated with early termination), while termination of a Fund Manager ordinarily requires the consent of a majority or supermajority of the other limited partners, and oftentimes must be supported by "cause" attributable to the action (or inaction) of the Manager. However, there are also significant costs and trade-offs associated with this flexibility, including that the Investor must identify and agree upon terms with a suitable Manager, and the time commitment and expertise required by the Investor to be actively involved in analyzing and approving investment recommendations made by the Manager. Likewise, the Manager will require a sizeable commitment to the Separate Account to overcome the inefficiency of a Separate Account as compared to operating a Fund with a larger pool of committed capital, more beneficial fee structures, and discretion over investment decisions.

Benefits of Credit Facilities for Separate Accounts

Notwithstanding the differences between Separate Accounts and Funds, Investors and Managers alike would benefit from access to a credit facility in connection with a Separate Account. To begin with, credit facilities provide a ready source of capital so that investment opportunities (once approved) can be quickly closed. Timing considerations are critical in a competitive environment for quality investments, particularly if internal Investor approvals are difficult to obtain quickly. The liquidity offered by a credit facility can decrease Investor burden and shorten the overall investment process by eliminating the need for simultaneous arrangement of funding by the Investor. The closing of an investment through a credit facility minimizes administration by both the Investor and Manager, as funding of the obligations to the Separate Account can be consolidated into a routine call for capital (instead of multiple draws taxing the human capital of both the Manager and Investor executing the objectives of the IMA). And, perhaps most importantly from the Investor's perspective, a credit facility may eliminate the need to continually maintain liquidity for the capital required to fund investments contemplated by the Separate Account.

Although alternatives exist (including asset-level financing arrangements), many Funds have established Facilities for purposes of obtaining liquidity, flexibility and efficiency in connection with portfolio management. The most common form of Facility is a loan by a bank or other credit institution (the "Creditor") to a Fund, with the loan obligations being secured by the unfunded capital commitments (the "Unfunded Commitments") of the limited partners of the Fund. Under a Facility, the Creditor's primary and intended source of repayment is the funding of capital contributions by such limited partners, instead of collateral support being derived from the actual investments made by the Fund. The proven track record of Unfunded Commitments as collateral has generally enabled Creditors to provide favorable Facility pricing as compared to asset-level financing, although many Funds utilize both forms of credit in order to increase overall leverage of the investment portfolio.

Assuming the Investor is a creditworthy institution, the IMA can be drafted to take advantage of the flexibility afforded by a Facility by including certain provisions found in most Fund documents supporting the loan.[3] More specifically, the IMA should expressly permit the Manager to obtain a Facility and provide as collateral all or a portion of the unfunded commitment of the Investor (the "Required Commitment") to supply a capital contribution for approved investments ("Account Contributions") contemplated by the Separate Account. Then, as part of the Investor's approval of an investment under the IMA, the Investor may elect to authorize the Manager to make a draw upon the Facility for the relevant investment(s) and cause the Required Commitment to be pledged, along with the right to request and receive the related Account Contribution when called by the Manager (a "Capital Call"), to the Creditor. If so, the Investor retains discretion with respect to both investment selection and Facility utilization and, when drawn upon the Facility, would be supported by a pledge of: (a) the Required Commitment; (b) the right of the Manager to make a Capital Call upon the Required Commitment after an event of default under the Facility (and the right of the Creditor to enforce payment thereof); and (c) the account into which the Investor is required to fund Account Contributions in response to a Capital Call. Creditors may also require investor letters from the Investor acknowledging the rights and obligations associated with this structure from time to time. As mentioned above, most Investors and Managers are familiar with these terms and recognize the benefits afforded by establishing a Facility for purposes of flexibility, efficient execution, and administration of private equity investments.

Conclusion

The number of Funds seeking a Facility is steadily increasing due to the benefits these loans provide to Investors and Managers in terms of liquidity and facilitating investment execution, while simultaneously decreasing the administrative burden associated with numerous and/or infrequent capital calls. Likewise, Creditors have benefitted from the reliability of unfunded capital commitment collateral and the low default rates associated with these Facilities.

These same attributes apply in the context of Separate Accounts and, with careful attention to Facility requirements at the onset of Separate Account formation, similar loans may be provided for the benefit of parties to an IMA. Please contact any of the authors with questions regarding these issues and the various methods for effectively establishing a Facility in connection with Separate Accounts. ◆

Endnotes

1. "CalSTRS Joins Chorus Favoring Separate Accounts Over Funds", Pension & Investments, March 5, 2012.
2. "The Rise of Private Equity Separate Account Mandates", Preqin, February 21, 2013.
3. In the context of a Separate Account structured so the Investor does not maintain any form of commitment (and instead merely funds individual investments with equity capital in connection with approval and closing thereof), this Facility support structure would not apply.

Subscription Credit Facilities: Certain ERISA Considerations

A subscription credit facility (a "Facility"), also frequently referred to as a capital call facility, is a loan made by a bank or other credit institution (the "Lender") to a private equity fund (the "Fund"). The defining characteristic of such Facilities is the collateral package, which is composed not of the underlying investment assets of the Fund, but instead by the unfunded commitments (the "Capital Commitments") of the limited partners of the Fund (the "Investors") to make capital contributions ("Capital Contributions") when called from time to time by the Fund or the Fund's general partner.

The loan documents for the Facility contain provisions securing the rights of the Lender, including a pledge of (i) the Capital Commitments of the Investors, (ii) the right of the Fund or the Fund's general partner to make a call (each, a "Capital Call") upon the Capital Commitments of the Investors after an event of default accompanied by the right to enforce the payment thereof and (iii) the account into which the Investors fund Capital Contributions in response to a Capital Call.

As recovery from the financial crisis continues, fund-raising activity is up markedly, due to increases in both the Capital Commitments made by Investors to existing Funds and the number of new Funds being formed. Consequently, this activity is driving an increase in the number of Facilities sought by such Funds given (i) the flexibility such Facilities provide to Funds (in terms of liquidity and consolidating Capital Calls made to Investors) and (ii) the proven track record in regards to Capital Commitment collateral's reliability. The reliability of such collateral is due in part to the typically high credit quality of Investors in such Funds and low default rates of such Investors.

Many Funds are at least partially comprised of Investors that are subject to the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), and/or Section 4975 of the Internal Revenue Code of 1986, as amended (the "Code"). As discussed below, understanding a Fund's status under ERISA, as well as the status of individual Fund Investors under ERISA and Section 4975 of the Code, is critical from a Lender's perspective because of the prohibited transaction rules contained in these statutes.[1] A violation of the prohibited transaction rules under ERISA could result in severe consequences to the Fund and to Lenders under a Facility, including the possibility that the Facility be unwound and/or of excise tax penalties equal to 100% of the interest paid under the Facility being imposed on the Lender. Despite these potential pitfalls, ERISA issues can be effectively managed through awareness of these rules and regulations and guidance from seasoned counsel specializing in ERISA and experienced in these Facilities. This newsletter outlines some of the basic ERISA considerations of which Lenders and Fund borrowers should be aware in connection with these Facilities.

Background

ERISA was adopted by Congress to protect the interests of participants in employee benefit plans that are subject to ERISA. Concerned with the difficulty of enforcing a law based on good faith or arm's-length standards, Congress imposed:

1. fiduciary status on all persons who exercise control over employee benefit plan assets (whether or not they intend or agree to be fiduciaries);
2. stringent fiduciary standards and conflict of interest rules on such fiduciaries;
3. except where specifically exempted by statute or by the Department of Labor, prohibitions on all transactions between employee benefit plans and a wide class of persons (referred to as "parties in interest" in ERISA and "disqualified persons" in the Code)[2] who, by reason of position or relationship, might, in Congress' view, be in a position to influence a fiduciary's exercise of discretion over plan assets; and
4. onerous liabilities and penalties on both fiduciaries who breach ERISA and third parties who enter into transactions that violate the prohibited transaction rules.

ERISA Prohibited Transaction Rules

The most significant issue for a Lender to a Fund that is or may be subject to ERISA is the impact of the prohibited transaction rules under ERISA, which strictly prohibit a wide range of transactions, including loans or other extensions of credit, between an ERISA plan and a person who is a "party in interest" with respect to such plan, unless an exemption is available (as described below). Financial institutions often have relationships with ERISA plans that cause them to be parties in interest, such as providing trustee, custodian, investment management, brokerage, escrow or other services to the ERISA plan.

A party in interest that enters into a nonexempt prohibited transaction with an ERISA plan is subject to an initial excise tax penalty under the Code equal to 15% of the amount involved in the transaction and a second tier excise tax of 100% of the amount involved in the transaction, if the prohibited transaction is not timely corrected. In order to correct the prohibited transaction, the transaction must be unwound, to the extent possible, and the ERISA plan must be made whole for any losses. In addition, if a transaction is prohibited under ERISA, it may not be enforceable against the ERISA plan.

As discussed below, a Fund that accepts ERISA plan Investors could, itself, become subject to these prohibited transaction rules under ERISA. During the negotiation of the term sheet and initial due diligence for a Facility, it is critical to understand the Fund's structure, the current ERISA status of the Fund and, if the Fund has not closed in all of its Investors and/or made its first investment, the intended ERISA status of the entities within the Fund's structure. Such information is necessary to draft appropriate representations and covenants in the loan documents. The representations and covenants will assure the Lender that either the Fund is not subject to ERISA or the Fund may rely on an exemption from the prohibited transaction rules under ERISA that will apply to the transactions contemplated by the Facility. Lenders may also require certain ERISA-related deliveries as a condition to the initial borrowing under the Facility, as well as annual deliveries thereafter.

Plan Asset Rules

A Fund that accepts ERISA Investors could itself become subject to ERISA if the assets of the Fund are deemed to be "plan assets" of such ERISA Investors. The rules governing the circumstances under which the assets of a Fund are treated as plan assets are generally set forth in Section 3(42) of ERISA and a regulation, known as the "plan asset regulation," published by the Department of Labor. Section 3(42) of ERISA and the plan asset regulation set forth a number of exceptions on which a Fund may rely to avoid being deemed to hold the plan assets of its ERISA Investors.

COMMON EXCEPTIONS TO HOLDING PLAN ASSETS

The exceptions to holding plan assets most commonly relied on by Funds[3] seeking to admit Investors subject to ERISA are the "less than 25%" exception and the "operating company" exception. Prior to permitting the initial borrowing under a Facility, a Lender may require evidence of compliance by the Fund with these exceptions in the form of a certificate from the Fund's general partner (in the case of the less than 25% exception) or an opinion of qualified ERISA counsel to the Fund (in situations involving the "operating company" exception). In addition, the Facility may require annual certificate deliveries by the Fund to confirm the Fund's continued satisfaction of the conditions of an exception to holding plan assets. Regardless of the deliveries requested by the Lender, the Facility should contain representations, warranties and covenants from the Fund to the effect that the Fund satisfies an exception to holding plan assets and will continue to satisfy such an exception throughout the period any obligations under the Facility remain outstanding.

Less Than 25% Exception

The less than 25% exception is available to a Fund[4] if less than 25% of each class of equity interests in the Fund are owned by benefit plan investors. For the purpose of the less than 25% exception, Investors that are treated as "benefit plan investors" include, among others, private pension plans, union-sponsored (or Taft Hartley) pension plans, individual retirement accounts, and certain trusts or commingled vehicles comprised of assets of such plans. Government plans and non-US plans are not subject to ERISA or Section 4975 of the Code and are not counted as benefit plan investors for the purpose of the less than 25% exception. In addition, when determining the size of the class of equity interests against which benefit plan investor participation will be measured, the interests of the Fund manager or general partner and other persons who exercise discretion over Fund investment or provide investment advice to the Fund, and affiliates of such persons, are disregarded. The percentage ownership of the Fund is measured immediately after any transfer of an interest in the Fund. Accordingly, a Fund relying on the less than 25% exception must monitor the percentage of its benefit plan investors throughout the life of the Fund.

Operating Company Exception

A Fund[5] relying on the operating company exception will typically do so by seeking to qualify as either a "real estate operating company" or a "venture capital operating company." A real estate operating company ("REOC") is an entity that is primarily invested in actively managed or developed real estate with respect to which the entity participates directly in the management or development activities. A venture capital operating company ("VCOC") is an entity that is primarily invested in operating companies (which may include REOCs) with respect to which the entity has the right to participate substantially in management decisions. It is common for real estate-targeted Funds to rely on the VCOC exception by investing in real estate through subsidiary entities that qualify as REOCs. Both VCOCs and REOCs must qualify as such on the date of their first long-term investment and each year thereafter by satisfying annual tests that measure their ownership of qualifying assets and their management activities with respect to those assets. If a Fund does not qualify as a VCOC or REOC on the date of its initial long-term investment or fails to continue to qualify as a VCOC or REOC, as applicable, on an annual testing date, the Fund is precluded from qualifying as a VCOC or REOC, as applicable, from that date forward. Accordingly, a Fund relying on an operating company exception must properly structure and monitor investments and test for compliance annually.

Certain Timing Considerations Related to Exceptions to Holding Plan Assets

To avoid the application of the prohibited transaction rules and risks described above to the transactions contemplated by a Facility, the Fund must satisfy an exception to holding plan assets at the time of the initial borrowing under the Facility and throughout the period any obligation under the Facility remains outstanding.[6] With respect to the operating company exception, the timing of the initial investment, the initial Capital Call from Investors and the initial borrowing must be carefully monitored.

As noted above, a Fund cannot qualify as a VCOC or a REOC until the date of its initial long-term investment. Accordingly, benefit plan investors typically will not make Capital Contributions to a Fund intending to qualify as a VCOC or REOC until the date such Fund makes its first investment that qualifies the Fund as a VCOC or REOC, as applicable. To call capital in advance of the initial investment, such a Fund would need to establish an escrow account to hold the Capital Contributions from its benefit plan investors outside of the Fund until the first qualifying investment is made by the Fund. Since the escrowed funds have not been contributed to the Fund, the escrow account may not be pledged by the Fund as security to the Facility. The escrow account used for this purpose needs to satisfy certain conditions set forth in an advisory opinion issued by the Department of Labor in order to avoid causing the Fund to be deemed to hold plan assets. Depending on the facts and circumstances, a Fund may not be able to make an affirmative representation in the Facility documents that it does not hold ERISA plan assets until the date on which the Fund makes its initial investment that qualifies the Fund for an operating company plan asset exception.[7]

PROHIBITED TRANSACTION EXEMPTIONS FOR PLAN ASSET FUNDS TO ACCESS A FACILITY

A Fund that has admitted ERISA Investors and does not satisfy the conditions of an exception to holding plan assets is subject to ERISA. An ERISA Fund would not necessarily be precluded from accessing a Facility if such Fund could rely on one of the prohibited transaction exemptions described below. As noted above, financial institutions provide a variety of services to many ERISA plans, causing such institutions to be parties in interest to such ERISA plans. Accordingly, in connection with a Facility with an ERISA Fund, it is imperative that the Facility documents contain representations and covenants from the ERISA Fund to support the conclusion that a prohibited transaction exemption is available for the transaction.

QPAM Exemption

One frequently used exemption is referred to as the "QPAM exemption."[8] This class exemption from the prohibited transaction restrictions of ERISA was granted by the Department of Labor for certain transactions between a plan and a party in interest where a qualified professional asset manager or "QPAM" has the responsibility for negotiating the terms of and causing the plan to enter into the transaction. If a loan constitutes a prohibited transaction, ERISA would preclude the ERISA plan from indemnifying the Lender for the excise taxes or other losses incurred by the Lender as a result of the violation of the prohibited transaction rules. For this reason, the Lender may require the QPAM itself to make representations and covenants confirming compliance with the QPAM exemption and to indemnify the Lender for any breach of such representations and covenants.

Service Provider Exemption

Another exemption potentially available is a statutory exemption (the "Service Provider exemption")[9] that provides broad exemptive relief from ERISA's prohibited transaction rules for certain transactions between a plan and a person who is a party in interest solely by reason of providing services to the plan, or by

reason of certain relationships to a service provider, provided that the plan receives no less or pays no more than adequate consideration. The Service Provider Exemption is available for a broad range of transactions, including loans or a Facility. As noted above, one of the conditions of the Service Provider Exemption is that the plan neither receives less nor pays more than "adequate consideration." In the case of an asset other than a security for which there is a generally recognized market, "adequate consideration" is the fair market value of the asset as determined in good faith by one or more fiduciaries in accordance with regulations to be issued by the Department of Labor.[10] To date, the Department of Labor has not issued such regulations. Until applicable regulations are promulgated by the Department of Labor, Lenders may not be comfortable relying on the Service Provider Exemption.

STRUCTURING ALTERNATIVES FOR INCLUDING INVESTORS: MASTER/FEEDER FUNDS

Certain Funds are structured with one or more feeder funds through which Investors invest in the Fund. Frequently, the feeder funds may not limit investment by benefit plan investors and may be deemed to hold the plan assets of such Investors. Accordingly, the prohibited transaction rules will apply to any feeder fund that does not satisfy the less than 25% exception to holding plan assets discussed above. The activity of such feeder funds is typically limited to investment into the master Fund, which is designed to satisfy an exception to holding plan assets. Since the Fund manager does not have discretion over feeder fund investments and transactions, the QPAM exemption would not be available for loans to the feeder fund. In such cases, the feeder funds generally do not enter into lending transactions directly, or even provide guarantees of master Fund loans. However, there are structures that can be established to make sure the Fund receives credit/borrowing base capacity for the feeder fund. For instance, the feeder fund may pledge the unfunded Capital Commitments of its Investors to the master Fund. The master Fund, in turn, pledges those assets to the Lenders. Accordingly, the Lenders are entering into a transaction only with the master Fund, which does not hold plan assets, but the Lenders still have access to the feeder fund Capital Commitments to the extent included in the pledged assets.

Investor Consents

For various reasons, Lenders may require an Investor consent letter (also commonly referred to as an Investor letter or Investor acknowledgment), where an Investor confirms its obligations to fund Capital Contributions after a default to repay the Facility. To the extent that these Investor consents are sought from benefit plan investors, it is important to consider the ramifications of the plan asset regulation.

Even if a Fund satisfies one of the exceptions to holding plan assets set forth in Section 3(42) of ERISA or the plan asset regulation, an Investor consent directly between a Lender and a benefit plan investor could be deemed to be a separate transaction that may give rise to prohibited transaction concerns under ERISA and/or Section 4975 of the Code. Certain Lenders have obtained individual prohibited transaction exemptions from the Department of Labor to eliminate this prohibited transaction risk in connection with Investor consents, provided the conditions of the exemption are satisfied. Each of these individual prohibited transaction exemptions assumed that the assets of the Fund were not deemed to be ERISA plan assets. Without an individual prohibited transaction exemption, it is essential that the Investor consents with benefit plan investors be structured so that such Investors are merely acknowledging their obligations under the governing documents of the Fund. Investor consents carefully drafted so Investors are acknowledging obligations

arising under the Fund documentation (instead of being styled as an agreement between such Investor and the Lender) should not be viewed as "transactions" with the Lender for prohibited transaction purposes under ERISA or Section 4975 of the Code.

Loans Funded With Plan Assets

Typically Facilities are funded out of general assets of one or more Lenders, and not with ERISA plan assets. However, it is important to note that if a loan were funded in full or in part from, or participated to an account or fund comprised of ERISA plan assets, the ERISA prohibited transaction considerations discussed above would be triggered, regardless of whether the borrower Fund is deemed to hold plan assets. For this reason, borrowers often request Lenders to represent and covenant that the loan will not be funded with ERISA plan assets.

Conclusion

A Fund that contemplates taking advantage of the benefits associated with a Facility must be mindful of ERISA issues. Beginning with structuring the Fund with an eye towards the inclusion of ERISA Investors, through the selection and timing of Fund investments coinciding with the term of the Facility, careful consideration of the impact ERISA rules and regulations may have on the Fund can increase (or limit entirely) the available amount of the loan. Lenders must also pay particular attention to ERISA issues commencing with due diligence of the Fund and Investor documentation, through execution of final loan documents for the Facility and the necessary representations, warranties, covenants and required deliverables related thereto for purposes of limiting exposure to a violation of ERISA rules and regulations. With careful planning and attention to ERISA issues (including to those described above), the closing and execution of a Facility should not be hindered by these complex rules and regulations.

Please contact any of the authors with questions regarding these issues and the various methods for effectively establishing a Facility. ◆

Endnotes

1 The prohibited transaction rules under ERISA are similar to the prohibited transaction rules of Section 4975 of the Code. For ease of reference, this newsletter will discuss ERISA.

2 The definition of "disqualified persons" in the Code differs from the definition of "parties in interest" under ERISA. For ease of reference, this newsletter will only refer to parties in interest.

3 In this newsletter, we discuss the Fund as though it is a single entity. If a Fund is comprised of multiple parallel funds, feeder funds and/or alternative investment vehicles, each entity that is a party to the Facility would need to satisfy an exception to holding plan assets or would need to rely on a prohibited transaction exemption in connection with the Facility.

4 For this discussion of the less than 25% test, we assume that the Fund is a single entity. If a Fund were comprised of multiple parallel funds and each parallel fund intended to rely on the less than 25% exception to holding plan assets, each parallel fund would be tested separately.

5 Again, we assume that the Fund is a single entity. If a Fund were comprised of multiple parallel funds, for example, and more than one parallel fund intends to operate as a VCOC, each such parallel fund would be tested separately.

6 We are assuming that the Lender did not fund the loan with plan assets of any benefit plan investor. See Section VI.

7 Nevertheless, a Lender may permit a Fund to make a small borrowing under the Facility (typically for purposes of paying costs and expenses incurred prior to closing of the Facility) before such initial qualifying investment, with the balance of the Facility available after the Fund demonstrates that it qualifies for an operating company plan asset exception following the qualifying investment.

8 See Class Exemption for Plan Asset Transaction Determined by Independent Qualified Professional Asset Managers, 49 Fed. Reg. 9494 (Mar. 13, 1984), amended by 70 Fed. Reg. 49,305 (Aug. 23, 2005) and 75 Fed. Reg. 38,837 (July 6, 2010).

9 See ERISA § 408(b)(17) and Code § 4975(d)(20).

10 See ERISA § 408(b)(17)(B)(ii) and Code § 4975(f)(10).

Net Asset Value Credit Facilities

As real estate, buyout, infrastructure, debt, secondary, energy and other closed-end funds (each, a "Fund") mature beyond their investment or commitment periods (the "Investment Period"), they have often called and deployed the majority of their uncalled capital commitments ("Unfunded Commitments") on the acquisition of their investment portfolio (each, an "Investment").

As result, they often have greatly diminished borrowing availability under the borrowing base ("Borrowing Base") of a traditional subscription credit facility (a "Subscription Facility", often referred to as an "Aftercare Facility" when provided post-Investment Period). However, these post-Investment Period Funds still have significant ongoing liquidity needs, including funding follow-on Investments, letters of credit, ongoing fund expenses and the costs of maintenance and liquidation of their Investments. To address these needs, certain banks (each, a "Lender") have been working to structure financing solutions for Funds, recognizing that a fully invested Fund has inherent equity value in its Investment portfolio. Of course, lending against a Fund's equity value is a far different credit underwrite than a traditional Subscription Facility, so Lenders have historically been cautious in their approach. One solution we have seen has been to leave the Subscription Facility largely intact, but extend the Borrowing Base significantly to add borrowing availability. Under this approach, the Lender may set the advance rate for included investors ("Included Investors") to 100% with no concentration limits or even set the Borrowing Base itself equal to 100% of the Unfunded Commitments of all investors ("Investors") (i.e., not just Included Investors), but couple the increase with a covenant that the Fund must at all times maintain a certain minimum net asset value ("NAV"). The NAV covenant is typically steep from the Fund's perspective, and is designed to near fully mitigate the additional risk incurred by the Lender in connection with the more generous Borrowing Base. This Aftercare Facility approach is merely a way to extend the life of an existing Subscription Facility and, of course, provides no borrowing availability if the Fund has exhausted its remaining Unfunded Commitments. Similarly, some Funds' organizational documentation prohibits the entry of a Subscription Facility (or perhaps does not authorize the Fund to call capital to repay debt incurred after the end of the Investment Period). These limitations therefore require Lenders to take a different approach, and one type of facility that certain Lenders are considering in these contexts is primarily based on the NAV of the Fund's Investment portfolio (hereinafter, an "NAV Credit Facility"). In this Legal Update, we set out the basic structure and likely issues that may present in an NAV Credit Facility.

Basic Structure

NAV Credit Facilities may take different forms based upon the structure of the Fund and its investments ("Investments") and the terms and structure of such facilities are typically underwritten on a case-by-case basis. However, such facilities share key structuring concerns as further described below.

BORROWING BASE

While NAV Credit Facilities may or may not explicitly articulate a Borrowing Base, they certainly have its components. Availability under an NAV Credit Facility is traditionally limited to an amount equal to the "Eligible NAV" of the "Eligible Investments," multiplied by an advance rate. The "Eligible NAV" typically equals the NAV of the Eligible Investments, less any concentration limit excesses deemed appropriate by the Lender under the circumstances. Typically the advance rates for these facilities are low in comparison to other asset-based facilities, reflective of both the lack of immediate liquidity of the Investments and the Lender's view of the Investments' likely cash flow and related value. "Eligible Investments" will typically be a subset of Investments that are not subject to certain specific adverse credit events as described below.

INVESTMENT PORTFOLIO

Many Funds that enter NAV Credit Facilities have a mature portfolio of Investments, so the Lender may assess at the outset which Investments should be included as "Eligible Investments" for the NAV Credit Facility. To the extent additional Investments may be added from time to time, Lender consent is generally required and criteria for inclusion may need to be met. Generally speaking however, "Eligible Investments" will typically be defined as those Investments that are not subject to any liens (although depending on the facility, leverage at the operating company level may be permitted and considered in the Lender's calculation of NAV) and that are not subject to certain specific adverse credit events. Assessing what credit events are relevant will turn on the particular asset class of the Investment. For example, standard eligibility criteria for Investments of a buyout fund will require that the underlying portfolio company not be in bankruptcy, not be in breach of any of its material contractual obligations, etc. Additionally, to the extent the Investment portfolio is made up of debt or equity issued by one or more third-party issuers, the status of the Investment itself as a performing or non-performing asset and the status of the issuer of such Investment may trigger the exclusion of the Investment from the Borrowing Base.

SECURITY PACKAGE

Some Lenders in certain high-quality asset classes will consider NAV Credit Facilities on an unsecured basis. But while most Lenders recognize that complete security over all the Investments is commercially challenging, there is a strong preference among Lenders towards a secured facility. Thus, while NAV Credit Facilities are not typically secured by all the underlying Investments, they are often structured with a collateral package that does provide the Lender with a certain level of comfort compared to an unsecured exposure. The collateral for these Facilities varies on a case-by-case basis, often depending on the nature of the Investments the Fund holds. In many NAV Credit Facilities the collateral includes: (1) distributions and liquidation proceeds from the Fund's Investments, (2) equity interests of holding companies through which the Fund may hold such Investments or (3) in some cases, equity interests relating to the Investments themselves. The method of obtaining the security interest in cash distributions and liquidation proceeds is similar to traditional Subscription Facilities. The Fund covenants that all cash from its Investments will be directed into (or immediately deposited into if received directly) an account that is pledged to the Lender and governed by an account control agreement. The Fund is prohibited from making withdrawals

from the account unless the Borrowing Base is satisfied on a pro forma basis. Likewise, the steps needed to secure the pledge of equity are similar to equity pledges common in the leveraged loan market. Thus, in a workout scenario, the Lender could foreclose on the equity interest collateral, and either take ownership control of the interests in the holding companies or sell such equity interests and apply the foreclosure sale proceeds to its debt.

Key Issues

As with all asset-based credit facilities, NAV Credit Facilities have their share of issues and challenges. Two of the more common are: (1) the proper valuation/calculation of NAV for inclusion in the calculation of the Borrowing Base and (2) the legal challenges associated with an equity pledge, especially in the case where the pledge is the primary collateral support for the facility.

VALUATION

One of the primary challenges in an NAV Credit Facility is the Lender's comfort around the calculation of the NAV of the Investments, as Funds often invest in illiquid positions with no readily available mark. This risk may be somewhat mitigated by the Fund's historical performance track record, as well as the valuation procedures built into the Fund's organization documents (which procedures were likely blessed by the Fund's Investors at the outset of their initial investment). That said, Lenders typically require the ability to remark the Investments if they either disagree with the valuation provided by the Fund or if certain adverse credit events happen with respect to the Investments. Lenders may therefore require a third-party valuation process or even the ability to revalue the Investments themselves based on their own good faith judgment. Similarly, valuation timing is a related challenge because there is frequently a time lag between a valuation and a reporting date. Lenders often want certain covenants to report interim adverse credit events to mitigate inter-period risks.

PLEDGED EQUITY LIMITATIONS

When a pledge of holding company equity is included in the collateral package of an NAV Credit Facility, there are three primary legal challenges that Lenders may confront in an NAV Credit Facility: (1) perfection issues, (2) transfer restrictions and change of control provisions and (3) tax implications for the Fund.

Perfection Issues

The manner in which a Lender obtains a valid security interest in equity interests requires a legal analysis on how the equity interests should be categorized for perfection purposes. Equity interests in corporations are "securities" for purposes of Article 9 of the Uniform Commercial Code ("UCC") and, if such equity were represented by a certificate, the Lender would ordinarily perfect its security interest by taking possession of the certificate.[1] Portfolio companies formed as limited liability companies or partnerships raise different issues, in that the equity securities issued by such companies would ordinarily be characterized for UCC purposes as "general intangibles" (as to which the proper perfection method is the filing of a UCC financing statement); however, the UCC also permits such an entity to "opt into" Article 8 of the UCC, in which case the equity of such entity would be considered a security for UCC purposes instead of a general intangible.[2]

To the extent that obtaining a direct lien on the Investments is sought and all or part of the Investments of a portfolio company are held in street name in a securities account, the Lender may seek to obtain a securities account control agreement over the underlying account or a lien over the securities entitlement relating thereto in order to have the best means of perfection. In a case where custodial arrangements are used, the Lender will want to understand how such arrangements work.

Different perfection issues will arise if the equity to be pledged is issued by a non-US entity or is held in a non-US account. In such cases, laws of non-US jurisdictions may apply.

Transfer Restrictions and Change of Control Provisions

Lenders should be aware that the governing documents of the entity whose equity is being pledged, or even the credit agreements of the underlying portfolio companies or other Investments, may have transfer restrictions that prohibit some of the proposed collateral from being transferred or even pledged. Lenders should consider whether their counsel should review the governing documentation of the pledged equity (or the Investments) to identify such risks or if representations from the Fund will suffice. Similarly, in the case of buyout funds, because the value of the equity interest is derivative of the underlying business operations, Lenders may want to diligence material agreements (e.g. credit agreements, sale agreements, purchase agreements, etc.) of the pledged entity to identify any problematic "change of control" provisions. In the event these issues are present, a Lender could be deprived of the actual value of its pledged collateral when it sought to foreclose.[3]

Tax Implications

There can be significant tax implications for certain Funds that pledge their equity interests, including a "deemed dividend" issue in the case of certain controlled non-US entities[4] and, with respect to pledges of equity in certain non-US entities, such entities being treated as "Passive Foreign Investment Companies" ("PFICs") for US tax purposes.[5] Determining the applicability and impact of these tax concepts requires an in-depth look and understanding of both the Fund and the NAV Credit Facility. While these issues are beyond the scope of this Legal Update, there are certain structuring techniques that can be used to mitigate the impact to the Fund and the Lender.

Conclusion

As more Funds look to unlock the value of their underlying Investments to support credit facilities, we expect that Lenders will receive increased inquiries for NAV Credit Facilities. And while the underwriting process of NAV Credit Facilities is materially different from that of Subscription Facilities and requires different expertise, when structured properly, NAV Credit Facilities can offer an attractive risk-adjusted return for a Lender, while providing Funds needed liquidity and flexibility. We expect this financing market to expand in the future. ◆

Endnotes

1 See UCC §8-103(a). A security interest in securities may be perfected by filing or by control. UCC §§9-312(a), 9-314(a). A security interest in securities perfected by control has priority over a security interest perfected by a method other than control. UCC §9-328(1).

2 See UCC §8-103(c).

3 Note that in certain instances these types of restrictions on transfer, to the extent contained in the organization documents of the issuers of the pledged equity, may be invalidated by the UCC. See UCC §9-406 and §9-408. Certain states, including Delaware and Texas, have non-uniform UCC provisions that make §9-406 and §9-408 inapplicable to equity in limited liability companies and limited partnerships. In other states, where the UCC provisions apply, the better view would seem to be that an anti-assignment provision would be completely invalidated by the UCC to the extent it applied to the pledge of an economic interest (right to receive distributions and other payments) but only partially invalidated as to a pledge of governance rights (in which case the secured party could take the pledge without causing a default under the limited partnership or limited liability company agreement, but could not enforce the pledge against the issuer, such as by having the issuer recognize the secured party as a member or partner). These issues are beyond the scope of this Legal Update, but could be relevant under the circumstances.

4 Subject to certain exceptions, a pledge of equity of a "controlled foreign corporation" (a "CFC") to secure an obligation of a US party related to such CFC may be considered a repatriation of the CFC's earnings to its shareholder and thereby taxed as a dividend. Generally, a CFC is a foreign entity (treated as a corporation for US tax purposes) the equity of which is characterized as more than 50% owned by "US shareholders." For purposes of this test, "US shareholders" are generally US persons treated as owning more than 10% of the voting equity in the foreign corporation.

5 A PFIC is generally any foreign corporation if (i) 75% or more of the income for the taxable year is passive income or (ii) the average percentage of the assets held by such corporation during the taxable year that produce passive income is at least 50%. Pursuant to the US Internal Revenue Code, if a US taxpayer pledges PFIC stock as security for a loan, the US taxpayer will be treated as having disposed of such PFIC stock (a "Deemed Disposition"). Consequently, such a Deemed Disposition may result in a taxable event for the US taxpayer.

Collateralized Fund Obligations: A Primer

Collateralized fund obligations ("CFOs") emerged in the early 2000s as a means of applying securitization techniques developed for collateralized debt obligations ("CDOs") to portfolios of hedge fund and private equity fund investments (each, an "Investment").

CFOs allow portfolio investors, secondary funds and funds of funds (each, a "Fund Investor") an alternative and diversified capital markets financing solution and, potentially, a means of earlier monetization of their holdings. This article reviews the basic structures and features of a CFO.

The core concept of a CDO is that a pool of defined financial assets will perform in a predictable manner (that is, with default rates, loss severity/recovery amounts and recovery periods that can be reliably forecast) and, with appropriate levels of credit enhancement applied thereto, can be financed in a cost-efficient fashion that captures the arbitrage between the interest and yield return received on the CDO's assets, and the interest and yield expense of the securities (the "Securities") issued to finance them. Each of Fitch, Moody's, Standard & Poor's and DBRS, Inc. have developed CDO criteria and statistical methodologies and analyses to 'stress' a pool of specified CDO assets to determine the level of credit enhancement required for their respective credit ratings for the Securities issued to finance such pools.

These same concepts apply for CFOs and a number of CFOs were consummated prior to the financial crisis.

In a CFO, a bankruptcy-remote special purpose entity (the "CFO Issuer") purchases (or acquires directly) and holds a diversified portfolio of Investments. To finance the purchase, the CFO Issuer issues tranches of Securities secured by these assets. The majority of the Securities issued are debt instruments, with only a small portion consisting of equity in the CFO Issuer. Each tranche (other than the junior most tranche) has a seniority or priority over the other tranches, with "tighter" collateral quality tests that when triggered divert all interest and principal proceeds that would otherwise be allocable to more junior tranches to only the more senior tranches. This tranched capital structure allows an investor in the Securities to determine its preferred risk/return investment and an opportunity in the junior CDO tranches for enhanced returns due to the leveraged structure of the CFO.

Credit enhancement in the CFO is provided through overcollateralization, primarily through eligibility criteria and concentration limits. The rating agency

methodologies in certain transactions have (at least in part) required that Investments be seasoned for some minimum tenor and that they be sponsored by fund managers ("Sponsors") with a history of favorable performance. In addition, the rating agencies have required concentrations around "diversity" of Investment by style (i.e., early/late stage venture, buy-out, mezzanine, special situation, etc.), by industry and by commitment "vintages." In addition, one pre-crisis CFO even had an unusual two-tier overcollateralization test that became more stringent if a trailing 12 month-volatility of the portfolio test exceeded certain specified levels. As with similar asset classes, the rating agency requirements for CFOs will inevitably change and evolve as the agencies gain more experience with them.

CFOs contain two primary structuring challenges. First, since many Investments will not have specified or consistent periodic payments (and may themselves be leveraged with senior secured and mezzanine debt), the dividends and other distributions on such Investments are difficult to predict and model. Thus, the capital structure of the CFO Issuer cannot not include significant current interest or other payment obligations (i.e., the CFO Issuer must issue zero coupon Securities) or must include a liquidity facility, cash flow swap or other similar arrangement to "smooth" cash flows to ensure timely payment of CFO liabilities. In addition, the typical private equity Investment requires an investor (in this case, the CFO Issuer) to commit to make capital contributions to the Investment in a maximum amount from time to time when called. As a result, unless such Investment is fully funded prior to being acquired by the CFO Issuer, the capital structure of the CFO must include available capital with sufficient flexibility (such as a revolving credit facility or a delay-draw tranche) to allow the CFO Issuer to make the required capital contributions.

Coming out of the financial crisis, we are seeing increased interest in CFOs. Fund Investors are attracted to the diversification of funding source, as well as the potential for longer term financing availability in the capital markets compared to the bank markets. CFOs allow such Fund Investors to realign their portfolios, freeing up capacity for additional Investments with favored Sponsors or rebalancing portfolios to desired Investment styles, industries or vintages. In addition, CFOs may offer certain institutional Fund Investors an opportunity for regulatory capital relief, as an Investment portfolio can be "exchanged" for CFO Securities that in the aggregate require such Fund Investor to hold less capital under applicable regulatory requirements since the senior tranches will be highly rated. Although we do not currently see an active market for the equity portion of CFOs, if it were to develop, CFOs could certainly provide an alternative liquidation solution to the more standard portfolio secondary sale. While we do not forecast a major uptick in the CFO market in the latter half of 2013, we do expect issuance to gradually increase to its pre-crisis levels, as investors look for attractive and more tailored opportunities. We see this as a positive for the market generally, as they offer increased liquidity, diversification and the potential to improve the transparency of their underlying Investment markets. ◆

Benchmark Rate Reform: Orderly Transition or Potential Chaos?

In the wake of several widely reported LIBOR and other benchmark rate manipulation scandals reflected in headline-grabbing stories of litigation and official inquiries and investigations,[1] followed in some cases by eye-popping related settlements,[2] policymakers have responded with varied attempts at benchmark rate reforms, which as of early April 2013 remain a work-in-progress.

Notably, the International Organization of Securities Commissions (IOSCO), issued a consultative paper in January 2013 that received more than 55 comments. On April 15, IOSCO issued a consultation report titled "Principles for Financial Benchmarks," which includes specific principles for governance, regulatory oversight and dealing with conflicts of interest.

Probably the most important pending benchmark rate reform as a practical matter is the implementation of the Final Report of The Wheatley Review of LIBOR and its 10-point plan for comprehensive reform of LIBOR (Wheatley Plan).

The value of potentially affected transactions (estimated in the Final Report to be in excess of $300 trillion) affirms the importance of appropriate LIBOR reform as well as the need to implement that reform in a way that does not unduly disrupt affected transactions or the related market. Unfortunately, some early practical experience with the implementation of point #6 of the Wheatley Plan—requiring that the British Bankers Association (BBA) cease compiling and publishing LIBOR for those currencies and tenors for which there is insufficient trade data to corroborate submissions—provides evidence that suggests market participants face a real risk of disruption.

Consistent with the Wheatley Plan, secondary legislation came into force in the United Kingdom amending the Regulated Activities Order and making the "administering of, and providing information to, specified benchmarks" a regulated activity under the UK Financial Services and Markets Act 2000. Currently, the only specified benchmark is BBA LIBOR, although recently reported investigations of possible manipulation of the ISDA swap rate[3] suggest that others soon may be added.

Also, as contemplated by point #6 of the Wheatley Plan, the BBA, after public consultation, announced in late 2012 a timetable for the discontinuance of compilation and publication of LIBOR for certain currencies and maturities (see Annex 1 to the BBA feedback statement), including a complete discontinuance of BBA LIBOR quotations for Australian dollars, Canadian dollars, New Zealand dollars, Danish krone

and Swedish krona and the elimination of certain maturities (including two-week and nine-month) for euro, United States dollars, yen, sterling and Swiss francs. Certain of these discontinuances have already occurred, with the remainder scheduled to become effective in May 2013. ISDA has recently published commentary on these discontinuances, which includes a link to a form amendment letter.

Many lenders and borrowers have begun considering how their credit agreements are affected by these discontinuances. At this point, there does not appear to be market consensus about how best to deal with the discontinuance of LIBOR for interest period tenors and currencies. We can, however, suggest several steps that market participants should take.

Examine Existing Credit Facilities

Many credit agreements contain provisions that protect lenders from having to extend LIBOR loans in circumstances where a LIBOR quotation is not available. The following provisions should be reviewed carefully.

DEFINITION OF INTEREST PERIOD

Many definitions of "Interest Period" in credit agreements provide that interest periods of nine months are available to borrowers, but only if "available to" all relevant lenders. The fact that LIBOR is not being quoted by the BBA does not necessarily mean that it is not available to a lender. Credit agreements that currently provide that a nine-month interest period is available to the borrower if all relevant lenders agree or consent would deal with the issue more clearly.

DEFINITION OF LIBOR

Many credit agreements contain several alternatives for calculating LIBOR. The first (and preferred) alternative in most cases is a reference to the BBA rate, often as published on a specified data service. If such rate is not available, many definitions then provide for a variety of fall-back alternatives, including the following : (i) the agent determining a rate based on an average of rates for deposits for such interest period in the relevant currency offered to major banks in the interbank market; (ii) the LIBOR rate being set at the average rate for deposits for such interest period in the relevant currency offered to a set of specified reference banks (most often, several banks that are members of the lending syndicate); and (iii) the LIBOR rate being set at the rate for deposits for such interest period in the relevant currency offered to the agent. LIBOR definitions applicable to non-US dollar currencies may in certain cases refer to alternate, non-BBA benchmark rates. Alternatives other than referring to the BBA rate may be more cumbersome to work with, but they may allow for the possibility of continuing to borrow and fund loans in a currency or tenor for which the BBA has discontinued its rate.

MARKET DISRUPTION PROVISIONS

A common provision in many credit agreements is the so-called "market disruption" or "Eurodollar disaster" clause, which generally provides that if the credit agreement agent determines that "adequate and reasonable means" do not exist for ascertaining LIBOR for a requested borrowing for a particular interest period, or if a requisite number of lenders advise the agent that LIBOR for an interest period will not adequately and fairly reflect the cost to such lenders of making or maintaining their loans included in such borrowing for such interest period, the lenders are not obligated to fund such borrowing at LIBOR and (in the case of US dollar-denominated borrowings) that such borrowing will instead bear interest at the base rate.

It is possible that the market disruption clause might be invoked by lenders in a situation where, for example, the credit agreement permitted borrowings in a tenor that had been discontinued by the BBA, but where it was possible to determine LIBOR for such tenor under the credit agreement's LIBOR definition

by virtue of an alternative to the BBA quotation set forth in such definition. In a proper case, the lenders might determine that the rate set by the reference banks did not adequately and fairly reflect the cost of lending by such lenders and therefore invoke the market disruption clause. Of course, invoking the market disruption provision may raise reputational and competitive issues for the lender doing so, especially if other lenders are not doing so.

It may be that certain market disruption clauses are too broad because they do not distinguish between the remedies that should be applied in a situation where a particular interest period is unavailable and situations where LIBOR is generally unavailable for all interest periods: for example, certain language may state that if adequate and reasonable means do not exist for ascertaining LIBOR for a requested nine-month interest period, that LIBOR borrowings of all tenors are unavailable. A potential workaround in such situations might be for the borrower to cease requesting borrowings in discontinued tenors, which may technically avoid triggering such a result.

The market disruption clause typically provides that in cases where borrowings in non-US dollar currencies are affected, the interest rate applicable to the borrowing is not the base rate but is instead a cost of funds rate. For example, under the Loan Market Association's form facility agreement, upon a market disruption event, each lender in a syndicated credit facility is to send to the agent a rate equivalent to the cost to that lender of funding its participation in the borrowing "from whatever source it may reasonably select." This could obviously lead to a situation where the borrower becomes obligated to pay several different interest rates for the loans comprising a single borrowing, which could be administratively burdensome, among other things. Alternatively, some credit agreements provide for the borrower and the lenders to negotiate a substitute interest rate in the event LIBOR becomes unavailable. The outcome of any such negotiation would of course depend on whether there was an appropriate substitute on which the parties might agree.

Possible Changes Going Forward

As noted above, we are not aware of a consensus approach dealing with these issues. We expect that credit agreement language on definitions of LIBOR and interest period, and the market disruption clause, may change to eliminate some of the issues set forth above. It is possible that certain of the discontinued tenors may no longer be used, at least as widely as they were before. For the discontinued currencies, other non-BBA benchmark rates will likely be used, such as CDOR for Canadian dollars or BBSW for Australian dollars, and, in fact, the BBA has suggested (but expressly declined to endorse) several possible local alternatives in the BBA feedback statement.

With respect to discontinued tenors, it may be possible to deal with such a situation by interpolating between two tenors that continue to be quoted, as suggested by ISDA for swaps.

With time the market is likely to identify and adopt substitute benchmark rates for those that are discontinued; however, it is unclear how much time this will take and, between then and now there will likely be issues of the kind that we describe (and undoubtedly others) that will require the attention of senior managers and counsel. ◆

Endnotes

1 See, for example: "The Worst Banking Scandal Yet?," Bloomberg, July 12, 2012 and "Taking the L-I-E Out of Libor," Bloomberg, July 9, 2012.

2 Over $2.5 billion so far for Barclays, RBS and UBS with Swiss, UK and US regulators.

3 See, for example: "CFTC Said Probing ICAP on Swap Price Allegations: Credit Markets," Bloomberg, April 9, 2013.

Court Rejects PBGC Position That an Investment Fund is Part of a Controlled Group for Purposes of Pension Liabilities of a Portfolio Company

Late in 2012, in *Sun Capital Partners v. New England Teamsters* ("Sun Capital"),[1] a federal district court in Massachusetts (the "District Court") held that certain private equity funds were not trades or businesses that could be held jointly and severally liable for the pension obligations of a portfolio company in which such funds had invested.

In so holding, the District Court rejected a 2007 ruling of the Appeals Board of the US Pension Benefit Guaranty Corporation ("PBGC") that a private equity fund was engaged in a trade or business and, therefore, a member of one of its portfolio companies' controlled group for purposes of pension liabilities to the PBGC. The District Court's decision in the Sun Capital case was also a departure from a 2010 Michigan district court decision that examined similar facts and issues and found the PBGC Appeals Board's reasoning persuasive.[2]

While the decision in *Sun Capital* is an encouraging development, the issue is far from settled. Accordingly, as discussed below, in structuring their investments, private equity funds must continue to be mindful of the potential for controlled group liabilities for the pension obligations and liabilities of their portfolio companies.

Background

Under the Employee Retirement Income Security Act ("ERISA") and the Internal Revenue Code (the "Code"), all employees of trades or businesses, whether or not incorporated, that are under common control are treated as being employed by a single employer for purposes of applying various employee benefit requirements and imposing various employee benefit liabilities. As the guarantor (up to statutory limits) of participants' accrued benefits under private pension plans, the PBGC will seek to recover from the members of a controlled group the liabilities it has incurred as a result of an underfunded pension plan's termination. Under ERISA, withdrawal liability to multiemployer pension plans is also imposed on a controlled group basis. In addition, the PBGC lien that arises on the date of an underfunded plan's termination applies to all assets of a controlled group that includes the sponsor of the underfunded plan, and all members of a controlled group are liable for the payment of contributions to pension plans.[3]

The liability of a controlled group member for pension obligations under ERISA is joint and several. Because of this joint and several liability, the PBGC or a multiemployer plan may seek to recover against

any member of the controlled group, including a private equity fund if it is deemed to be part of a controlled group. The PBGC need not look first to the actual sponsor of an underfunded pension plan for recovery.

Applicable regulations provide that trades or businesses are under common control if they are part of one or more chains of trades or businesses connected through ownership of a controlling interest with a common parent. In general, a controlling interest means stock possessing at least 80 percent of the combined voting power of all classes of stock entitled to vote, or at least 80 percent of the total value of all classes of stock of a corporation, or ownership of at least 80 percent of the profits interests or capital interests of a partnership.

THE APPEALS BOARD RULING

As noted above, in 2007 the PBGC Appeals Board ruled that a private equity fund (the "Fund") that owned an 80 percent controlling interest in a portfolio company was a "trade or business" and therefore a member of the portfolio company's controlled group for purposes of pension liabilities to the PBGC. As a member of the portfolio company's controlled group, the Fund (along with other portfolio companies owned 80 percent or more by the Fund) was held to be jointly and severally liable to the PBGC for the unfunded pension liabilities that the PBGC had assumed following the portfolio company's bankruptcy.

Under the Supreme Court case of *Commissioner v. Groetzinger*,[4] a person will be deemed to be engaged in a trade or business if (i) its primary purpose is to produce income or profit and (ii) its activities are performed with continuity and regularity. In its decision, the PBGC Appeals Board concluded that the Fund constituted a trade or business under the Groetzinger test because (i) the stated purpose of the Fund was to make a profit (its partnership tax returns stated that it was engaged in investment services) and (ii) it attributed the activities of the Fund's advisor and general partner to the Fund, which received consulting fees, management fees and carried interest, thereby satisfying the "continuity and regularity" test of *Groetzinger*. The PBGC Appeals Board distinguished two Supreme Court cases[5] and a Fifth Circuit opinion[6] holding that passive investment activities do not constitute a trade or business, finding that those cases dealt with individuals managing their own personal investments.

SUN CAPITAL

In *Sun Capital*, a multiemployer pension plan ("Multiemployer Plan") sought to recover approximately $4.5 million in withdrawal liability from two investment funds (the "Sun Funds") established by Sun Capital Advisors following the bankruptcy of Scott Brass, Inc. ("Scott Brass"), a portfolio company whose employees were covered by the Multiemployer Plan and that, prior to its bankruptcy, had made contributions to the Multiemployer Plan pursuant to a collective bargaining agreement. The Sun Funds together owned 100 percent of the equity interests in Scott Brass; Sun Fund IV held a 70 percent ownership interest and Sun Fund III held a 30 percent interest. The Sun Funds defended against the Multiemployer Plan's claims on the grounds that they were passive investors and therefore not trades or businesses and not under common control with Scott Brass.

In ruling that the Sun Funds were not trades or businesses, the District Court found that the Appeals Board had misread *Groetzinger* and had incorrectly limited *Higgins* and *Whipple*. In applying *Groetzinger* and finding that the Fund had engaged in investment activities with regularity and continuity (and, accordingly, was no mere passive investor), the District Court found that the Appeals Board incorrectly attributed the activities of the Fund's investment advisor and its general partner to the Fund itself. It also found no basis for limiting *Higgins* and *Whipple* to individuals, noting court cases and IRS rulings to the contrary.

The Multiemployer Plan also sought to hold the Sun Funds liable for its portfolio

company's withdrawal liability under ERISA § 4212(c)[7], which imposes liability on parties to a transaction if a principal purpose of the transaction is to evade or avoid liability. The Multiemployer Plan argued that the Sun Funds' decision to invest in Scott Brass at a 70 percent/30 percent ratio was itself sufficient to trigger liability under ERISA §4212(c). In rejecting this theory, the District Court found that while the Sun Funds may have considered potential withdrawal liability when structuring their initial investments, it was not their principal purpose and that their structuring was not aimed at avoiding or evading a known or impending withdrawal liability. In reaching that conclusion, the District Court also distinguished between transactions that would evade or avoid withdrawal liability that is a predetermined certainty (such as a sale transaction involving a company for which withdrawal liability already exists) from transactions that minimize a prospective future risk of withdrawal liability.

The District Court also addressed the Multiemployer Plan's claim that regardless of whether or not the Sun Funds constituted trades or businesses, they should still be jointly and severally liable as partners of Scott Brass. The Multiemployer Plan argued that because ERISA, the Multiemployer Pension Plan Amendments Act of 1980 and applicable federal tax regulations do not recognize limited liability companies, Scott Brass should be considered an unincorporated organization and, by default, a partnership with liabilities extending to its partners (e.g., the Sun Funds). Rejecting this argument, the District Court concluded that Delaware law (and not federal law) was applicable and that under Delaware law, the Sun Funds, as members of a limited liability company, would not be personally responsible for any debt, obligation or liability of Scott Brass.

The Multiemployer Plan has appealed the District Court's decision in *Sun Capital*, and there are no federal appellate court decisions addressing this issue. The issue remains unsettled, and the PBGC has given no indication that it has changed its views on the issue. Accordingly, until there is more clarity regarding the application of ERISA's controlled group liability to private equity investment funds, such funds and their advisors should take controlled group liability considerations into account in structuring their investments. The lowest level of risk is, of course, an investment in a portfolio company in which the private equity fund's ownership percentage is always less than 80 percent, with unrelated entities or investors holding the remaining interests. If that is not feasible, consideration should be given to spreading the ownership interest among two or more funds. ◆

Endnotes

1 No. 1:10-cv-10921-DPW, 2012 WL 5197117, (D. Mass. Oct. 18, 2012).

2 *Board of Trustees, Sheet Metal Workers' National Pension Fund v. Palladium Equity Partners, LLC*, 722 F. Supp.2d 854 (E.D. Mich. 2010). In this case (referred to herein as "Palladium"), two multiemployer pension plans brought an action against three private equity funds and their common advisor alleging that the funds were liable for the withdrawal liability of bankrupt portfolio companies in which the funds invested. The *Palladium* court found the PBGC Appeals Board's reasoning "persuasive" and described it as being "faithful to the general rule that no matter how large an investor's portfolio or how much managerial attention an investor pays to his investments, investing alone does not constitute a 'trade or business.'" The *Palladium* court described the standard coined by the Appeals Board as an "investment plus" standard. In applying this standard to the facts at hand, the *Palladium* court found that the private equity funds' activities might support a conclusion that the "investment plus" standard had been met. However, due to unresolved factual matters, the *Palladium* court did not reach a conclusion on the question.

3 Other liabilities or actions determined on a controlled group basis include liability under transactions in which a principal purpose of the transaction is to evade liability for unfunded pension benefits where the plan terminates within five years of the transaction (determined on the date of plan termination), liability for PBGC premiums, and the ability of a portfolio company to terminate an underfunded pension plan.

4 480 U.S. 23 (1987).

5 *Higgins v. Commissioner*, 312 U.S. 212 (1941) and *Whipple v. Commissioner*, 373 U.S. 193 (1963).

6 *Zink v. United States*, 929 F.2d 1015 (5th Cir. 1991).

7 29 U.S.C. §1392(c).

WINTER 2013

In this Winter 2013 edition of our *Fund Finance Market Review* we discuss some of the more noteworthy trends impacting the subscription credit facility and fund finance markets, including our views of the challenges and opportunities likely to be present in 2014. We also explore some of the new and accelerating sources of capital for funds and the shifting legal and regulatory landscape affecting facility lenders. Special thanks to guest contributor, Gavin Rees, Director at Barclays, for submission of his article, "London, Paris, Stockholm, Moscow: European PE and Fund Finance Update."

Winter 2013 Market Review

Capital call subscription credit facilities (each, a "Facility") continued their positive momentum in 2013 and had an excellent year as an asset class. As in the recent past, investor ("Investor") funding performance remained as pristine as ever, and the only exclusion events we are aware of involved funding delinquencies by noninstitutional Investors (in many cases subsequently cured). Correspondingly, we were not consulted on a single Facility payment event of default in 2013. In addition to the very positive credit performance, the asset class seemed to enjoy significant year-over-year growth. Below we set forth our views on the state of the Facility market and the current trends likely to be relevant in 2014.

Material Growth and Its Drivers

While the Facility market currently lacks an industry-accepted data collecting and reporting resource making it difficult to pinpoint the exact size of the market, we are confident based on our experiences as well as anecdotal reports from multiple Facility lenders (each, a "Lender") that the Facility market expanded materially in 2013. As one available data point, the Mayer Brown LLP Facility practice was up 66% in 2013 compared to 2012, measured by volume of consummated transactions. This positive growth for Facilities in 2013 was driven by a confluence of factors, not the least of which was the uptick in the fund formation market (especially in the United States). According to Preqin data for the U.S.-based fund market, 485 closed-end real estate, infrastructure and private equity funds (each, a "Fund") raised an estimated $261 billion in gross capital commitments in 2013, which represents the highest levels seen in the market since 2008. This baseline growth in the number of prospective Fund borrowers clearly seeded the Facility market's growth, but other factors contributed extensively as well. We believe the Facility market would have expanded in 2013 even had the Fund formation market remained stagnant, as penetration into Funds that have historically not availed themselves of Facilities increased. Growth in 2013 was also supplemented by an increased recognition by Lenders of the quality of Facility collateral and, in reliance on that collateral quality, a greater comfort with customized Facility structures. Lenders clearly consummated Facilities in 2013, and included Investor capital commitments ("Capital Commitments") in borrowing bases, that would not have satisfied underwriting requirements previously. Similarly, Funds extended many of their existing Facilities upon their maturity instead of calling capital and paying them off, in many cases even well after the termination of their investment periods. This continuity of use of Facilities throughout a Fund's life cycle clearly contributed to 2013 growth as well.

Challenges

2013 was not all roses and champagne for the Facility market however, as certain very real challenges emerged. Fund formation was not up uniformly across the globe; Europe and Asia still report very

challenging fundraising environments for Funds, especially for relatively new fund sponsors (each, a "Sponsor"). These challenges resulted in the deferral and in some cases impracticability of potential Facilities. For Lenders, spread tightening had a very real impact on internal returns, as virtually every amend and extend consummated in 2013 priced flat to down from its precedent. And Facility structures trending downward on the credit spectrum created challenges for virtually every Lender in terms of internal credit approvals and policy adjustments. But on the whole and despite these challenges, 2013 was a very positive year for the Facility market.

Key Trends

In our Summer 2013 Market Review, we identified four key trends that were impacting the Facility market: (i) the general maturation of the Facility product and market; (ii) the continuing expansion of Facilities from their real estate Fund roots into other 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.[1] We think these trends hold. They bear repeating here because they will continue to have a material impact on the Facility market in 2014 and beyond.

But there are a number of additional trends that either presented or accelerated in the second half of 2013 that we believe will become increasingly relevant in the Facility market in the year ahead, including the following: (i) an improving global fund formation market, which will drive Facility growth in 2014, especially in international sub-markets; (ii) an influx of new market participants in particular Facility sub-markets, bringing different structuring standards and mixing up existing competitive balances; (iii) an expansion of Investor interest in Facilities, including the exercise of influence into Facility terms and structure; (iv) Lender recognition of the positive historical credit performance of Facilities and a resulting comfort in expanding traditional frameworks and going further down the credit spectrum; (v) a constantly evolving regulatory environment for Lenders coupled with real difficulty applying promulgated regulation to Facilities; and (vi) continuing stress on some of the largest Investors—municipal pension funds—and accelerating interest in procuring defined contribution plan monies for Funds. We analyze each below.

An Improving Global Fund Formation Market

We are seeing increased Fund formation activity globally, including in Europe and Asia which have been somewhat slower to emerge from the crisis. Based on 4th Quarter 2013 experiences and certain recent macroeconomic data, we are optimistic this positive trend will continue into 2014. According to Preqin data, non-North American based and focused Funds raised approximately $144.4 billion in capital in 2013, up slightly from 2012. Additionally, according to Preqin surveys, 34% of all expected Fund launches in the market are targeted with a geographic focus in Asia. Thus, our expectation is that a moderate to healthy increase in consummated Funds will lead to additional expansion of the Facility market in 2014, perhaps with the biggest growth occurring outside of the United States.

New Market Participants

The Facility market has for some time noted the efforts of new entrants (Lenders, law firms, etc.) trying to establish themselves in the space, each with different strategies and often with varying levels of success. In 2013 however, certain new entrant movements occurred or accelerated that have the potential to be disruptive to the historical competitive dynamics, at least at the

margins. For example, multiple European Lenders are investing in and building their capabilities in the United States. Unlike some of their new entrant predecessors, these Lenders have real, demonstrable execution capabilities, if primarily in a different sub-market. Similarly and in reverse, many of the dominant US Lenders are increasingly attentive to Europe and Asia, recognizing the positive opportunities those sub-markets may hold. Several US-based Lenders had demonstrable success in 2013, at least in Europe. As Lenders emigrate in both directions, they bring their historical Facility structures and underwriting guidelines to the new sub-market. As a result, Funds are increasingly finding themselves with term sheets for Facilities that are no longer distinguishable only by Lender name and pricing. Funds are now weighing significant structural variation (a traditional borrowing base vs. a coverage ratio, as a simple example) in their Facility proposals.

Along a parallel path, multiple regional US Lenders are expanding beyond their historical geographies and middle-market Fund roots, often in efforts to keep up with the growth of their Fund clients. Many of such regional Lenders have increased their Facility maximum hold positions to levels comparable to that offered by the money center Lenders, at least for certain preferred Funds. In fact, several of the regional Lenders made substantial progress increasing their relevance in the greater Facility market in 2013. As their Facility structures and underwriting parameters often differ from a traditional Facility, they are also altering the competitive landscape. Correspondingly, variances in Facility structure dictate the syndication strategy and prospects for a particular Facility, adding additional complexity to a transaction.

Expansion of Investor Influence Into Facilities

Investor recognition and consideration of Facilities is increasing, and Investors are taking a more active look at how Facilities are structured and what their delivery obligations are in connection with a Facility. Investor side letters ("Side Letters") now routinely incorporate provisions addressing the Facility, often displaying Investor efforts to carve back their delivery obligations to Lenders. We often see entire Side Letter sets with a limitation that Investors only need deliver financial statements made publicly available. Further, a few tax-exempt Investors have inserted themselves into Facility structuring, insisting that the parallel fund they invest through be only severally liable for borrowings under the Facility so as to preserve a more favorable tax structuring analysis with respect to the separation between the multiple parallel funds. Whether facilitated through the work of the Institutional Limited Partners Association or just via greater investing experience, Investors appear increasingly aware of the Facilities their Funds are entering.

Extension of Credit Guidelines

No doubt partly in response to both the excellent historical credit performance of Facilities and the competitive landscape, Lenders are increasingly willing to go further down the risk continuum than they have in the recent past. While this has been true for some time now with respect to the historical requirements for delivery from Investors of acknowledgment letters ("Investor Letters") and legal opinions, we are now seeing a greater acceptance of less than ideal Fund partnership agreements ("Partnership Agreements"). Many Lenders are no longer requiring a near-verbatim recital of a historical form Investor Letter in the Partnership Agreement, but instead are accepting less explicit authorization and acknowledgment language. Similarly, Lenders are increasingly finding ways to get comfortable including municipalities with sovereign immunity issues, certain sovereign wealth funds and fund of funds in a borrowing base that have historically been excluded. We have also seen some shifting in view on Investor withdraw/cease funding rights in relation to a Fund's breach of its representations regarding

placement agents and political contributions, with some Lenders now willing to partially accept this risk, at least in limited concentration scenarios. Further, we have seen a relatively significant expansion in the underwriting consideration of Fund assets, both in terms of supporting more aggressive borrowing bases and for mitigating other perceived credit weaknesses in a particular Facility, such as a tight overcall limitation. Notably, many Lenders are now actively considering NAV-based facilities or hybrid variations (especially for Funds later in the life cycle), and we expect these trends to continue as Lenders look for higher yielding opportunities.

Importantly, in our view, we think the data supports these trends. We see this as a rational expansion based on the greater availability of positive historical Investor funding and Facility performance data; we have not yet seen many Facilities consummated which we deemed unduly risky or reaching.

The Regulatory Environment

Lenders are, and have been since the crisis, facing a regulatory environment as challenging as we have seen in a generation. Many of the regulations emanating from the crisis are now moving to the finalization and implementation stages, and Lenders are having to adapt.

Moreover, additional regulations continue to be proposed. Virtually every post-crisis law and regulation that has been proposed or implemented is not express as to Facilities, and judgment must be applied to determine the appropriate impact. For example, the Volcker Rule's application to Facilities, whether a Facility constitutes a "securitization" under the European securitization risk retention regulation CRD 122a and what outflow rate is appropriate under the recently proposed US Liquidity Coverage Ratio requirements are all occupying significant time at present.[2] We think it is quite possible some of these regulations will lead Lenders to offer structural variations to their Facilities, such as uncommitted Facilities or uncommitted Tranches within Facilities, as a means of counteracting some of the regulatory capital burdens accompanying changing regulation. We expect the regulatory environment will be increasingly relevant in 2014, as Lenders adapt to the shifting landscape.

Municipal Pensions

Municipal pension funds ("Municipal Pensions") in the United States, often the flagship Investors in Facilities, are under ever-increasing economic pressures. Despite the relatively robust performance of the equity markets in the United States and the significant rebound in many real estate markets in 2013, the outlook for Municipal Pensions to meet their prospective funding obligations seemed to get bleaker on a real-time basis last year. Many states are actively making efforts to enact reform, but such reforms are severely limited by constitutional protections for earned and accrued benefits, let alone political gridlock. The initial holding by the U.S. Bankruptcy Court for the Eastern District of Michigan that Detroit has the ability to alter its pension obligations under Chapter 9 of the U.S. Bankruptcy Code combined with Illinois' massive funding deficiencies and reform struggles have furthered the uncertainty.[3] We expect Municipal Pensions to occupy the headlines throughout 2014 and for a considerable period of time to come. We think these funding deficiency challenges are ultimately (although not promptly or easily) solvable, and we expect a major part of any solution will include a greater emphasis on defined contribution plans ("DC Plans") for employees going forward. As a result, our expectation is that the credit profile of many Municipal Pensions will continue to trend negatively in 2014 and that Sponsors will be increasing their speed of pursuit of a Fund product for DC Plans. We forecast breakthroughs in this regard in 2014 and think Facility market participants should all be thinking about how the connection between DC Plans and Funds could best be structured to positively impact the Facility market.

Additional Trends

In the coming years, we also expect to see healthy growth in the volume and frequency of commitments to Funds by sovereign wealth funds and in the use of separate accounts by Investors.[4] Preqin estimates show that in 2013 sovereign wealth funds surpassed the $5 trillion mark for total assets under management, a number which is up more than $750 billion from 2012 and nearly $2.5 trillion since 2008. Meanwhile, 19% of Investors surveyed by Preqin currently invest through separate accounts, as opposed to only 7% a year ago. 64% of those surveyed indicated that separate account commitments will become a permanent part of their investing strategy going forward. Thus, including sovereign wealth funds in Facility borrowing bases and single Investor exposure when lending to separate accounts will become increasingly relevant for Lenders going forward.

Conclusion

We project a robust Facility market in 2014 building on the growth and positive momentum experienced in 2013, but with challenges at the margins. We expect the number of Facilities consummated will continue to grow at a solid clip as fundraising improves, the product further penetrates the private equity asset class and a greater number of existing Facilities get refinanced. But we expect that Fund structural evolution, Investor demands and competitive dynamics will continue to challenge Facility structures and ultimately drive Facilities somewhat further down the credit continuum. ◆

Endnotes

1. *Summer 2013 Market Review*, please refer to page 19.
2. For an in-depth review of applying the Liquidity Coverage Ratio to Facilities, please see Mayer Brown's Legal Update, *Capital Commitment Subscription Facilities and the Proposed Liquidity Coverage Ratio*, on page 75.
3. For more information about the initial holdings in the Detroit, Michigan bankruptcy proceeding, see Mayer Brown's Legal Update, *Detroit, Michigan, Eligible to File Chapter 9 Bankruptcy*, on page 127.
4. For more information regarding separate accounts, please see Mayer Brown's article, *Separate Accounts vs. Commingled Funds: Similarities and Differences in the Context of Credit Facilities*, on page 35.

Management Fee Credit Facilities

As the subscription credit facility market matures,[1] lenders seeking a competitive advantage are expanding their product offerings to private equity funds (a "Fund") from traditional capital call facilities made to closed-end Funds to other financing products, including lines of credit to open-ended Funds, separate-account vehicles and net asset value facilities.[2] Another emerging product gaining traction in the market with some Fund sponsors (a "Sponsor") is a so-called management fee credit facility (a "Facility"). A Facility is a loan made by a bank or other financial institution (a "Lender") to the general partner (the "General Partner") of the Fund or a Sponsor-affiliated management company or investment advisor (collectively, the "Management Company") of a Fund, and has a collateral package that is distinct from other types of security arrangements commonly associated with Fund Financings.

The basic collateral package for a Facility consists of the General Partner's or Management Company's, as applicable, right to receive management fees ("Management Fees") under the Fund's limited partnership agreement (the "Partnership Agreement") or other applicable management or investment advisory agreement (the "Management Agreement"), and rights related thereto, together with a pledge over the deposit account into which the Management Fees are paid (the "Collateral Account"). A control agreement among the General Partner or Management Company, the Lender and the depository bank would be needed to perfect the Lender's security interest in the Collateral Account. Additionally, since the General Partner, the Management Company or another Sponsor-affiliated entity (a "Special Limited Partner") generally has an equity investment in the Fund, the security for a Facility may also include a pledge by such entity or other Sponsor-affiliated investing entity's right to receive distributions from the Fund and, in some instances, its limited partnership interest.

Background

In a typical Fund structure, the General Partner or the Management Company receives Management Fees as compensation for evaluating potential investment opportunities, providing investment advisory services and attending to the day-to-day activities of managing the Fund.[3] The Management Fee also covers operating expenses (such as overhead, travel and other general administrative expenses) as well as salaries for the Management Company's investment professionals and other employees. The Management Fee payable by an Investor is often determined by multiplying a percentage[4] times such Investor's capital commitment. In addition, some Management Fee structures include a component that is based on the Fund's performance so as to provide additional incentive to the General Partner or the Management Company to maximize the Fund's performance.

Facilities are becoming increasingly popular for a number of reasons. First, Sponsors may find a Facility attractive because it provides the Sponsor (or applicable affiliated entity) with immediate capital to smooth its cash flow and pay operating expenses in between the

typically quarterly or semiannual payments of the Management Fees it receives. Second, post-economic downturn, Investors are increasingly interested in seeing Sponsors make larger investments in the Funds they manage to increase their "skin in the game" and further align the Sponsor's and Investors' interests in maximizing Fund performance. By leveraging the income stream from future expected Management Fees, a Facility may help enable a Sponsor or its Special Limited Partner to make a larger commitment to a Fund than it otherwise may be able to commit. Also, to the extent a Sponsor or its Special Limited Partner is an Investor in a Fund, a Facility may be drawn on short notice to permit the Sponsor or Special Limited Partner to honor a capital call prior to receipt of cash from the principals or employees that ultimately constitute the Sponsor or Special Limited Partner. From the Lender's perspective, aside from earning revenue from the fees and interest income generated by a Facility, providing a Facility to a Fund is also a chance for the Lender to broaden its relationship with the Sponsor and develop a deeper understanding of the Sponsor's business and its potential financing needs. This in turn may lead to opportunities for a Facility Lender to provide other products such as subscription credit facilities, net asset value facilities, portfolio-company level financings or perhaps even private wealth products to the Sponsor's principals.

While there are many potential benefits to both a Sponsor and a Lender associated with a Facility, it is important to note that a Facility is best-suited for established Sponsors that have significant Fund management experience and a proven track record of receipt of the Management Fees, ideally from a diverse platform of Funds. Management experience and an uninterrupted history of receiving the Management Fees are important because the Lender is ultimately looking to the Management Fees as the source of repayment of the Facility in underwriting the risk associated with lending to a particular Sponsor.

Even though Management Fee performance history and management experience of a particular Sponsor may make it an ideal candidate for a Facility, as more fully described below, not all Funds will have Partnership Agreements, Management Agreements or Management Fee structures that are suitable for a Facility. Further, some Partnership Agreements limit the General Partner's or Special Limited Partner's right to pledge its equity interest in the Fund, although, a pledge of any distributions associated with such equity interest may be possible. Thus, the Partnership Agreement and/or Management Agreement must be carefully analyzed to confirm that the intended collateral can be granted to the Lender and the Lender will be able to adequately enforce its rights against the collateral.

Structure and Loan Documentation

Facilities are typically structured as revolving lines of credit to the General Partner or Management Company (depending on the Fund's structure), secured by a pledge by the General Partner or the Management Company of its right to receive the Management Fees and the account into which such Management Fees are paid. If the Sponsor group has made an investment in the Fund through a Special Limited Partner or other affiliated entity, the collateral package may also include a pledge of the right to receive distributions from the Fund and the account into which such distributions are paid. If the Sponsor manages more than one Fund, the collateral package may include Management Fee streams from multiple Funds and the right to distributions from those Funds.

The basic loan closing documentation for a Facility will typically consist of (i) a credit agreement, (ii) a security agreement pursuant to which the General Partner or the Management Company assigns its rights under the Partnership Agreement or the Management Agreement, as applicable, to receive and enforce the payment of Management Fees and proceeds thereof, (iii) a pledge of the Collateral Account into which Management Fees are to be

paid, (iv) a control agreement covering the Collateral Account to perfect the Lender's security interest therein and permit the blocking of such account by the Lender, (v) a security agreement from the Special Limited Partner or other Sponsor-affiliated entity pledging its right to receive distributions from the Fund, if it is the part of the collateral package, together with a pledge of the deposit account into which such distributions are to be paid and a control agreement covering such account, (vi) Uniform Commercial Code financing statement(s) filed against the applicable pledging entities, and (vii) and customary opinion letters, certified constituent documentation of the Fund and pledging entities, evidence of authority and related diligence items.

In addition to the traditional collateral package, it is not uncommon for a Lender to receive a personal guarantee by one or more of the principals in the General Partner, the Management Company or Sponsor to support the Facility. The extent of such a guaranty is often negotiated, and it is not unusual for a principal's guaranty to be limited to a capped amount based on its pro rata ownership percentage of the underlying Fund and the related outstanding balance of the Facility, as opposed to a more traditional unlimited (or joint and several) guaranty of the Facility. A guaranty may also be delivered by the Special Limited Partner, the General Partner or the Sponsor, depending on the structure of the Facility and the identity of the borrower under the Facility.

The terms of a Facility will typically include customary representations, warranties, affirmative and negative covenants and events of default that a Lender would expect to see in any secured financing, along with a few provisions that are tailored to address the unique features of a Facility's collateral package. Such provisions may include a requirement that the General Partner or the Management Company receive a minimum amount of Management Fee income, or that the amount of Management Fees received does not fall below a certain specified percentage of the aggregate commitments of the Fund's Investors. A Facility will normally include limitations on amending the Partnership Agreement or the Management Agreement, and prohibitions on terminating or waiving the General Partner or the Management Company's right to receive payment of Management Fees. Additionally, so that the Lender can monitor the Fund's overall performance (and have advance warning of potential performance issues that may give rise to a reduction in Management Fees or Investors balking at paying Management Fees), a Facility will usually require regular financial reporting and may also include a minimum net asset value test with respect to the Fund's investments or a similar financial covenant with respect to the General Partner, Management Company or Special Limited Partner, as applicable, and its investment in the Fund. Some Facilities that include a pledge of distribution rights may contain a maximum loan-to-value or similar metric measured by looking at the Special Limited Partner's pro rata share of the underlying portfolio investments in the Fund.

Partnership Agreement & Management Agreement Diligence

As part of due diligence for any Facility, a Lender must carefully review the Partnership Agreement and Management Agreement for any restrictions on the right of the General Partner or the Management Company to pledge its right to receive Management Fees or the Special Limited Partner's ability to pledge its right to distributions. For example, a potentially problematic, though not uncommon, restriction is that the General Partner or Special Limited Partner cannot pledge its economic interest in the Fund, which would include its equity interest, without the consent of a certain percentage of the other Investors in the Fund. Some Partnership Agreements allow for such pledges without the consent of the other Investors while others do not. To the extent Investor consent is required, it may be an impediment to entering into a Facility.

In addition, the Partnership Agreement or the Management Agreement should be reviewed to

determine how Management Fees are paid, and whether they may vary over time. For example, the Management Fee may decrease upon termination of the period in which the Fund is permitted to make new investments. It is important for the Lender to understand whether Management Fees are paid by the Investors directly to the General Partner or the Management Company, or if Management Fees flow through the Fund and/or the General Partner (or another affiliated entity) to the Management Company, as applicable, so that the relevant Fund-related entities are included within the scope of the collateral documents to minimize potential leakage, if necessary.

Some Partnership Agreements provide for Management Fee offsets, whereby receipt by the Sponsor, its principals, employees or other affiliates of advisory, break-up or other similar fees and income related to the investment activities of the Fund may reduce the amount of the Management Fee. The Partnership Agreement and the Management Agreement should be reviewed to determine if such offsets exist, and the Lender should consider whether the loan documentation should prohibit the General Partner or the Management Company from applying any discretionary offsets if possible. Alternatively, the Lender may consider requesting that any such advisory fees or other income or proceeds that may be offset against Management Fees be included as part of the collateral package in addition to Management Fees if the Fund's documents permit it.

In underwriting a Facility, Lenders will want to keep in mind that while the Partnership Agreement and the Management Agreement will dictate whether a Facility is permissible and how and when Management Fees are to be paid, exogenous events may occur that could affect the payment of Management Fees. For example, in the late 2000s during the market downturn, Sponsors with troubled Funds in fact suspended or eliminated their Management Fees. Even though such activities would be prohibited by the loan documentation for a typical Facility, it is important for Lenders to consider the overall investment and economic environment in which a Fund operates, as market conditions may stress the underlying underwriting assumptions of a Facility.

Conclusion

While Management Fee Facilities have not been very common to date, they are becoming increasingly popular and offer an opportunity for a Lender to kick off or expand its relationship with a Fund Sponsor. With a careful review of the relevant operating and constituent documentation of a Fund, it may be possible to structure a Management Fee Facility to offer a seasoned Fund Sponsor increased liquidity while satisfying a Lender's underwriting criteria. Please don't hesitate to contact any of the authors with questions regarding these Facilities, including the various structures that can be implemented in connection with their establishment. ◆

Endnotes

1. A subscription credit facility, also known as a capital call facility, is a loan made by a bank or other credit institution to a private equity fund, for which the collateral package is the unfunded commitments of the limited partners in the fund (the "Investors") to make capital contributions when called by the fund's general partner (as opposed to the underlying investment assets of the fund). For a more detailed description of the subscription credit facility market and features of the subscription credit facility product in general, please see Mayer Brown's Fund Finance Markets Legal Update *"Summer 2013 Market Review"* on page 19.
2. For an in-depth analysis of certain alternative Fund financing products, please see Mayer Brown's Fund Finance Market Legal Updates *"Structuring a Subscription Credit Facility for Open-Ended Funds,"* on page 31, *"Separate Accounts vs. Commingled Funds: Similarities and Differences in the Context of Credit Facilities"* on page 35 and *"Net Asset Value Credit Facilities"* on page 44.
3. Depending on the Fund's structure, Management Fees may be paid by the Investors through the Fund or GP to the Management Company or directly to the Management Company.
4. Historically, the percentage has usually ranged from 1.5% to 2% per annum.

Foreign Investor Capital: Collateral Enforceability and Minimization of Risk

Due to previous challenges in the United States fundraising market for sponsors of real estate, private equity and other investment funds (each a "Fund"), many Fund sponsors have sought to expand their sources of capital to include investors domiciled outside of the United States ("Foreign Investors"). As such, Fund sponsors are increasingly requesting that the unfunded capital commitments of these Foreign Investors be included in the borrowing availability (the "Borrowing Base") under the Fund's subscription credit facility (a "Subscription Facility").

While traditionally Funds have not chosen their lenders solely based upon whether such lender would include Foreign Investors' capital commitments in the Borrowing Base, it is becoming a more critical factor. Consequently, understanding and addressing collateral enforceability issues related to Foreign Investors has become increasingly important for lenders. Below we set out our views on common concerns regarding collateral enforceability and some possible solutions for minimizing such risk.

Subscription Credit Facilities and Foreign Investors

A Subscription Facility, also frequently referred to as a capital call facility, is a loan made by a bank or other credit institution (a "Lender") to a Fund. The defining characteristic of such Subscription Facility is the collateral package, which is comprised not of the underlying investment assets of the Fund, but instead by the unfunded capital commitments ("Capital Commitments") of the limited partners of the Fund (the "Investors") to make capital contributions ("Capital Contributions") when called from time to time by the Fund's general partner (the "General Partner"). The loan documents for the Subscription Facility contain provisions securing the rights of the Lender, including a pledge of (a) the unfunded Capital Commitments of the Investors, (b) the right of the General Partner to make a call (each, a "Capital Call") upon the Capital Commitments of the Investors after an event of default accompanied by the right to enforce the payment thereof, and (c) the account into which the Investors fund Capital Contributions in response to a Capital Call. Such rights of the Fund and its General Partner are governed by the Fund's constituent documents, including its limited partnership agreement or operating agreement (collectively, the "Constituent Documents").

Lenders have become comfortable with this collateral package because of (i) their ability to select high-credit quality Investors whose Capital Commitments comprise the Borrowing Base, and (ii) in the event that an Investor fails to fund its Capital Commitments, ability to enforce payment of its Capital Contributions in and under the laws of the United States. However, as the momentum toward including Foreign Investors in the Borrowing Base increases,

Lenders are facing new challenges, including (i) the ability to determine the credit quality of Foreign Investors and (ii) the ability to enforce the payment of Capital Contributions from these Foreign Investors.

Key Issues

The three primary collateral enforceability issues that arise in connection with Foreign Investors include (i) as with all Investors, obtaining financial and other information during the due diligence process necessary to properly assess such Foreign Investor's creditworthiness; (ii) obtaining jurisdiction in the courts of the United States over such Foreign Investor; and (iii) enforcing judgments issued by a court of the United States against such Foreign Investor.

Due Diligence

The Subscription Facility due diligence process typically includes obtaining and reviewing (i) the Constituent Documents of the Fund; (ii) the form subscription agreements ("Subscription Agreements") executed by each Investor detailing, among other things, such Investor's willingness to be bound by the terms and conditions of the Constituent Documents and disclosing, among other things, certain information of such Investor; and (iii) other side agreements ("Side Letters" and, together with the Subscription Agreements, the "Subscription Documents") detailing alterations or exceptions, if any, to the Fund's partnership agreement and/or the form of Subscription Agreement.

For Investors domiciled in the United States ("US Investors"), Lenders have typically included in the Borrowing Base investment-grade, non-investment grade and non-rated institutional Investors. Assessment of the credit quality of such Investors has been relatively uncomplicated. Conversely, with regard to Foreign Investors, Lenders have been reluctant to assess their credit quality, often citing lack of financial information, which Foreign Investors are reluctant to provide for confidentiality reasons.

Nevertheless, Fund sponsors are becoming more aware of the need to obtain financial information from their Foreign Investors and are raising the matter earlier in the solicitation process. We anticipate that acquiring financial information from Foreign Investors whom the Fund would like included in the Borrowing Base will become a more customary part of the overall diligence process. However, many Foreign Investors have and are continuing to push back on requests for non-public information. It is not uncommon for a Foreign Investor to negotiate such a provision in its Side Letter with the caveat that it will cooperate with reasonable information requests from the Fund sponsor if necessary in connection with obtaining a Subscription Facility. Lenders will almost certainly require financial information from the Foreign Investor (or its parent entity) before giving the Fund full Borrowing Base credit for such Investor (credit that is typically at a 90% advance rate). Where the Foreign Investor is a subsidiary or special purpose vehicle owned by a parent entity with substantial credit quality, a guarantee or comfort letter providing direct credit linkage to the parent will often be required by Lenders before giving full Borrowing Base credit to the subsidiary or special purpose vehicle. Lenders are more often than not gaining comfort regarding credit quality from most Foreign Investors by obtaining financial and/or other information regarding such Foreign Investors from publicly available sources. We have also seen, and expect to see more, Lenders cooperating with their foreign affiliates to obtain additional information. Lenders relying on such information are often giving creditworthy Foreign Investors some Borrowing Base credit (at times at a 60-65% advance rate), which are often subject to tight concentration limits (both individually and as a class of Foreign Investors) and sometimes even skin-in-the-game tests aimed to limit the Lenders' risk and overall exposure to this class of Investor. We expect to see the treatment of Foreign Investors develop over the coming years as the information becomes more

transparent and these Investors become more critical to a Fund's Borrowing Base.

Jurisdictional Issues

Foreign Investors can take the form of either individuals or entities, including governmental pension plans, state endowment funds, sovereign wealth funds and other instrumentalities of foreign governments ("Governmental Investors"). Such Governmental Investors are becoming more prevalent and are often some of the largest Investors in the Investor pool. For Lenders, the common concern with including such Investors in the Borrowing Base has been whether certain sovereign immunity rights, rooted in the common law concept that "the King can do no wrong," could provide a defense against enforcement of such Investor's obligation to make Capital Contributions after an event of default. Although sovereign immunity in its purist form could shield a governmental entity from all liability, Governmental Investors must be evaluated on a case-by-case basis to ascertain if any sovereign rights apply and, if so, whether such Investor has effectively waived its immunity.[1]

With regard to Foreign Investors generally, some Lenders have been reluctant to include such Investors due to concern with litigating and enforcing judgments in a United States court. A United States court's ability to hear a case involving allegations against a foreign person or entity is governed by the laws of the applicable state and the Constitution. The laws of most, if not all, states provide that parties to a contract may select their governing law and venue for litigating disputes arising under such contract. For this reason, most, if not all, Subscription Documents and Constituent Documents include these provisions. Most often, either New York or Delaware is selected as the governing law and venue under these documents. Furthermore, most, if not all, Constituent Documents include provisions that would allow the General Partner (or Lender in the case of a default and failure of such Foreign Investor to fund its Capital Contribution) to liquidate the applicable Foreign Investor's partnership interest or offset damages against distributions that would otherwise be payable to the Foreign Investor.

Lenders can additionally gain comfort by obtaining Investor consent letters, also commonly referred to as Investor letters or Investor acknowledgments ("Investor Letters"), wherein such Foreign Investor would confirm its unconditional obligation to fund its Capital Contribution, in accordance with the Subscription Documents and Constituent Documents. These letters could also address forum, venue and sovereign immunity provisions directly in favor of the Lenders.

To the extent that forum and venue selection provisions are included in the Subscription Documents, Constituent Documents or Side Letters, the Lender can seek to enforce such provisions against a defaulting Foreign Investor, as assignee of the General Partner's rights, under the collateral documents of the Subscription Facility. Such Lender could file a lawsuit or arbitration claim directly against such Foreign Investor in the applicable United States court or tribunal. While service of process on such Foreign Investor is always a concern when filing such a lawsuit or arbitration claim, Lenders could gain comfort by requesting in an Investor Letter (i) the designation of a United States entity to accept service of process and/or (ii) the express waiver of any objection as to adequacy of such service of process, so long as it has been effected. Similarly, as Fund sponsors become more aware, it is likely that such Fund sponsors will include comparable provision in Subscription Documents and Side Letters. Alternatively, the inclusion of arbitral provisions in Subscription Documents, Constituent Documents or Side Letters would avoid recognition and enforcement issues in most instances and would mitigate sovereign immunity claims in the case of most Governmental Investors. Immunity concerns (except to the extent otherwise covered in the

Foreign Investor's Subscription Documents, Side Letters or Investor Letters) could additionally be overcome via the Foreign Sovereign Immunities Act of 1976 and the exceptions included within Sections 1605-1607 thereof, including an exception for commercial activity that has a nexus to the United States.

Enforcement of Judgments

If a judgment is obtained against a Foreign Investor in a United States court, it may be difficult for the Lender to enforce such judgment against such Investor in the United States, unless such Foreign Investor has assets in the United States that are not otherwise subject to immunity. Therefore, the concern for many Lenders is whether such judgment could be enforced against such Foreign Investor in its country of domicile. While there is currently no treaty between the United States and any other country regarding recognition and enforcement of judgments, the United States is a party to some multilateral treaties requiring the recognition and enforcement of arbitral awards. For this reason, it is generally advisable to include submission to arbitration provisions in Subscription Documents, Side Letters and Investor Letters, as applicable, in which Foreign Investors are a party.

To the extent that enforcement is sought in the Foreign Investor's country of domicile, the law of such country will determine whether any judgment is enforceable. Most countries with developed legal systems do have laws that provide for the recognition of legitimate judgments issued abroad. If the amount of damages does not appear excessive, foreign countries will typically consider, among other matters, whether (i) the court had proper jurisdiction, (ii) the defendant was properly served or otherwise had sufficient notice, (iii) the proceedings were fraudulent or otherwise fundamentally unfair, and (iv) the judgment violates the public policy of such foreign country. As with most litigation involving foreign parties, local foreign counsel should be consulted as to the particular laws of the applicable country.

Conclusion

As fundraising challenges persist, Funds will continue to seek additional sources of capital, including Foreign Investor capital. As Lenders adapt to meet the changing needs of their clients, we expect to see the Capital Commitments of Foreign Investors being included in the Borrowing Bases of more Subscription Credit Facilities. Those Lenders that can quickly and effectively evaluate the creditworthiness of these investors will be well-positioned to receive additional opportunities from their Fund clients. ◆

Endnotes

1 *"Sovereign Immunity Analysis in Subscription Credit Facilities,"* Mayer Brown Legal Update, November 27, 2012, on page 9.

London, Paris, Stockholm, Moscow: European PE and Fund Finance Update

2012 vs. 2013

In 2012, growth in the European PE sector, in contrast to its more vigorous US counterpart, remained pedestrian. The Eurozone sovereign debt crisis continued to concern North American investors, austerity economics dampened economic growth prospects, and disparities in asset valuations between PE buyers and institutional sellers made deployment of capital difficult. Raising new commitments was hampered by the weight of dry powder in existing funds, and divestment levels remained low, limiting the amount of capital that could be returned to investors (total exit value in Europe was 34% down on 2011, compared with 18% globally). Europe held on to its #2 PE position more due to a cooling of the Asia-Pacific region than any renewed vigour across the Old World.

2013, however, seems to have witnessed an improvement. First and final closings have become more frequent, with funds raised also by managers outside of the gilded top 20 firms. Credit markets in Europe are active (the "refinancing cliff" has been managed, leverage multiples have soared), and IPO ($18bn for Q1-Q3 2013, 3x that for the same period in 2012) and PE-backed buy-out ($27bn in Europe in Q2 2013, compared with $29bn in North America) activity has rebounded. Signs of recovery are apparent in various European economies, including the UK, and business sentiment is turning positive.

Managers have plugged the holes left by nervous US investors with commitments from Northern European, Asian and Middle Eastern investors, as well as establishing dual-currency (EUR and USD) fund structures. While the dual-currency approach does not fundamentally alter the risks associated with investing in Eurozone-focussed funds—and also creates administrative and hedging headaches for the manager—it can provide succour to foreign investors concerned with the fate of the Euro.

Winners and Losers

The performance of European funds has been chequered. A growing disparity has emerged between the performance of top-quartile players and the remainder, which points toward a continued shake-out of managers. Investors, particularly those from North America with continuing reservations about the fate of Europe, will only be successfully

wooed by teams with compelling track records, management stability and the ability to turn unrealised gains into distributions.

Certain PE sectors (distressed debt, infrastructure, mid-market buy-out) and geographies (Scandinavia, Northern Europe and the UK, where in 2012 the value of new fund-raising and exits increased to £5.9bn and £7.2bn respectively) gained momentum, whilst others—notably Southern Europe—remain a bridge too far for investors seeking yield (though optimism remains unabashed: despite only €1bn being committed to Italy- and Spain-focussed funds since 2010, 15 buy-out firms with this focus intend to come to market in 2014, seeking an aggregate €4bn of capital). As in the US, investors are seeking creative ways to invest in PE on their terms, through separate accounts, investor "clubs" or direct sponsorship. Some managers are settling on "stop-gap" funds—comprising smaller total commitments from friendly repeat investors—to help keep the lights on for the next two years, in the hope that conditions improve to allow for a fully fledged fund-raising down the road.

Luxembourg Re-invented

The UK remains the hub for European PE managers. In 2012, 53% of total investments from London-based PE firms were invested in Continental Europe. By extension, the vast majority of European fund structures remain English, Guernsey or Jersey limited partnerships. However, this dominance will come under pressure with the introduction in 2013 of the Luxembourg "special limited partnership" structure, established with the express intent of mirroring the well-understood Anglo-Saxon LP/GP model in the AIFM-compliant Grand Duchy. Meanwhile, in France, law firms are successfully striving to establish bridging facility structures for FCPR funds, which will place lenders in a position comparable to that where they lend to UK limited partnerships.

These breakthroughs will incentivise European managers (perhaps with no connection to the UK other than the domicile of its fund vehicles) to contemplate establishing new funds in Luxembourg or France. This may, in turn, increase the level of continental European bank involvement in the PE funds finance market, which has, to this point, been underweight.

Competition Intensifies

The differences between the US and European fund finance markets have become less distinct, with subscription facility structures becoming increasingly harmonised. Over the last five years, the London fund finance market has seen an influx of North American players, such that competition is as likely to come from a New York- or Charlotte-based bank as one of the three or four large UK banks active in this sector. Furthermore, given the slower fund raising pace in Europe, the funds finance market has, if anything, become more competitive than in the US, with a gaggle of providers chasing more limited opportunities.

The UK banks' ability to provide for the broad needs of European PE firms and their investee companies has been challenged by the deep pockets and innovative approaches to subscription facility structures of US players. Competition is made more intense by the tendency of managers to favour bilateral solutions and, where clubs of banks are formed, for the manager itself to do the match-making. Also, a number of managers with significant London presences have been bought by US entities (BlackRock/MGPA, Rockefeller Group/Europa, ARES/AREA), further enticing to these shores US lenders with strong ties to the acquiring organisations. However, the ability to deliver soup-to-nuts onshore and offshore solutions to fund managers and their administrators, paired with a full-service European investment bank offering, is still a significant additional string-to-the-bow for certain UK banks.

Given the tendency for UK facilities to be bilateral rather than syndicated, and for

managers to exercise more loyalty to traditional banking partners, customisation of fund facilities has always been par for the course in Europe. However, banks in the European market have increasingly looked beyond cookie-cutter subscription lines towards more esoteric approaches to bridging facilities, such as incorporating non-institutional investors into borrowing bases, hybrid structures where a proportion of the borrowing base is derived from fund NAV, or post-investment period NAV lines to cover residual liquidity or trade finance needs. Furthermore, banks that can provide debt to fund managers to ease their co-investment requirements will be able to insulate themselves somewhat from the increasingly competitive pressures in the subscription line market, albeit the risk they are taking on is a different one.

A Better 2014...

The European PE sector has been buffeted to a greater extent than the North American PE sector since the financial crisis, though—as in the US—the funds finance market has proven resilient, both in terms of fund performance and supply of credit to funds. 2013 has seen a number of hopeful signs suggesting that the sector is ready to follow the US out of its lull, which will present additional opportunities to banks active in this sector. Cheers/santé/skaal/budem to that. ◆

Capital Commitment Subscription Facilities and the Proposed Liquidity Coverage Ratio

On November 29, 2013, the Board of Governors of the Federal Reserve System (FRB), the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC, and collectively, the Agencies) published in the Federal Register a notice of proposed rule making (the Proposed Rule) to strengthen the liquidity positions of large financial institutions.[1] The Proposed Rule creates for the first time a standardized liquidity requirement in the form of a minimum liquidity coverage ratio (LCR) and generally follows the liquidity ratio requirement as revised and adopted by the Basel Committee on Banking Supervision of the Bank of International Settlements (Basel LCR) earlier this year.

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The Proposed Rule's LCR (US LCR) aims to require banking organizations with $250 billion or more in total assets and certain other large or systemically important banking or other institutions (Covered Banks) to hold sufficient high-quality liquid assets (HQLA) to meet the Covered Bank's liquidity needs for a thirty (30) day stress scenario.[2] As with many of the statutory and regulatory requirements emanating from the financial crisis, applying the requirements of the US LCR to capital commitment subscription credit facilities (each, a Facility) requires both seasoned familiarity with Facility structures and reasoned judgment as to the application.

The Basic LCR Ratio

Both the Basel LCR and the US LCR are in the form of a minimum ratio, the numerator of which consists of the value of the Covered Bank's HQLA and the denominator of which consists of the Covered Bank's expected total net cash outflows over a thirty (30) day period. For both the Basel LCR and the US LCR, the minimum LCR requirement is 100% (i.e., that the LCR equals or exceeds 1.0). For the numerator, assets that constitute HQLA are generally unencumbered liquid assets without transfer restrictions that can reasonably be expected to be converted into cash easily and quickly. The Proposed Rule provides categories of HQLA and sets forth qualifying criteria and haircuts for less immediately liquid HQLA. The US LCR denominator is the total net cash outflows, which is defined as total expected cash outflows minus total expected cash inflows, during the stress period. Under the US LCR, Covered Banks would be required to hold sufficient HQLA to cover the highest daily amount of cumulative net cash outflow for the stress period. Total expected cash outflows are calculated by multiplying the outstanding balances of various categories or types of liabilities (such as the undrawn portion of a revolving tranche of a Facility) by the predicted rates at which they are expected to be drawn down. Determining the drawdown of the undrawn portion of a Facility for purposes of calculating the US LCR's cash outflows will be the primary focal point for Facilities under the Proposed Rule.[3]

Cash Outflow Framework

Committed Credit Facilities and Liquidity Facilities. The US LCR specifies outflow rates that are intended to approximate cash outflows for particular funding obligations during severe liquidity stress. The outflow rates were reportedly developed by taking into account supervisory experience and observation from the recent financial crisis. Outflow rates are categorized by the particular type of funding obligation and Facilities will be classified in the category titled "Commitment Outflow Amount," which includes both committed "credit facilities" and "liquidity facilities" (terms explicitly defined in the Proposed Rule). The distinction has a material impact on outflow rates, as liquidity facilities are given significantly higher outflow rates than credit facilities. Under the US LCR, a "liquidity facility" is defined as "a legally binding agreement to extend funds at a future date to a counterparty that is made *expressly for the purpose of refinancing the debt of the counterparty when it is unable to obtain a primary or anticipated source of funding*." (Emphasis added.) The definition goes on to articulate examples of liquidity facilities, including "an agreement to provide liquidity support to asset-backed commercial paper by lending to, or purchasing assets from, any structure, program or conduit in the event that funds are required to repay maturing asset-backed commercial paper." On the other hand, a "credit facility" is defined as "a legally binding agreement to extend funds if requested at a future date, including a general working capital facility such as a revolving credit facility for general corporate or working capital purposes." While virtually all Facilities offer their closed-end real estate and private equity fund borrowers (each, a *Fund*) a certain degree of liquidity (as does every corporate revolver), we think Facilities are more appropriately categorized as "credit facilities" for the reasons discussed below; however, we admit this determination is not unequivocally clear from the proposed US LCR related text. In our experience, Facilities are typically not made "*expressly for the purpose of refinancing the debt of the counterparty*" as required by the definition of a liquidity facility.[4] Facilities are not standby liquidity to cover a Fund's inability to issue commercial paper, obtain other short-term "debt" or the like. Rather, Facilities are established to provide general working capital to a Fund, a concept that is expressly carved out of the definition of liquidity facility: "[l]iquidity facilities exclude facilities that are established solely for the purpose of general working capital, such as revolving credit facilities for general corporate or working capital purposes."

Outflow Rates. Outflow rates on committed credit facilities and liquidity facilities are stratified by borrower classification, as the Agencies have assumed that financial institutions will be highly interconnected and most impacted during a stress period and therefore most likely to draw down all available funds. Thus, for example, a Covered Bank's outflow rate is 10% for a committed credit facility and 30% for a committed liquidity facility where the borrower is a "wholesale customer or counterparty that is not a regulated financial company, investment company, *non-regulated fund*, pension fund, investment adviser, or identified company, or to a consolidated subsidiary of the any of the foregoing" (such excluded entities being *Specified Financial Borrowers*). (Emphasis added.) In contrast, the outflow rate for Specified Financial Borrowers is 40% for a committed credit facility and 100% for a committed liquidity facility.[5] We expect that a majority (but not all) of private equity Fund borrowers will be Specified Financial Borrowers since they will satisfy the definition of "non-regulated fund," which is: "any hedge fund or private equity fund whose investment adviser is required to file SEC Form PF (Reporting Form for Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors), and any consolidated subsidiary of such fund...." Under SEC Rule 204(b)-1, adopted under the Investment Advisers Act of 1940 (Advisers Act), and in CFTC Rule 4.27, adopted under the

Commodity Exchange Act, most investment advisers of private equity funds (Sponsors) holding in excess of $150 million in assets under management are required to file Form PF. However, there are exceptions, including real estate funds that rely on the exception from the definition of "investment company" under Section 3(c)(5)(C) of the Investment Company Act of 1940, and venture capital funds whose advisers are relying on the "venture capital fund adviser" exemption from registration under the Advisers Act. We estimate that a fair portion, perhaps even a majority, of the typical real estate Fund Facility borrowers will be exempt from filing Form PF, including most core real estate Funds. However, those real estate Funds sponsored by multi-asset class Sponsors, such as those that also sponsor private equity Funds, are likely to be required to file, and hence, "non-regulated funds." Thus, based on the above, our expectation is that the majority of Facilities will be classified as committed credit facilities to Specific Financial Borrowers under the Proposed Rule, drawing an outflow rate of 40%, but that the Facilities with Fund borrowers exempt from filing Form PF would only be subject to a 10% outflow rate.

Facility Considerations under the Proposed Rule

General Considerations. Under the Proposed Rule, Covered Banks will be required to comply with the US LCR requirement by January 1, 2017, with phased-in compliance of 80% by January 1, 2015 and 90% by January 1, 2016. Thus, current Facilities with a typical three (3) year tenor will likely become subject to the US LCR if the Proposed Rule is adopted as proposed. Consequently, even in a current Facility, Facility lenders (Lenders) might want to consider including or adding the following:

(1) The stated purpose of providing working capital to the Fund should be express in the Facility documentation. If a Facility is expressly offered only to provide short term, bridge capital while awaiting the receipt of capital contributions from the Fund's limited partners, a Facility runs the risk of confusing the Agencies and unintentionally appearing closer to extending monies "for the purpose of refinancing the debt of the counterparty when it is unable to obtain a primary or anticipated source of funding" (and hence being classified a liquidity facility). Because Facilities "that have aspects of both credit and liquidity facilities would be classified as liquidity facilities for the purposes of the proposed rule," Lenders should steer clear from any ambiguity as to intent.

(2) Lenders should confirm via representation whether their Fund borrowers are required to file Form PF under SEC Rule 204(b)-1, as a lower outflow rate may be available in the event the Fund borrower satisfies an exception to the reporting requirement.

(3) Lenders should pay close attention to the structure of their Fund borrowers and any alternative investment vehicles or portfolio companies a Fund borrower may wish to have join the Facility. Because different borrowers have different classifications under the US LCR, a Lender would not want to unknowingly increase its outflow rate by permitting the joinder of a new Fund entity that resulted in an unexpected, increased outflow classification.

Structural Solution. There is a potential Facility structuring solution that would provide relief to the 40% outflow rate for Lenders, although they would require material changes and concessions from Fund borrowers. The outflow rates apply only to "committed" credit facilities, not uncommitted credit facilities. As a portion of the Facility market currently operates on an uncommitted basis, offering uncommitted Facilities (or perhaps separate committed and uncommitted tranches), would result in a 0% outflow rate on any uncommitted portion.

Real-World Cash Outflow

We believe the 40% outflow rate for Facilities under the US LCR is in complete and total contrast with the actual experience realized by

Lenders during the crisis. In fact, based on anecdotal reports from many different Lenders, Facility utilization on a portfolio-wide basis never increased in a material way throughout the entire crisis, let alone during any thirty (30) day stress period. Borrowing under a Facility creates immediate negative arb for a Fund if it must hold the borrowed cash and not promptly deploy it into an investment. At the height of the crisis, Funds were in large part nervous about acquisitions because pricing marks were hard to come by. Most sat patiently and waited, and did not borrow extensively under their Facility. In fact (and ironically), some Lenders were frustrated with low unused commitment fee pricing because many Facilities were so undrawn for so long that Lenders were challenged to meet their own return projections on their Facilities. For Funds, internal rate of return (IRR) is extremely important, and paying interest on large amounts of undeployed cash can materially undermine IRR. The 40% outflow rate is, in our opinion, divorced from actual experience during the financial crisis and very conservative. It does not "reflect aspects of the stress event experienced during the recent financial crisis," as the Agencies intend, and we expect that multiple Lenders could provide clear and convincing data supporting a lower outflow rate. However, we are very sympathetic to the Agencies here, as Facilities are a largely under-the-radar lending product in a completely private market, and the Agencies cannot possibly be expected to be familiar with Facility performance characteristics without extensive industry input.[6] The Agencies have explicitly requested comments on the Proposed Rule by January 31, 2014. In light of the disconnect between actual Facility utilization during the crisis and the proposed 40% outflow rate, Lenders should consider what impact the US LCR and a 40% outflow rate will have on their Facility portfolio. They should consider how it will impact their capital requirements, internal cost of capital, and what if any impact it will have on the unused commitments fees they will need to pass along to Funds. We expect that the actual impact of the US LCR will vary significantly for different Lenders. These and other factors should be considered in determining whether a comment letter to the Agencies may be appropriate. ◆

Endnotes

1. For an in-depth review of the Proposed Rule, please see Mayer Brown LLP's Legal Update, "The US Banking Regulators Propose a Liquidity Coverage Ratio For Large Banking Organizations and Systemically Important Non-Banks," available at http://www.mayerbrown.com/The-US-Federal-Reserve-Board-Proposes-a-Liquidity-Coverage-Ratio-For-Large-Banking-Organizations-and-Systemically-Important-Non-Banks-10-30-2013/.

2. Under the US LCR, the specified stress period for standard Covered Banks is thirty (30) calendar days, while the stress period for certain smaller Covered Banks (those with total assets in excess of $50 billion) is reduced to twenty-one (21) calendar days. This Legal Update focuses on the thirty (30) day stress period but recognizes the twenty-one (21) day period will be relevant for certain Covered Banks.

3. Particular business segments within a Covered Bank may have additional issues in connection with a Facility, such as the outflow rates for deposits from fund depositors, derivative exposures to a fund borrower, etc.

4. However, at least with respect to those Facilities that are merely providing short-term funding in anticipation of capital call proceeds, they are, at least potentially in the view of the Agencies, an extension of funds to a counterparty "when it is unable to obtain a primary or anticipated source of funding."

5. The outflow for any committed facility to a special purpose entity, whether credit or liquidity, is 100%.

6. We also suspect that Facilities may be one of the very few lending products to financial institution-type borrowers that did not experience high outflow rates during the crisis. Thus, the default assumption by the Agencies that financial institution-type borrowers will be most likely to face liquidity constraints and hence draw down on all available funding sources may be predictably and understandably overbroad in this context.

Infrastructure Funds Primer

Infrastructure funds are private equity vehicles that invest in a wide range of assets—including assets that could be described as transportation, energy and utility, communications, and "social" infrastructure, and investments that may be specific to a particular asset or in a company that develops such assets or is otherwise involved in their operation. Like other private equity funds, they have limited lifespans, typically five to ten years. They often attract capital commitments from investors with appetites for relatively stable, long-term cash flows, many of which have liabilities stretching over several decades. General partners of infrastructure funds are often able to leverage those commitments during the investment period.

In recent years, institutional investors have felt increased pressure to search for higher returns and diversify from traditional asset categories such as public equities and fixed income instruments. After slumping in 2011, fund-raising by infrastructure funds improved significantly in 2012 and 2013, with capital raised in the first three quarters totaling $19 billion.[1] Despite an increase in the average fundraising life-cycle,[2] not only did capital commitments to infrastructure funds continue to grow, investors indicated that they were looking to expand their infrastructure allocation.

Pension funds are notably increasing their exposure. The Alaska Retirement Board committed $300 million to two infrastructure funds—$200 million to IFM Global Infrastructure Fund and $100 million to J.P. Morgan Infrastructure Investments Fund—and has a long-term infrastructure target allocation of 12.5% within the real assets portfolio, or 2.125% of total plan assets.[3] The Kentucky Teachers' Retirement System committed $100 million to IFM's Global Infrastructure Fund,[4] and the Missouri Education Pension Trust committed $75 million to Alterna Core Capital Assets Fund II.[5] The $420 million Chicago Park Employees' Pension Fund entered the infrastructure space by committing $10 million each to infrastructure funds managed by Ullico Investment Co. and Industry Funds Management.[6] There is, however, considerable room for growth among pension funds. According to a new report from the Organization for Economic Co-Operation and Development (OECD), unlisted equity and debt infrastructure investments for the 69 survey respondents amounted to only 0.9% of total respondent assets.[7]

This growth is being driven by renewed demand for stable, long-term returns in a lower-yield environment, and a variety of "infrastructure" asset classes are filling that demand. With respect to power production, renewables have been popular, and the largest independent power producers were able to take operating assets into the public markets in ways that provide attractive exit opportunities. In 2013, Pattern Renewable Energy and NRG publicly listed "yieldcos," which aggregate the cash equity return from utility-scale power projects that have debt and

tax equity financing. Several other renewable energy developers are in the process of evaluating if such a structure would benefit them.

In the transportation space, several states moved forward with initiatives to facilitate private investment in toll roads and other similar assets, and successful project completions in recent years leads some to believe that future formations of such partnerships are likely. Virginia is moving ahead with a series of PPP toll road procurements following the successful completion of its I-495 Express Lanes project, which at $2 billion was delivered on time and on budget. In November 2013, the New Jersey Turnpike Authority put out a request for proposals seeking bids for toll collection services, including management of the electronic tolling system and the toll collectors.[8] MAT Concessionaire, LLC (MAT) received a 35-year concession agreement, which includes 55 months for design and construction, for the Port of Miami tunnel project, one of the first to make use of availability payments. Design and construction costs are currently at $663 million. MAT will be paid $156 million in milestone payments during construction and a $350 million payment upon final acceptance of the construction works. The majority of MAT's equity is being provided by a Meridiam infrastructure fund.

A number of infrastructure funds are also seeking to satisfy the need for debt as an alternative to traditional bank and bond financing at the project level.[9] Of the 1,700+ active investors in the infrastructure asset class tracked by Preqin, as of February 2013, 285 were actively considering debt investment opportunities. Darby Overseas Investments has raised three debt funds totaling $442 million, and Allianz Global Investors is currently working on a £1 billion UK-focused debt fund that will provide debt financing to a wide range of both economic and social infrastructure projects.[10]

While investor appetite for the various infrastructure asset classes continues to grow, so have fundraising challenges for a variety of reasons, first among them the record number and aggregate target of all funds in market.[11] (A consequence of the crowded fundraising environment is the increasing use of placement agents to assist in the fundraising process, and with reason—over the past two years, infrastructure funds that have used placement agents have been more likely to meet or exceed fundraising targets and to reach financial close.[12]) Investors indicate that the most attractive managers are those with cohesive and concise plans, a focus on high cash yield and defensive and predictable investments, a healthy deal pipeline, and, most importantly, strong past performance.[13] (Globally, the top ten infrastructure fund managers account for 45% of capital raised by infrastructure funds in the last ten years, and the largest firm, Macquarie Infrastructure and Real Assets, raised over six times the amount raised by the tenth largest firm, LS Power Group, but that percentage has dropped in recent years as more firms have entered the asset class.[14]) Current portfolios of infrastructure fund limited partners demonstrate a preference for regional-focused funds, but there is increasing preference for geographic diversification as well.[15]

Further increasing pressure on fund managers is the trend for large, sophisticated institutional investors to bypass infrastructure funds entirely and make direct investments.[16] While the motivations vary—to avoid paying fund management fees and lower carrying costs, increase control over asset disposition decisions, deploy additional capital, and avoid the disposition of assets that could continue to generate steady returns—making direct investments requires significant investments in manpower and the development of a variety of skills. In addition to performing upfront technical, legal, regulatory, and financial diligence, such investors need project management and asset divestiture expertise. While only the largest and most sophisticated investors are able to execute such a direct investment strategy effectively, direct

investments and co-investments are increasingly utilized,[17] and investors are conditioning fund commitments on the ability to retain control of key investment decisions, including investment horizons.[18]

In assessing infrastructure investments, investors and fund managers face a variety of concerns that are less relevant in other asset classes. In particular, the stability of the applicable regulatory regime, and the possibility of changes in law that may materially impact investments, are often critically important inquiries. For investments in emerging markets, the risks of adverse action by local governments come to mind fairly readily, but such actions have major impacts in developed markets as well. The renewable sector provides particularly clear examples. Spanish solar tariffs were reduced retroactively, Germany's were cut prospectively, and elections in Ontario, Canada, were in large part a referendum on the province's renewable energy programs. In the United States, key federal tax incentives have repeatedly been renewed and extended only on short-term bases, and there is concern about the deferral of state renewable mandates and the implementation of reliability and market-efficiency mandates by quasi-governmental grid operators. Other infrastructure asset classes present similar concerns. The privatization of government-owned assets generally requires express legislative or municipal authorization, which can be heavily conditioned, and is often subject to intense public scrutiny that may lead to renegotiation, as occurred last summer with respect to the City of Chicago's parking concession.

Infrastructure funds face uncertainties less relevant to funds than investments in other asset classes—for example, the significant risk of statutory and regulatory change affecting existing and target assets, the prevalence of pension and sovereign investors that have strong motivations to bypass the fund structure in favor of direct and co-investments, and the range of expertise needed to diligence and manage such a broad category of assets. Their recent growth, and the momentum of that growth, suggests that that the industry is able to turn such challenges into opportunities. We expect that it will continue to do so, and that the financing structures the industry utilizes will continue to evolve as well. ◆

Endnotes

1. *The Preqin Quarterly Update: Infrastructure* (Preqin, New York, N.Y.), Oct. 2013.
2. *Infrastructure Fundraising: Time on the Road*, Infrastructure Spotlight (Preqin, New York, N.Y.), Oct. 2013, at 2.
3. Kevin Olsen, *Alaska Retirement Board Earmarks $300 Million for 2 Infrastructure Funds*, Pensions & Investments (Sept. 25, 2013, 2:14 PM).
4. *Infrastructure Investor Research & Analytics: Infrastructure Investor Half Year Fundraising Review* 2013, 1, 7 (Ethan Koh Ke Ling ed., 2013).
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9. *BlackRock Infrastructure Debt Team, BlackRock: Bridging the Gap—The Rise of Infra Funds in Privately Financed Infrastructure*, CFI (Oct. 29, 2013), available at http://cfi.co/europe/2013/10/blackrock-bridging-the-gap-the-rise-of-infra-funds-in-privately-financed-infrastructure.

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[12] *Infrastructure Fundraising: Future Prospects*, INFRASTRUCTURE SPOTLIGHT (Preqin, New York, N.Y.), Nov. 2012, at 2, 4.

[13] *Infrastructure Fundraising: Future Prospects*, INFRASTRUCTURE SPOTLIGHT (Preqin, New York, N.Y.), Nov. 2012, at 2, 4; Arleen Jacobius, *Heydays Past, Infrastructure Firms Feel Heat*, PENSIONS & INVESTMENTS, Aug. 5, 2013, available at http://www.pionline.com/article/20130805/PRINT/308059979/heydays-past-infrastructure-firms-feel-heat.

[14] Press Release, Preqin, *The Top 10 Infrastructure Fund Managers Account for 45% of Capital Raised by Infrastructure Funds in the Last 10 Years* (July 17, 2013).

[15] *Infrastructure Investor Research & Analytics: Infrastructure Investor Half Year Fundraising Review 2013*, 1, 7 (Ethan Koh Ke Ling ed., 2013).

[16] Tim Burroughs, *Infrastructure Funding: A Beast with Two Heads*, ASIAN VENTURE CAPITAL J., Sept. 25, 2013, available at http://www.avcj.com/avcj/analysis/2296692/asian-infrastructure-a-beast-with-two-heads.

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[18] *Infrastructure Investor Research & Analytics: Infrastructure Investor Half Year Fundraising Review 2013*, 11 (Ethan Koh Ke Ling ed., 2013).

Detroit Eligible to File Chapter 9 Bankruptcy

On December 5, 2013, Judge Steven Rhodes of the US Bankruptcy Court for the Eastern District of Michigan held that the city of Detroit had satisfied the five expressly delineated eligibility requirements for filing under Chapter 9 of the US Bankruptcy Code1 and so could proceed with its bankruptcy case. The court also found that the city had filed its bankruptcy petition in good faith, going so far as to hold that the city should not have been required to engage in prepetition negotiations with creditors when any such negotiations were doomed to fail from the start.[1]

Several creditors and other parties in interest, including representatives of Detroit's pension funds, have already appealed Judge Rhodes' decision and have sought authorization to have that appeal heard directly by the Sixth Circuit Court of Appeals, instead of the intervening district court. A hearing on the direct appeal request has been set for December 16, 2013.

In making his ruling, among other issues of import, Judge Rhodes held that (i) the city could alter its pension benefits in bankruptcy, notwithstanding certain otherwise protective Michigan state constitutional provisions (the court had earlier indicated that it would put off a decision on this issue until a plan altering pensions was actually proposed), and (ii) the city was authorized to file bankruptcy under Michigan state law despite both US and state constitutional challenges, and despite a Michigan state court ruling to the contrary. Additionally, in dicta Judge Rhodes suggested that Detroit may have been better off filing for bankruptcy years ago.

Pension Obligations

A key issue in Detroit's bankruptcy filing has been the ability of the city to alter its pension obligations under Chapter 9, obligations that are protected by the Michigan state constitution.[2] Prior to issuing his eligibility opinion, Judge Rhodes had indicated some unwillingness to rule on this particular issue prior to the city's proposal of an actual plan. This would have left the city, and other parties in interest, in the unenviable position of spending thousands, if not millions, of dollars on plan negotiations, only to see those negotiations go for naught to the extent the court were to later rule that that the plan's proposed alteration of pension obligation was impermissible.

Additionally, without a clear ruling, pension fund representatives were likely to remain entrenched in their views that pension obligations were unalterable in bankruptcy, thus causing them to refuse to negotiate with the city.

Recognizing these exigencies and the need for a ruling on the pension issue sooner rather than later, Judge Rhodes reconsidered his initial view and issued a

ruling holding that Detroit was permitted to alter its pension obligations in bankruptcy. In particular, Judge Rhodes held that, while the Michigan state constitution stated that such rights could not be "diminished or impaired," in a US bankruptcy case, it could not afford them any more extraordinary protection than a typical contractual right which also may not be "impaired." In fact, Judge Rhodes pointed out, the reason that pension rights were enshrined in the Michigan state constitution was to recognize them as contractual rights, since, prior to an amendment to the Michigan state constitution, whether pension obligations even qualified as contractual rights was very much in doubt.

Judge Rhodes held that, while neither the State of Michigan nor the City of Detroit could unilaterally alter Detroit's pension obligations outside of bankruptcy, the federal government, in the form of US Bankruptcy Court, could. As Judge Rhodes noted, "impairing contracts is what the bankruptcy process does." To the extent the state guarantied Detroit's pension obligations or provided security for them, Judge Rhodes' opinion implied that his analysis may have been different. Michigan law, however, was clear that pension obligations were ordinary contractual obligations and were thus subject to impairment in a properly authorized Chapter 9 proceeding.

Specific Authorization to File

In a related ruling, and for reasons similar to those noted above, Judge Rhodes also held that Detroit's bankruptcy filing was "specifically authorized" under state law, as required by Bankruptcy Code section 109(c)(2). In so ruling, Judge Rhodes overruled objections by several parties, as well as a contrary opinion from a Michigan state court, that such authorization was unconstitutional under the US and Michigan state constitutions in that it did not provide for the protection of accrued pension benefits.

While again acknowledging that Michigan and Detroit did not have the right to alter pension rights, or any other contractual rights, under the contracts clause of the United States constitution outside of bankruptcy, and that therefore, the state could not authorize the city to do so, Judge Rhodes noted that such impairment is expressly permitted during, and is in fact one of the primary purposes for, bankruptcy proceedings. The state of Michigan's authorization of Detroit's Chapter 9 filing, through the process established under the state's emergency manager law was therefore proper, even to the extent that it could result in the impairment of the city's pension obligations. As Judge Rhodes noted, the Michigan legislature could have elected to prevent Michigan municipalities from filing under Chapter 9 but did not. Instead, it chose to let them file, knowing full well that in Chapter 9, pension obligations could be altered.

For similar reasons, Judge Rhodes also rejected the argument, put forward both by several objecting parties and a contrary Michigan state court opinion, that the Michigan law permitting the appointment of an emergency manager for the city of Detroit, and the filing of a chapter 9 petition, was unconstitutional under Michigan state law. As an initial matter, Judge Rhodes held that the state court opinion was void in that it was issued after Detroit's bankruptcy petition had been filed in violation of the automatic stay. Judge Rhodes described the state court judgment as a perfect example of the "chaotic and disorderly race to judgment" that the automatic stay is specifically meant to avoid. Judge Rhodes further noted that he believed the Michigan Supreme Court would agree that Michigan's emergency manager law was constitutional, even if a Chapter 9 filing could lead to alteration of a city's pension obligations.

Good Faith

An additional issue addressed in Judge Rhodes' ruling focused on Detroit's "good faith" leading up to its bankruptcy filing. In particular, two of the five express eligibility factors (i.e., whether the city desired to effect

a plan to adjust its debts and whether the city negotiated with its creditors in good faith) depend on the city's good faith intent, as does the more general question of whether the petition itself was filed in good faith.

While finding that Detroit had demonstrated the requisite intent to satisfy all of these requirements, Judge Rhodes did note certain questionable actions by the city. For instance, in describing the city's discussions with creditors in the weeks prior to its filing, the court refused to accept that they were indeed good faith negotiations in which the city truly expected to succeed, pointing for instance to the presentational, rather than conversational, method in which they were presented and the short time frames in which creditors were required to respond. Similarly, the court quoted from a bevy of emails which indicated that Detroit had in fact set itself on a course for a bankruptcy filing years ago, its protestations to the contrary notwithstanding.

According to Judge Rhodes, whether or not the negotiations themselves could be described as having been conducted in good faith, much of this was simply unnecessary. With respect to negotiations with creditors, Detroit may have been better served by accepting (and publicly stating) that negotiations with hundreds of thousands of creditors was impractical; indeed, Judge Rhodes noted that he was satisfied that when Congress enacted the impracticability provision, which permits a municipal bankruptcy filing in spite of no good faith negotiations with creditors if such negotiations are impractical, "it foresaw precisely the situation facing the City of Detroit." More generally, Judge Rhodes noted that, with its worsening financial crises, Detroit "could have, and probably should have, filed for bankruptcy relief long before it did, perhaps even years before" and that putting off that filing in order to engage in what it viewed as the necessary processes likely did more harm than good.

Conclusion

As the largest municipality to file under Chapter 9, decisions rendered in Detroit's bankruptcy case will impact the municipal debt market for years to come. One can already see the long-term potential impact from this recent eligibility opinion both from the big-ticket items, such as the bankruptcy court's ruling on the ability of municipalities to alter long-term pension obligations, and the smaller items, such as if and when a city should consider filing. All in all, Judge Rhodes' first major decision in the case appears to provide a guideline for municipal filings in the future. ◆

Endnotes

1. Judge Rhodes held that the city was: (i) a "municipality" as defined by the Bankruptcy Code; (ii) specifically authorized to file for bankruptcy protection under state law; (iii) "insolvent" as defined by the Bankruptcy Code; (iv) desired to effect a plan to adjust its debts; and (v) not required to negotiate in good faith with its creditors in advance of its bankruptcy filing since such negotiations were impractical.

2. See Article IX, Section 24, Michigan Constitution ("The accrued financial benefits of each pension plan and retirement system of the state and its political subdivisions shall be a contractual obligation thereof which shall not be diminished or impaired thereby.").

Sixth Circuit Rules that Collateral Proceeds Do Not Include Accounts

The US Court of Appeals for the Sixth Circuit has ruled that a lender's security interest in accounts was not perfected because a reference to "proceeds" in the lender's UCC financing statement did not expressly refer to "accounts." The Sixth Circuit surprisingly interpreted the definition of "proceeds"[1] in Article 9 of the Uniform Commercial Code to exclude "accounts"[2] (despite and without reference to provisions of UCC Article 9 to the contrary). While the Sixth Circuit's stated basis for this decision is questionable, this decision illustrates the risk of a security interest not being perfected when the collateral description in a UCC filing does not match the collateral description in the related security agreement.[3]

In *1st Source Bank v. Wilson Bank & Trust et al.*, 2013 WL 5942056 (No. 13-5088, Nov. 7, 2013), the Sixth Circuit settled a priority dispute between 1st Source and a group of other secured lenders over their respective security interests in accounts receivable of two debtors.

The security agreements in favor of 1st Source granted security interests in, among other things, tractors, trailers and accounts, as well as the proceeds of the agreed-upon collateral. 1st Source's UCC financing statements filed against the debtors described the collateral, in relevant part, as specific pieces of equipment and several types of collateral, "together with all present and future attachments, accessories, replacement parts, repairs, additions and exchanges thereto and therefore [sic], documents and certificates of title, ownership or origin, with respect to the equipment, and all proceeds thereof, including rental and/or lease receipts." The UCC financing statement collateral descriptions, however, unlike the security agreements, did not use the terms "accounts," "accounts receivable" or other similar language.

The other lenders' UCC financing statements were filed later than 1st Source's UCC financing statements. However, unlike 1st Source's UCC financing statements, their UCC financing statements expressly included in their identified collateral "all accounts receivable now outstanding or hereafter arising."

Applying Tennessee law, the Sixth Circuit ruled that 1st Source did not have perfected security interests in the accounts receivable because accounts receivable were not included in the reference to proceeds in 1st Source's UCC financing statements against the debtors. Accordingly, 1st Source's unperfected security interests were junior to the perfected security interests of the other lenders.

1st Source argued that the proceeds referred to in its UCC financing statements included the accounts. The Sixth Circuit rejected that argument on the basis that the terms are separately defined in UCC Article 9 and that the general term proceeds does not subsume the specific term accounts.

That assertion lacks support in UCC Article 9 itself: "Proceeds" clearly may consist of "accounts." The

priority rules stated in UCC Section 9-324 with respect to inventory collateral and its proceeds make key distinctions depending on whether the proceeds are accounts.[4] Moreover, many general UCC Article 9 collateral category terms encompass more specifically defined UCC Article 9 collateral category terms. For example, the term "goods" includes, among other collateral categories, "inventory" and "equipment,"[5] the term "instruments" includes "promissory notes"[6] and the term "investment property" includes, among other collateral categories, "security," "security entitlement" and "securities account."[7]

We note that the Sixth Circuit approvingly cited in its decision a line of cases that impose a limited reading of the UCC Article 9 definition of proceeds to the effect that it does not include property earned by a debtor from the debtor's use of collateral that remains in the debtor's possession (as contrasted with property received by the debtor from the sale, lease or other disposition of collateral by the debtor to another party).[8] While such a limited reading is in itself controversial due to the existence of arguments that accounts arising from use of collateral may indeed fit within the definition of proceeds, the Sixth Circuit's expression of its ruling in this case is more troublesome in suggesting that accounts can never be proceeds of other collateral because the UCC Article 9 definition of "proceeds" does not include accounts.

Unfortunately, because the 1st Source decision was decided by a Federal Circuit Court, and may be followed by other courts, the decision may well need to be dealt with by secured creditors in litigation and otherwise. The UCC definition of "proceeds" has been used by bankruptcy courts in determining under Section 552 of the Bankruptcy Code whether a pre-petition security interest extends to certain property of the debtor arising post-petition, as the Bankruptcy Code does not contain its own definition of proceeds.[9] This means that the 1st Source holding may have an impact in bankruptcy cases as well as in cases decided outside of bankruptcy.

As a result, creditors whose interests are secured by property—and their counsel—may wish to consider listing accounts arising from the sale, lease, other disposition or use of such property specifically as original collateral in their security agreements and financing statements.[10] ◆

Endnotes

1 Defined in UCC Section 9-102(a)(64). The definition reads as follows:

"Proceeds", except as used in Section 9-609(b), means the following property:

(A) whatever is acquired upon the sale, lease, license, exchange, or other disposition of collateral;

(B) whatever is collected on, or distributed on account of, collateral;

(C) rights arising out of collateral;

(D) to the extent of the value of the collateral, claims arising out of the loss, nonconformity, or interference with the use of, defects or infringement of rights in, or damage to, the collateral; or

(E) to the extent of the value of collateral and to the extent payable to the debtor or the secured party, insurance payable by reason of the loss or nonconformity of, defects or infringement of rights in, or damage to, the collateral.

2 Defined in UCC Section 9-102(a)(2).

3 But, in certain cases of a security interest covering all personal property of a debtor, mismatched collateral descriptions do not pose that risk where the UCC filing collateral description uses a supergeneric collateral description (such as "all personal property") as expressly authorized by UCC Section 9-504(2). In contrast, a supergeneric collateral description is not permitted for the collateral description in the granting provision of the security agreement. See UCC Section 9-108(c). (A grant of a security interest in all personal property may, in certain circumstances, be accomplished by listing all UCC Article 9 collateral category terms in the granting provision of the security agreement. See UCC Section 9-108(b).)

4 See Official Comments 8 and 9 to UCC Section 9-324.

5 See UCC Sections 9-102(a)(44), (48) and (33).

6 See UCC Sections 9-102(a)(47) and (65).

[7] See UCC Section 9-102(a)(49).

[8] See, e.g., *In re Gamma Center, Inc.*, 489 B.R. 688 (Bankr. N.D. Ohio 2013), in which the court held that proceeds of equipment only included proceeds of sale of the equipment instead of proceeds of the use of the equipment, and *In re Las Vegas Monorail Co.*, 429 B.R. 317 (Bankr.D.Nev.2010), in which the court held that rider fees were not proceeds of a monorail franchise.

[9] See Collier on Bankruptcy, ¶552.02[1].

[10] If the Sixth Circuit had found, to the contrary, that 1st Source did have senior perfected security interests in the accounts, this case would have presented the difficult issue of whether a senior perfected secured party may recover (on the basis of a conversion claim or otherwise) from a junior perfected secured party the proceeds of accounts collected by the junior perfected secured party.

Bankers' Bonus Cap: Where Are We Now?

We covered the forthcoming bankers' bonus cap, as contained in the Fourth Capital Requirements Directive (CRD IV), in detail, and discussed the other remuneration provisions of CRD IV, in our July 2013 legal update. In summary, the bonus cap will restrict the variable remuneration of relevant staff to a maximum of the amount of their fixed remuneration, or, with shareholder approval, two times the amount of their fixed remuneration, and will thus represent a major change to the remuneration structures of many affected institutions.

The provisions apply to banks, and some MiFID investment firms, headquartered in the European Economic Area (EEA), even in respect of staff not located in the EEA, and also to the EEA subsidiaries of institutions headquartered outside the EEA.

This update contains a brief summary of the main developments in relation to the bonus cap, and other remuneration provisions of CRD IV, since we put out our July update, focussing on implementation in the UK.

July 2013 - FCA Consultation on CRD IV for Investment Firms

On 31 July 2013 the FCA put out a consultation paper (CP13/6) on their proposed changes to the FCA Handbook as a result of the implementation of CRD IV. The proposed changes cover the remuneration provisions of CRD IV, other than those that relate to the bonus cap.

Largely, the changes are effected by copying out the wording of CRD IV into the Remuneration Code (SYSC19A of the FCA Handbook) without change, although the accompanying guidance is updated to reflect the changes. One interesting point from the changes relates to the new requirement to ensure that any of the total variable remuneration (not just deferred variable remuneration) is subject to malus or clawback arrangements (SYSC19A.3.51A). There has been no addition to the guidance to indicate that firms in proportionality level three (broadly, firms that previously fell in proportionality tiers three and four) may disapply this rule – although the existing guidance states that it will normally be appropriate for such firms to disapply the rules on retained shares, deferral and performance adjustment. It is not clear whether this is an oversight, or it is intended that this provision should not be disapplied by those firms, or they are waiting for guidance to be produced by the European Banking Authority (EBA) on the point.

Shortly afterwards, in August, the PRA produced a consultation paper on the implementation of CRD IV (CP5/13), although this does not address remuneration issues.

July 2013 – EBA Consultation on Draft Regulatory Standards for Instruments Used for Variable Remuneration

The European Banking Authority (EBA) published a consultation paper dated 29 July 2013 on the classes of instruments that are appropriate to be used for the purposes of variable remuneration under Article 94(2) of CRD IV.

One of the requirements of CRD IV (Article 94(1)(l)) is that a substantial proportion, and in any event at least 50%, of any variable remuneration shall consist of a "balance" of shares or share-linked instruments, and "where possible" other instruments qualifying as Additional Tier 1 instruments or Tier 2 instruments (as defined in the Capital Requirements Regulation) or "other instruments which can be fully converted to Common Equity Tier 1 instruments or written down, that in each case reflect the credit quality of the institution as a going concern and are appropriate for the purposes of variable remuneration".

The directive mandates the EBA to prepare draft regulatory technical standards (RTS) on classes of instruments that satisfy these requirements for instruments other than shares and share-linked instruments.

A full summary of the proposals is beyond the scope of this alert, but we would highlight the following points:

- to ensure that instruments reflect the credit quality of the institution as a going concern, strictminimum triggers for write-down and conversion of instruments are proposed;
- to ensure that instruments are appropriate for the purposes of variable remuneration, instruments should have a sufficient maturity to cater for deferral and retention mechanisms, and distributions should adequately reflect market conditions for comparable instruments;
- to meet this latter concern, a significant portion, being not less than 60%, of the instruments should be issued publicly or privately to other investors, or if instruments are used for the sole purpose of variable remuneration, a cap should be set on the distributions paid. The EBA will finalise the draft RTS at the beginning of 2014, taking into account consultation responses and the opinion of the Banking Stakeholder Group, and submit them to the European Commission by 31 March 2014. The Commission then has to decide whether to adopt or amend the RTS, and the Council or European Parliament can veto it. It could thus take some months before these procedures are concluded and the relevant legislation adopted and published.[1]

September 2013 – UK Legal Challenge

On 25 September the UK government lodged a legal challenge with the European Court of Justice on the bonus cap.

The bonus cap was strongly resisted by the UK during the negotiations for CRD IV, and the government does not think the bonus cap provision, which was implemented without any assessment of its impact or supporting evidence, is "fit for purpose" —to improve stability across the banking system. The challenge also covers various legal issues regarding the compatibility of the bonus cap with the EU Treaty and the powers delegated to the EBA, which the government believes go well beyond its remit of setting technical standards. It is important to note that the UK's legal challenge does not give institutions an excuse to delay the implementation of the bonus cap. The challenge does not suspend the coming into force of the bonus cap provision, and it will not be resolved until long after the bonus cap becomes effective: it can take around two years for the Court of Justice to hear a legal challenge. The UK will be implementing the bonus cap, as required by European law, by the beginning of 2014.

However, the challenge does give a strong indication of the UK government's view, and

there is the expectation that this may be reflected in a lenient interpretation of the bonus cap in the UK by the relevant regulators.

October 2013 – PRA and FCA Consultation on the Bonus Cap

Following the announcement of the UK Government's legal challenge, and in recognition of the fact that the challenge will not delay implementation, the PRA and FCA issued consultation papers in relation to changes to their respective Remuneration Codes to accommodate the bonus cap in the UK (and, for the PRA, all the CRD IV remuneration provisions). The approach has generally been to do the minimum possible to comply with the directive, and, as for the earlier FCA consultation, the proposed rule changes largely copy out the CRD IV wording without amendment. Any discretions left to member states have been exercised so as to give maximum flexibility.

The PRA consultation paper includes no new guidance on how the proportionality principle may apply to permit firms to disapply the bonus cap. Their original proportionality guidance (LSS8/13) published in April 2013 states that it may be appropriate for BIPRU limited licence firms and BIPRU limited activity firms to disapply the ratios between fixed and variable components of total remuneration (see paragraph 32 of the guidance), in the context of the CRD III requirement for firms to set appropriate ratios.

The FCA, however, does include proposed guidance on the application of proportionality to the bonus cap (see paragraphs 2.13 to 2.21 of their consultation paper). Given that all relevant firms currently prudentially regulated by the FCA fall into proportionality level 3, the effect of this guidance would be that all firms would generally be able to disapply the bonus cap, unless they are treated as being level 1 or 2 because they are part of a group—in which case the group is likely to be PRA-regulated.

For more details, see the FCA's CP13/12 and the PRA's CP8/13.

October/November 2013 – FCA Regulated Firms Remaining on CRD III Rules

CRD IV contains a discretion for regulators to allow certain limited-licence investment firms to remain on CRD III rules (BIPRU). The FCA has, following the July 2013 consultation, decided to exercise this discretion, and in October wrote to potentially affected firms, which, if they would meet the relevant criteria going forward, could notify the FCA of this and remain on the CRD III rules.

As some firms which the FCA did not contact may also benefit from this discretion, the FCA published details on its website on 19 November 2013 of the criteria to be met, and the process to be followed if a firm considers those criteria are met, in order to remain on the CRD III rules.

October 2013 – EBA Consultation on Discount Rate

The EBA published a consultation paper dated 23 October 2013 containing draft guidelines on the applicable notional discount rate for variable remuneration, provided in Article 94(1)(g)(iii) of CRD IV.

Under Article 94, member states may allow institutions to apply a discount to up to 25% of variable remuneration for the purposes of calculating the bonus cap, provided that the variable remuneration discounted is in the form of instruments that are deferred for a period of not less than five years. The EBA is mandated to prepare and publish guidelines on the discount rate to be applied by 31 March 2014.

The draft guidelines set out a proposed methodology for applying the discount, and in particular contain a formula for calculating the discount rate to be applied. This formula is based on the inflation rate, the interest rate for EU government bonds, the number of

years over which the instruments are deferred, the number of years in any additional retention periods and the number of years in the vesting period of the tranche concerned.

The formula will need to be applied separately to each element of deferred variable remuneration (with each tranche of an award with a different vesting date being treated separately), so this could lead to a substantial amount of calculation.

The requirement for an award to be deferred over a period of at least five years does not prevent tranches of that award vesting prior to five years, although vesting cannot be faster than on a pro-rata basis. For a retention period to affect the discount rate, it needs to be at least two years.

It is beyond the scope of this alert to consider the detail of the formula. The draft guidelines contain various examples applying the formula: one of these shows that for an award which vests after five years and has a two-year retention period, the unadjusted value of the award is discounted by a little over a half, from €20,000 to €9,228.

Assuming the 25% portion of the variable remuneration was discounted down to zero (it wouldn't be far off this if awards were deferred for the ten years suggested by the Parliamentary Commission on Banking Standards), this would give a theoretical maximum for variable remuneration of two and two-thirds times fixed remuneration.

What's Next?

The revised Remuneration Code provisions (from both the PRA and FCA) will be finalised in December, as they will come into force on 1 January 2014. It is anticipated that the text will be published in time for a final review by interested parties.

However, there will still be missing pieces of the jigsaw after the commencement date. In particular:

- the EBA is due to deliver the draft RTS on identified staff (following the consultation process started in May 2013) to the European Commission by 31 March 2014: it will then be some time before the RTS is adopted (with or without amendments);
- the EBA is also due to deliver the RTS on appropriate instruments (referred to above) by 31 March 2014, and again it will be some time before the RTS is adopted;
- the final guidelines on the discount rate are to be published by 31 March 2014; and
- we understand that the EBA will revise the Guidelines on Remuneration Policies and Practices originally published by its predecessor body, CESR, towards the end of 2014: no draft of these revisions has yet been published.

Given that the bonus cap provisions apply to bonuses paid in relation to services or performance from the year 2014 onwards (so, generally, the 2015 bonus round will be the first affected), firms should be able to work with this timetable.

In the longer term, the European Commission, in close conjunction with the EBA, is required to review and submit a report on the remuneration provisions of CRD IV to the European Parliament and the European Council by 30 June 2016. This report is to take into account international developments, and have particular regard to the provisions' efficiency, implementation and enforcement, and the impact of the bonus cap in relation to competitiveness and financial stability and also in relation to staff working for non-EU subsidiaries.

The UK government's legal challenge, which may well cover similar ground to this report, could be underway at the same time as the EBA's review. It remains to be seen whether one will influence the other. ◆

Endnotes

[1] It is not uncommon for it to take approximately five months from the EBA submitting its draft legislation to the Commission to it being published in the Official Journal of the EU, but the process could take as long as ten months.

SUMMER 2014

In this Summer 2014 edition of our *Fund Finance Market Review,* we discuss some of the more noteworthy trends impacting the subscription credit facility and fund finance markets, including our views of the challenges and opportunities created by an increasingly prominent regulatory framework.

We also explore some of the new and accelerating sources of capital for funds, potential new facility products in response thereto and the shifting legal landscape affecting facility lenders.

Summer 2014 Market Review

On July 22nd and 23rd, we held our annual Fund Finance Mid-Year Market Update Panels, this year in Los Angeles and San Francisco (the "Market Updates").[1] Based on our experiences and the views expressed by the panelists at the Market Updates, capital call subscription credit facilities (each, a "Facility") have continued their positive credit performance and growth momentum in the first half of 2014. Below we set forth our views of the current market trends and developments likely to be relevant for the remainder of 2014.

Credit Performance

2014 Year-to-Date Credit Performance

Mirroring all of 2013, Mayer Brown LLP has not been consulted on a Facility payment event of default or an institutional investor exclusion event in 1H 2014 and we are not aware of any existing Facilities under credit duress. All five of the bank panelists speaking at the Market Updates reported consistent credit performance across their portfolios so far this year.

Short-Term Credit Forecast

Fund Investment Performance. There is an abundance of data that forecasts continuing positive Facility credit performance on the macro level for the foreseeable future. Private equity funds of virtually all asset classes and vintages (each, a "Fund") have achieved positive investment return performance in the recent past. The Cambridge Associates LLC US Private Equity Index® (the "C-A Index") shows one-year and three-year returns as of December 31, 2013 of 20.6% and 14.9%, respectively, and Preqin reports promising current aggregate cumulative returns for Funds of virtually all vintages and geographies. This positive performance has continued into 2014, with Preqin reporting as one example a 6.3% average increase in net asset value ("NAV") for real estate Funds in 1H 2014.[2] While positive Fund investment performance enhances Facility repayment prospects in its own right, Fund limited partners (each, an "Investor") with demonstrable NAV in a Fund are highly incentivized to fund future capital calls ("Capital Calls") and avoid the severe default remedies typical in a Fund partnership agreement (each, a "Partnership Agreement"). Setting aside the well-established, enforceable contractual obligations of the Investors, it is difficult to foresee widespread Investor funding defaults in the near term when the vast majority of existing Funds have generated positive returns.[3]

Harvest Events and Investor Distributions. Additionally, there is generally positive liquidity data at virtually every level of the Fund structure relevant for Facility lenders ("Lenders"). Private equity-backed investment exits in 2014 have continued and built upon the robust harvest activity in 2013, with 394 transactions valued at $137 billion in Q2 2014 alone.[4] Exit events of course lead to Investor distributions, and distributions

are at record levels. In 2013, Fund distributions to Investors greatly exceeded capital contributions called and funded, with Funds in the C-A Index calling $56.3 billion, while distributing $134.6 billion (the largest yearly amount since the C-A Index's inception). On a global basis, $568 billion was distributed back to Investors in 2013 (up 49% from 2012).[5] Investors receiving significant distributions forecasts well for their ability to fund future Capital Calls.

Secondary Funds. The fundraising success of secondary Funds, Facility borrowers in their own right, has created an unprecedented volume of dry powder available to offer exit opportunities to any Investor that experiences liquidity challenges and needs to exit a Fund position. In fact, the single-largest Fund closed in Q2 2014, and the single largest secondary Fund to close in history was the Ardian Secondary Fund VI, closing on $9 billion in April. There has reportedly been $15 billion raised by secondary Funds in 1H 2014 and there are multiple premier Sponsors in the midst of fundraising with significant interim traction. This significant growth in secondary Fund dry powder creates a readily available market for any Investor wishing to transfer, whether for diversification purposes or because of financial distress, and the current secondary market is very active. The first half of 2014 saw more than $16 billion of secondary transactions (an annualized pace that would exceed 2013 by over 10%) and it has been reported that the Montana Board of Investments received more than 40 offers for eight Fund positions that it recently put out for bid.[6] If the Facility market performed extremely well during the financial crisis when the secondary Fund market was a fraction of what it is today, today's secondary Funds market with some $50 billion in dry powder certainly provides Lenders a far greater buffer to any initial collateral deterioration.

Long-Term Credit Forecast Concerns

Despite the nearly uniform positive trending in the data above supporting Facility credit performance, none of it goes to the heart of the fundamental credit underwriting premise of a Facility. That is, that the Investors' uncalled capital commitments are unconditionally due, payable and enforceable when called, regardless of Fund investment performance, NAV, receipt of distributions, market liquidity or Investor transfers. And from this vantage point, the 2014 year-to-date trending has been far less beneficial for Lenders. We have for some time been noting that Facility structures have been drifting in favor of the Funds and that Lenders have become increasingly comfortable going incrementally down the risk continuum, at least for their favored Fund sponsors ("Sponsors"). In fact, at the end of 2013, we gave the view that much of the trending (as an example, the including of certain historically excluded Investors in borrowing bases at limited concentrations) seemed perfectly rational and completely supportable by the available Investor funding data. But as 2014 has progressed and the downward trending has continued, we are seeing the emergence of structural issues in prospective Facilities that we believe further conflict with Lenders' general expectations as to the appropriate allocation of risk between the Lenders, Funds and Investors. While the Facility market is far from uniform and every particular Facility needs to be evaluated in its own context, there are a number of emerging credit concerns we think Lenders should rightfully put heavy emphasis on. Examples include Partnership Agreements that fail to appropriately contemplate or authorize a Facility, overcall limitations structured so tightly that the degree of overcolleralization buffering Investor defaults is insufficiently adequate to cover the Facility obligations in a period of distress, lack of express Investor obligations to fund without setoff, counterclaim or defense, and Fund vehicles being formed in non-US partnership structures that require the Fund to issue some form of equity shares or certificates each time a Capital Call is funded. And there are others. Our view has been, and remains, that the most likely way a Lender will suffer losses in this space is not via widespread Investor credit deterioration, but rather via a Sponsor or Fund

failing to meet its contractual obligations to Investors, ultimately resulting in a dispute and an Investor enforcement scenario. Thus, Lenders should thoughtfully contemplate documentation and structural risks that undermine their expected enforcement rights. If this downward trending on the risk continuum continues at its current pace, we ultimately see an inflection point where particular Lenders determine that certain proposed structures simply drift too far from the fundamental tenets of a Facility and no longer meet the investment grade credit profile expected in a Facility.

Facility Market Expansion

Fundraising

Fund formation in the first half of 2014 has remained positive and generally consistent with levels seen in 2013. 417 Funds had their final closing, raising $236 billion in capital commitments in 1H 2014. The "flight to quality" trend has continued, with fewer Funds being formed but raising more capital, with the average Fund size in Q2 2014 being the largest to date.[7] We continue to think this trend towards consolidation slightly favors incumbent and larger Lenders at the expense of new entrants and smaller institutions. Experienced Sponsors are more likely to have existing relationships with incumbent Lenders in multiple contexts and larger Funds need larger Lender commitment sizes in Facilities. We note, however, that several smaller Lenders have greatly increased their maximum hold positions and have created syndicate partnerships to effectively compete.

Deal Volume and Pipeline

Facility deal volume remains robust and likely above 2013's pace, although we hesitate to confirm the double-digit growth we forecasted in January based on the available anecdotal evidence alone. The pipeline of both large syndicated transactions and bilateral deals forecasts well for the remainder of the year. We expect 2014 deal volume to ultimately finish ahead of 2013, albeit perhaps by only single digits.

Growth Prospects

The Facility market, in our view, still projects substantial opportunity for future growth. With global dry powder now at an all-time high of $1.16 trillion as of the end of Q2 2014, up a full 8% from the end of 2013, there is simply a greater and increasing pool of collateral available to support Facilities.[8] And if you take a ratio of Facility size to Fund uncalled capital across a large portfolio of Facilities (admittedly not a statistic clustered close to the mean) and determine an average percentage, say 30%, you could project out a potential Facility market size of well over $300 billion. As most market participants estimate the current Facility market to be less than $200 billion, it does appear that plenty of existing Funds have yet to benefit from Facilities. When you combine this room for further penetration into Funds new to Facilities with the greater volume of Funds presently fundraising (estimated currently around 2,000), the increasing use of returned capital mechanics to refresh dry powder and the greater use of Facilities throughout the entire Fund life cycle, it seems evident that the opportunity for outpaced growth remains.[9]

Facility Market Trends

There are a number of interesting trends in the Facility Market itself that are impacting both transaction structures and terms. We highlight below a few that are most impactful.

Extensive Refinancing Activity

Many Facilities of 2011 or so vintage have been coming up for renewal and the vast majority have been extending instead of terminating. Lenders are increasingly comfortable extending Facilities beyond Fund investment periods (subject to appropriately supportive language in Partnership Agreements) and Funds appear to be valuing the liquidity and other utility of a Facility well into their harvest periods. Virtually all Facilities coming up for renewal have been pricing flat to down, further

encouraging their extension. We expect the volume of amend and extend activity to increase slightly towards year-end, mirroring an uptick we experienced in 2H 2011.

Transaction Structures

Structural Evolution. The evolution of Fund structures continues to complicate Facility structures, as the incorporation of multiple Fund vehicles, in an effort to optimize investment structure for Investors, is continuing and perhaps accelerating. Separately managed accounts, co-investment vehicles, joint ventures and parallel funds of one are all increasingly common, each of which stress the traditional commingled Fund collateral package for a Facility. As the various vehicles often have challenges being jointly and severally liable for Facility obligations, Lenders are increasingly finding themselves with Facility requests involving single-Investor exposures. Interestingly, in certain instances, these single-Investor exposure structures are leading back to the delivery of Investor acknowledgment letters (which have been in certain cases trending out of the commingled Fund market), as Lenders seek credit enhancements to offset the lack of multiple Investor overcollateralization.

Umbrella Facilities. We are seeing increased appetite for umbrella Facilities (multiple Facilities for unrelated Funds advised by the same Sponsor but documented on the same terms in a single set of loan documents). In fact, Mayer Brown LLP has closed more umbrella Facilities in 1H 2014 than in all of 2013.

Hedging Mechanics. Embedding hedging and swap collateralization mechanics into Facilities has also accelerated in 1H 2014. While extending Facility collateral to cover collateralization requirements under ISDAs entered between the Fund and the Lender has existed in the bilateral Facility market for some time, including clear structural borrowing base allocation, tracking and measurement mechanics in syndicated Facilities is relatively new.

Regulatory Impact

The regulatory landscape continues to occupy a substantial amount of Lender and Sponsor time. Analyzing Facilities for compliance with the final Volcker Rule, for appropriate risk weighting under Basel III and other regulatory capital regimes and the appropriate outflow analysis under the minimum liquidity coverage ratio promulgated by the US regulatory agencies all require thoughtful care in application to Facilities, especially in light of the speed of Facility structural evolution. We expect the regulatory environment will be increasingly relevant throughout 2014 and that Lenders may ultimately need to structure around, or price, for their increasing regulatory requirements, particularly around Facility unfunded revolving commitments.[10]

Legal Developments

Cayman Islands Legal Developments

Two new statutory enactments have occurred in the Cayman Islands in 1H 2014, both of which are in small part helpful to Lenders. The first, the Contracts (Rights of Third Parties) Law, 2014, was enacted on May 21, 2014. Although not explicit as to Facilities, the new law allows third parties not party to a contract (such as a Partnership Agreement) to rely on and enforce provisions that are intended by the contracting parties to benefit the third parties, even though the third parties are not signatories. This brings Cayman Islands' third-party beneficiary law closer in line with other jurisdictions and can ultimately accrue to the reliance and enforcement benefit of Lenders if Partnership Agreements are expressly drafted to do so. The second key change is the enactment of the revised Exempted Limited Partnership Law, 2014, which took effect on July 2, 2014 and is a comprehensive revision of previous Cayman Islands exempted limited partnership law. While few of the changes are relevant for Facilities, the new law does expressly confirm that any right to make Capital Calls and to receive the proceeds thereof

vested in a general partner or the Fund shall be held by the general partner as an asset of the Fund, thus providing greater certainty of a Fund's right to grant security in the right to issue and enforce Capital Calls.[11]

Case Law Development: *Wibbert v. New Silk*

A case of interest to Lenders, *Wibbert Investment Co. v. New Silk Route PE Asia Fund LP*, *et al.*, is pending in the New York state courts. While no mention of a Facility is evident in the pleadings, the case is illustrative of the type of fact pattern and dispute that could potentially find a Lender in an enforcement scenario. In this case, the Investor, Wibbert Investment Co. ("Wibbert"), alleges, among other things, that the Fund failed to disclose the occurrence of a key person event after a principal of the Sponsor was charged and convicted of insider trading and that the Fund's general partner committed gross negligence and/or willful malfeasance. The Fund fully contests the claims and the facts are in dispute. Wibbert has declined to fund a Capital Call and alleges that the Fund has threatened to implement default remedies as a result. On June 17, 2014, at Wibbert's request, the New York Supreme Court, Appellate Division, granted a preliminary injunction in favor of Wibbert barring the Fund from declaring Wibbert in default and from exercising default remedies while the case proceeds. The ruling is currently on appeal. While the facts of this case are highly unique and have involved extensive publicity in connection with the trials and convictions of certain of the principals, the case does stand as evidence of why Lenders may want to consider the importance of a contractual obligation on Investors to fund Capital Calls to Lenders without setoff, counterclaim or defense. The case merits further attention and monitoring as it proceeds.[12]

Case Law Development: *TL Ventures, Inc.*

In June 2014, the US Securities and Exchange Commission (the "SEC") brought a pay-to-play case against a Sponsor pursuant to Sections 203(e) and 203(k) of the Investment Advisers Act of 1940 (the "Advisers Act"), to our knowledge the first such case brought by the SEC. The SEC alleged that an associate of TL Ventures, Inc. made a $2,500 campaign contribution to the Mayor of Philadelphia and a $2,000 campaign contribution to the Governor of Pennsylvania at a time when the Pennsylvania State Employees' Retirement System was an Investor in Funds sponsored by TL Ventures, Inc. Both the Mayor and the Governor have vested authority to appoint certain people with influence as to investment selection. The SEC alleged that this action violated Section 206(4) and Rule 206(4)-5 of the Advisers Act, noting that it need not allege or demonstrate a showing of *quid pro quo* or actual intent to influence an elected official by the Sponsor. The Sponsor, without admitting or denying the relevant subject matter, consented to an order with the SEC to resolve the matter. As Lenders are increasingly reviewing side letters between governmental Investors and Funds that contain withdrawal and/or cease-funding rights if prohibited political contributions are made or improperly disclosed, Lenders must bear in mind that such a circumstance may not be purely hypothetical and that even the most innocent and well-intentioned political contributions may trigger the withdrawal rights.[13]

LSTA Model Credit Agreement Provisions

On June 25, 2014, the Loan Syndications and Trading Association® published an exposure draft of its Model Credit Agreement Provisions. The proposed revisions include a host of technical revisions, but the two most relevant revisions relating to Facilities include an extensive set of mechanics governing facility extensions and changes to the lender assignment and participation provisions, including certain prohibitions of assignments or participations by lenders to competitors of the borrower or institutions the borrower has requested in advance be

disqualified for assignments or participations. August 8, 2014 is the current target date the LSTA plans to publish the revisions. A copy of the exposure draft is available to LSTA members on the LSTA's website at http://www.lsta.org/legal-and-documentation/primary-market.[14]

Conclusion

We project a robust Facility market to continue in 2H 2014 building on the growth and positive momentum to date, but with competitive, structural and underwriting challenges at the margins. We expect the number of Facilities consummated will continue to grow at an outpaced but measured rate, reflective of the time-consuming nature of educating new Sponsors of the utility and benefits of a Facility. We continue to anticipate excellent credit performance throughout the remainder of 2014, but recommend caution to Lenders as certain emerging Facility structures reallocate the traditional Facility risk allocations among Lenders, Funds and Investors and stress some of the most fundamental tenets of a Facility. ◆

Endnotes

1 Mayer Brown LLP would like to thank the panelists at the Market Updates. In Los Angeles: Kristin M. Rylko, Partner, Mayer Brown LLP (Moderator), John Gilb, Senior Managing Director, CBRE Global Investors, Ann Richardson Knox, Partner, Mayer Brown LLP, Nick Mitra, Executive Director, Natixis, Matt Posthuma, Partner, Mayer Brown LLP, Tom Soto, Managing Director, TCW, Emily Stephens, Managing Director, Oaktree Capital Management, LLP, David Wasserman, Executive Director, Sumitomo Mitsui Banking Corporation, and Tom Wuchenich, Partner, Simpson Thacher & Bartlett LLP. In San Francisco: Scott Case, Global Head of Private Equity Services, Silicon Valley Bank, Kevin Dunwoodie, Principal, Pantheon, Jeff Johnston, Managing Director and Head of Subscription Finance Origination, Wells Fargo Bank, N.A., Mary Touchstone, Counsel, Simpson Thacher & Bartlett LLP, Matt McCormick, Vice President, Stockbridge, Wes Misson, Attorney, Mayer Brown LLP, and Robert Wood, Director, Bank of America, N.A.

2 See *US PE/VC Benchmark Commentary*, Quarter and Year Ending December 31, 2013 (the "C-A Benchmark"), Table 1, page 2, Cambridge Associates, July 2014, available at http://40926u2govf9kuqen1ndit018su.wpengine.netdna-cdn.com/wp-content/uploads/2014/07/US-PE-VC-Benchmark-Commentary-4Q13.pdf; *Preqin Quarterly Update: Private Equity*, Q2 2014 ("Preqin PE Q2"), Figure 3, page 8; *Preqin Quarterly Update: Real Estate*, Q2 2014, page 7.

3 For an in-depth review of the enforceability of Investor capital commitments, please see Mayer Brown's Legal Update, *"Enforceability of Capital Commitments in a Subscription Credit Facility,"* on page 1.

4 *Preqin PE Q2*, page 8.

5 See *C-A Benchmark*, Figure 1, page 6; *Preqin PE* Q2, page 2.

6 See, *Secondaries Investor*, news compendium, page 3; available for download at http://www.secondariesinvestor.com/newscompendium/; *Secondary Market Trends & Outlook*, Cogent Partners, July 2014, p. 1.

7 See *Preqin PE Q2*, Figure 1, page 5.

8 *Id.*, page 2.

9 *Id.*, page 3.

10 For an in-depth review of applying the Volcker Rule to Facilities, please see Mayer Brown's Legal Update, *"Subscription Credit Facilities and the Volcker Rule"*; on page 103 for an in-depth review of applying the Liquidity Coverage Ratio to Facilities, please see Mayer Brown's Legal Update, *"Capital Commitment Subscription Facilities and the Proposed Liquidity Coverage Ratio,"* on page 75.

11 Mayer Brown LLP is not licensed to and does not give advice as to matters of Cayman Islands law. Any questions on the laws of the Cayman Islands should be directed to attorneys therein licensed. Appleby Legal Updates on these legal developments can be found at http://www.applebyglobal.com/publication-pdf-versions/e-alerts/ealert---cayman - to- welcome-third-party-rights-rules---(april-2014)-sraftopoulos--lrichter.pdf; http://www.applebyglobal.com/publication-pdf-versions/e-alerts/2014---07---update-changes-to-the-cayman-islands-exempted-limited-partnership-law---bh-sr-jb-ig-bw.pdf; and http://sites.appleby.vuturevx.com/18/2890/uploads/2014---04---changes-to-the-cayman-islands-exempted-limited-partnership-law-(bhunter--sraftopoulos--igobin--jblack).pdf.

12 The case is *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.

13 The case is *In the Matter of TL Ventures Inc.*, case number 3-15940, before the SEC.

14 Special thanks to Mayer Brown LLP summer associates, Kim Perez, 3L, University of North Carolina School of Law, and Daniel Waxman, 3L, Wake Forest University School of Law, for their research contributions to this article

Subscription Credit Facilities and the Volcker Rule

On December 10, 2013, the federal financial agencies (the "Agencies") approved joint final regulations (the "Final Regulation") implementing section 619 of the Dodd-Frank Act, commonly referred to as the Volcker Rule. Section 619 added a new section 13 to the Bank Holding Company Act of 1956 (the "BHCA"), which generally prohibits any banking entity from engaging in proprietary trading and acquiring or retaining an ownership interest in, sponsoring, or having certain relationships with, a hedge fund or a private equity fund. Banks and other lending institutions ("Lenders") commonly provide loan facilities to private equity funds ("Funds") that are secured by, or otherwise look to repayment from, the uncalled capital commitments of the Fund's limited partner investors (each a "Subscription Facility" or a "Facility"). In the typical Facility, the Lender does not directly sponsor, invest in or manage its Fund borrower, but rather only provides extensions of credit.[1] Lenders frequently inquire to ensure their Facilities are in compliance with the Final Regulation. This Legal Update clarifies why most Facility structures will not run afoul of the Final Regulation's prohibition against acquiring or retaining an ownership interest in a covered fund and what parameters a Lender should maintain to ensure continuing compliance.[2]

Covered Funds as Subscription Facility Borrowers

In order to be subject to the Volcker Rule, a Fund must be a "covered fund," as defined under the Final Regulation. A "covered fund" includes any issuer that relies solely on the section 3(c)(1) or 3(c)(7) exceptions from the definition of "investment company" under the Investment Company Act of 1940 (the "1940 Act"). It also includes any "commodity pool" under the Commodity Exchange Act that shares characteristics of an entity excluded from the 1940 Act under section 3(c)(1) or 3(c)(7). With respect to US banking entities only, a covered fund would also include any non-US fund owned or sponsored by the US entity itself or an affiliate if the fund would rely on section 3(c)(1) or 3(c)(7) if it were subject to US securities laws.[3] A majority of Fund borrowers in Facilities, in our experience, will be covered funds, as they frequently rely on section 3(c)(1) or 3(c)(7).

Subscription Facility Loans, not Ownership Interests

To the extent that an entity is a covered fund and is not covered by an exclusion, a Lender that is a banking entity under the Volcker Rule is generally prohibited from acquiring or retaining any "ownership interest" in the covered fund.

While it may seem inherent on its face that a debt facility like a Facility is not an "ownership interest" in even the most expansive interpretation, the Final Regulation does define "ownership interest" broadly to mean any equity, partnership or "other similar interest." The Final Regulation provides that "other similar interest" includes an interest that (i) has the right to participate in the selection or removal of a general partner, director, investment manager or similar entity (excluding certain creditor's rights); (ii) has the right to receive a share of the fund's income, gains or profits; (iii) has the

right to receive underlying assets of the fund after all other interests have been redeemed or paid in full (excluding certain creditor's rights); (iv) has the right to receive excess spreads under certain circumstances; (v) has exposure to certain losses on underlying assets; (vi) receives income on a pass-through basis; or (vii) has a synthetic right to receive rights in the foregoing. Accordingly, while a debt interest generally would not be considered an ownership interest, to the extent that a debt security or other interest in a covered fund exhibits any of the foregoing characteristics, it would be considered an ownership interest. The "other similar interest" component makes the definition of "ownership interest" broad and requires specific application to the facts of a given transaction.

The good news for Lenders is that debt interests held in a classic Facility, absent some atypical degree of control over the Fund or pricing mechanic, are unlikely to be considered an "ownership interest" because the loan documents for a Facility generally do not provide the Lender with any of the rights described in subclauses (i)–(vii) above. The Agencies additionally provided explicit clarifying guidance on this: An "ownership interest" generally does not include "typical extensions of credit the terms of which provide for payment of stated principal and interest calculated at a fixed rate or at a floating rate based on an index or interbank rate."[4] Thus, the Lender in a Facility does not directly have an equity stake in the Fund or any rights that amount to an ownership interest under the Volcker Rule.

Default Remedies and Collateral Foreclosures

While certain events may give rise to an event of default under a Facility and provide the Lender with the ability to accelerate the debt and enforce remedies against the Fund, including the ability to charge step-up default interest, such enforcement rights are in line with typical extensions of credit and are not akin to "an ownership interest" for Volcker purposes. The Agencies expressly carved out such rights in the commentary: "the Agencies believe[d] that a loan that provides for step-up in interest rate margin when a covered fund has fallen below or breached a NAV or other negotiated covenant would not generally be an ownership interest."[5] Similarly, rights to participate in the selection or removal of the fund's management are expressly subject to a creditor's right to exercise remedies upon the occurrence of an event of default as well.[6]

Even where a Lender obtains an ownership interest in a Fund by the exercise of remedies during a default (a circumstance potentially relevant to Lenders under hybrid structures that also take a security interest in the underlying assets or in the insolvency of a fund of funds borrower), the rulemakers provided an exception. This exception for ownership interests acquired in the ordinary course of collecting a "debt previously contracted" ("DPC") means that a Lender, as a secured party, that has covered fund ownership interests as collateral securing a Facility may foreclose on its security interest and thereby take possession and dispose of such ownership interests without violating the Volcker Rule. The Final Regulation expressly sanctions the ownership and sale of the covered fund ownership interest in such a DPC context, provided that the Lender acquiring an ownership interest in a covered fund "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, subject to possible extensions.[7]

Facility Limitations

We do advise Lenders to be conscious of the definition of "other similar interest" and curtail their creativity to structures that will not run afoul of the Final Regulation. For example, any

sort of warrant or other equity kicker, equity conversion feature, step-up in spread based on Fund performance or the like would all require a hard look under the Final Regulation.

Conclusion

We think it is highly unlikely that a Facility Lender, absent unusual control or profit-sharing mechanics in respect of a Fund borrower, could be deemed to hold an ownership interest in such covered fund under the Final Regulation solely as result of the typical Facility lending relationship. ◆

Endnotes

[1] If the Lender is the sponsor, investment advisor or investment manager of the Fund, significant additional compliance obligations are implicated which are beyond the scope of this Legal Update. Similarly, if the Fund borrower is itself sponsored or advised by a banking entity subject to the Final Regulation, additional analysis is required by the Lender.

[2] For an in-depth review of the Volcker Rule, please see Mayer Brown's Legal Update, "Final Regulation Implementing the Volcker Rule."

[3] A fund that is not an "investment company" in the first place or that is able to rely on an exception or exemption under the 1940 Act other than section 3(c)(1) or 3(c)(7) generally is not a covered fund. For example, a real estate fund that invests solely in real property rather than in securities is not an investment company, while a real estate fund that invests in a mix of real property and real estate-related securities may be able to rely on section 3(c)(5)(C) of the 1940 Act. In either case, the fund would not be a covered fund. In addition, even if an entity relies on section 3(c)(1) or 3(c)(7) of the 1940 Act, the entity is not a covered fund if it falls within a Volcker Rule exclusion. The Final Regulation expressly excludes from the definition of a "covered fund" various types of entities, including, among others, certain "foreign public funds" that are analogous to US-registered investment companies, foreign pension and retirement funds, and qualifying loan securitizations and asset-backed commercial paper conduits. If a fund is not an investment company in the first place or is covered by a Volcker Rule exclusion, a banking entity may not only invest in or sponsor the fund without needing to comply with a Volcker Rule exemption but it may also engage in covered transactions with the entity without regard for the so-called Super 23A prohibition.

[4] Final Regulation Preamble at 5706.

[5] Final Regulation Preamble at 5707.

[6] Final Regulation Preamble at 5706.

[7] Final Regulation Preamble at 5782.

Governmental Plan Investors and the Borrowing Base

A subscription credit facility, also frequently referred to as a capital call facility (a "Subscription Facility"), is a loan made by a bank or other credit institution (a "Lender") to a private equity fund (a "Fund").[1] What distinguishes a Subscription Facility from other secured lending arrangements is the collateral package, which is comprised not of the underlying investment assets of the Fund but, instead, of the unfunded capital commitments ("Capital Commitments") of the limited partners of the Fund (the "Investors") to make capital contributions ("Capital Contributions") when called from time to time by the Fund's general partner (the "General Partner").

As the Subscription Facility market continues to grow and mature,[2] Lenders willing to include the widest range of Investors within the borrowing availability (the "Borrowing Base") may enjoy a competitive advantage against Lenders that have a relatively more narrow set of Investors they will advance against, all things being equal. One way to potentially expand the borrowing capacity under a Subscription Facility is for a Lender to advance against more of the governmental Investors in the Fund and, in particular, governmental Investors that are public retirement systems (each a "System").[3]

Historically, full Borrowing Base credit (typically a 90% advance rate) is given to Investors that are Systems with (a) a senior unsecured debt rating (or its equivalent) of BBB+ or better by Standard & Poor's Financial Services LLC or Baa1 or better by Moody's Investors Service, Inc., and (b) a minimum funding ratio[4] above a specified threshold (typically 90% if the Investor's rating is BBB+/Baa1 (or equivalent) and no minimum for Investors with higher credit ratings). These rating and funding ratio criteria are often referred to as the "Applicable Requirement" in a Subscription Facility. Where it can be established that a state, county, municipality or other governmental subdivision is ultimately responsible for the obligations of a System, a Lender can reasonably look past the System's own credit profile and, instead, to the credit rating and quality of the responsible governmental entity in determining if the Applicable Requirement has been satisfied, or whether the System Investor otherwise merits inclusion in the Borrowing Base, perhaps at a lower advance rate (typically 60–65% of the unfunded Capital Commitment). Thus, establishing a credit linkage between a System and a creditworthy responsible governmental entity may provide a way for a Lender to get comfortable advancing against the unfunded Capital Commitment of a System Investor that would otherwise not satisfy the Applicable Requirement on its own. Below we outline a few alternate approaches and factors that a Lender may use to assess whether an adequate credit linkage exists between a System and a responsible governmental entity.

Overview of Public Retirement Systems

Systems are created and administered under the laws of a state (the "Plan Sponsor") to provide pension and

other retirement benefits to employees of governmental units such as states, cities and counties. Systems typically hold substantial reserves available for investment in a diverse array of financial products and often rely on significant investment returns to supplement the participating employee and employer contributions used to fund retirement benefits for the System's participants.

A System can be organized to provide benefits for employees of a single governmental unit or employees of multiple governmental units. A single-employer system is a System that provides benefits for employees of only one governmental entity, often the Plan Sponsor. Some common examples of a single-employer System are those that provide benefits to retired state judges or state legislators. In such a System, the relevant state would be the only employer of the individuals covered by the System. A multi-employer system is a System that covers the employees of more than one governmental entity.[5] An example of a multi-employer System is a System that provides retirement benefits to a state's public safety personnel. Such a System may cover employees of many different governmental entities, such as state university police departments, county sheriffs' departments and city fire departments.

The retirement benefits offered by a System may be structured in a variety of ways. Here, we will focus on Systems that are organized as defined-benefits Systems, where the employees covered by the System will contribute a statutorily determined percentage of their income during the term of their employment in return for a defined level of benefits during their retirement. Many states have constitutional protections safeguarding the pension benefits accrued by public employees during their careers.[6] These constitutional provisions can prevent Plan Sponsors from reducing the level of benefits promised to public workers, causing Plan Sponsors to focus on ways to increase the System's assets rather than reduce pension liabilities to ensure the financial health of the System.

Credit Linkage to Plan Sponsors

By demonstrating that a creditworthy governmental entity is ultimately responsible for the funding obligations of a System, a credit linkage analysis provides valuable underwriting information and may facilitate inclusion of a System in the Borrowing Base. Because the statutory regimes used to govern Systems are varied and often complex, a credit linkage review calls for a thorough analysis by counsel of multiple sources of state and local law, including state constitutions, statutes, ordinances and case law, as well as statements and financial reports issued by both the Plan Sponsor and the System. There are a number of ways that a Lender can attempt to link the credit rating of a System and its Plan Sponsor, some of which are quite direct while others are more attenuated. It is important to note, however, that the degree of connectivity between a System and its Plan Sponsor required to establish a sufficient credit linkage to permit inclusion of a System Investor's unfunded Capital Commitments in the Borrowing Base will differ based on the preferences of the relevant Lender. We will focus on two of the more popular methods used to demonstrate such a credit link in more detail below.

PLAN SPONSOR'S ASSUMPTION OF LIABILITY OF SYSTEM'S INVESTMENT OBLIGATIONS

Perhaps the most straightforward way to establish a credit linkage is to research and locate a source of law that expressly provides that the Plan Sponsor is responsible for the liabilities of the System. In the best case scenario, such a law would expressly designate all of the System's liabilities as direct obligations of the Plan Sponsor. In such a situation, a Lender can take comfort that the rated Plan Sponsor is ultimately responsible for funding the investment-related obligations of the System. The laws in this area, however, are seldom so clear, and a careful legal analysis will need to be undertaken to assess the extent

to which the Plan Sponsor actually assumes the System's liabilities. For example, the laws may provide that the Plan Sponsor assumes operational and administrative liabilities of the System but be silent as to investment liabilities or benefit obligations. This type of limited assumption of liability would likely not include the assumption of the System's obligation to fund Capital Contributions to a Fund. Thus, a Lender may not be comfortable advancing against a System Investor in reliance on such a limited assumption of liability and may need to undertake a different analysis to establish whether an adequate credit link exists to include such an Investor in the Borrowing Base.

PLAN SPONSOR'S RESPONSIBILITY FOR FUNDING THE SYSTEM

When clear statutory or case law evidence does not exist to establish credit linkage, another method that can be used involves conducting an analysis of the sources of the System's assets to ascertain the extent to which the Plan Sponsor is responsible for providing funds to the System vis-à-vis other participating employers. If the System primarily receives its funding (i.e., its assets) from the Plan Sponsor, it may be reasonable for a Lender to consider the credit worthiness of the Plan Sponsor as a primary factor in deciding whether or not it will advance against a System Investor. The purpose of this funding analysis is to determine the percentage of a System's assets that is coming from the Plan Sponsor in relation to other sources, thus illustrating for each entity its level of responsibility for funding a System's liabilities.

A System is often funded primarily by the three following sources: (i) employee contributions deducted from each participating employee's salary, (ii) employer contributions required to be made under the law and (iii) investment gains earned through investment of the System's reserves.[7] According to data gathered in 2010 by the US Census Bureau, from 1995–2010, 68 percent of public pension fund receipts came from investment earnings, 11 percent came from employee contributions and about 21 percent came from employer contributions.[8] Employer contributions are the only System assets that are funded directly from the coffers of Plan Sponsors; as such, the key task in conducting a funding responsibility analysis is to review applicable laws to determine the required annual employer contributions for each participating employer.

Once the amount each participating employer is required to contribute annually to a System has been determined, the next step in a funding analysis is to establish the percentage of employer contributions coming into the System that has historically come from each participating employer (including the Plan Sponsor) by reviewing the System's financial, actuarial and other information. This information will help a Lender assess the degree to which the Plan Sponsor has been responsible for providing funds to the System that, when extrapolated, may give the Lender enough comfort that the Plan Sponsor will provide adequate assets to the System to fund Capital Contributions going forward so as to enable the Lender to include the System Investor in the Borrowing Base.

With respect to a single-employer System, the sole employer (i.e., the Plan Sponsor) would be the only governmental unit responsible for providing funds to the System, making a credit linkage easier to establish. When analyzing a multi-employer system, however, it can become significantly more challenging to establish a credit linkage between the System and its Plan Sponsor.

In some cases, the Plan Sponsor of a multi-employer System assumes responsibility for funding the employer contributions of some or all of the other participating employers. For example, the Illinois Teachers' Retirement System is a multi-employer System consisting of approximately 1,000 governmental units, where approximately 95 percent of the employer-provided funding for the Illinois Teachers' Retirement System is the responsibility of the State of Illinois.[9]

More typically, with respect to multi-employer Systems, each governmental unit participating as an employer in the System is only responsible for making a required employer contribution for its own employees. In this scenario, a funding analysis requires locating and reviewing the financial, actuarial and other information related to the System to determine the extent to which the Plan Sponsor is responsible for funding the System relative to other participating employers in order to establish the extent to which the Plan Sponsor is supporting the System.

An additional layer of complexity is added when a Lender is considering advancing against a public pension fund that holds assets of multiple Systems. This situation can arise when a state that sponsors multiple Systems seeks out ways to reduce the administrative burden of operating multiple Systems by creating, for example, a common pension fund that collects, pools and invests moneys received from several different Systems (a "Common Fund").[10] When such a Common Fund is established to facilitate investment activities, the funds of each System may be invested jointly, while the gains and losses of the Common Fund are allocated among each System on a pro rata basis. In this scenario, again, a funding analysis calls for locating and reviewing the financial, actuarial and other information related to the Common Fund and each System participating in the Common Fund to determine the extent the Plan Sponsor is responsible for funding the assets of each System and, ultimately, the Common Fund relative to other participating employers.

ADDITIONAL CONSIDERATIONS

In deciding whether to advance against a System, in addition to a credit linkage analysis, there are other potential factors that a Lender may wish to consider and discuss with its counsel. For example, a Plan Sponsor of a System may have enacted a statutory regime that helps ensure that sufficient funds will be made available to the System for it to meet its liabilities.[11] In such a case, a Lender may become more confident in the overall creditworthiness of the System and may become comfortable advancing against a System (perhaps at a lower advance rate and/or with tight concentration limits) despite the lack of credit linkage to the Plan Sponsor.

Lenders should also be aware of a Plan Sponsor's ability to adjust the accrued liabilities of the System. As mentioned above, in many instances, System benefits are protected by state constitutional provisions. Certain states, such as Arizona, Illinois, Michigan and New Jersey, have pending cases relating to recently enacted pension reforms touching on this issue. These cases may have implications for the ability of Plan Sponsors in those states to limit their benefit liabilities as a means of managing the fiscal health of a System. As such, Lenders participating in the Subscription Facility market will want to consult with counsel familiar with these issues as they look to advance funds against Capital Commitments made by Investors that are Systems. Finally, it is important to note that, when a Lender is advancing against a governmental entity, it should consider the extent to which the entity may be able to use sovereign immunity defenses to impede enforcement of its contractual obligations in federal and/or state court.[12]

Conclusion

As the Subscription Facility market becomes increasingly competitive, a Lender's ability to provide Borrowing Base credit for a greater number of a Fund's Investors is one way for a Lender to distinguish itself from its competition. By analyzing the legal regime and publicly available financial and other information about a System and its sources of funding, a Lender may be able to establish sufficient credit linkage between a System Investor and a more creditworthy Plan Sponsor, facilitating inclusion of such an Investor in the Borrowing Base. ◆

Endnotes

[1] For a more detailed description of the subscription facility market and features of the subscription credit facility product in general, please see Mayer Brown's Fund Finance Markets Legal Update "*Summer 2013 Market Review.*" on page 19.

[2] For a discussion of key competitive and other trends in the Subscription Facility market, please see Mayer Brown's Fund Finance Markets Legal Update "*Winter 2013 Market Review.*" on page 59.

[3] For the sake of simplicity, we use the term "System" as encompassing both the legal entity established to administer pension benefits and the related retirement/ pension fund that holds assets in trust to pay liabilities.

[4] In a Subscription Facility, a governmental plan Investor's "funding ratio" is typically defined as the percentage obtained by dividing (i) the actuarial present value of the assets of the Investor by (ii) the actuarial present value of the plan's total benefit liabilities.

[5] The Plan Sponsor of a System does not necessarily have to be an employer of employees covered by the System. For example the Public School Teachers' Pension and Retirement Fund of Chicago was created and is governed under the laws of the State of Illinois, but does not cover employees of the State of Illinois. For illustrative purposes, this article focuses on Systems that have Plan Sponsors participating as employers in the System.

[6] For example, Article 13, Section 5 of the Illinois Constitution provides that membership in a pension system of any governmental unit in the state is "an enforceable contractual relationship, the benefits of which shall not be diminished or impaired."

[7] See "Public Pension Funding 101: Key Terms and Concepts," *Benefits Magazine*, April 2013, pages 28-33, page 30.

[8] NRTA and National Institute on Retirement Security, NRTA Pension Education Toolkit, Pension Contribution Requirements, 2011, Page 2.

[9] Official Statement for $750,000,000 State of Illinois General Obligation Bonds, Series of May 2014, dated April 25, 2014, Page 66.

[10] The Common Pension Funds established by the State of New of Jersey Department of the Treasury, Division of Investments are examples of Common Funds. The Division of Investments uses the Common Pension Funds to invest and manage the collective assets of seven different Systems: the Police & Firemen's Pension Fund, the Judicial Retirement System, the Police & Firemen's Retirement System, the Prison Officers Pension Fund, the Public Employees' Retirement System, the State Police Retirement System and the Teachers' Pension and Annuity Fund.

[11] The laws and regulations related to the funding of the Missouri Education Pension Trust (the "MEPT") serve as an interesting example of such a regime. The State of Missouri has established the MEPT to invest the assets of the School Retirement System of Missouri and the Public Education Employee Retirement System of Missouri. The State of Missouri does not guarantee the liabilities of the MEPT or assume responsibility for making employer contributions on its behalf, yet in recent years the employer contributions have been very high and often exceed the annual required contribution (determined in accordance with Governmental Accounting Standards Board accounting standards). This high rate of contribution may be due to the fact that if any employer fails to transmit the full amount of its actuarially required employee and employer contributions to MEPT, that employer will be responsible for twice the amount owed, and MEPT is empowered to bring suit against the responsible party to collect the funds, thus incentivizing the participating employers to stay current on their contributions. See Mo. Rev. Stat. § 169.030.2, Mo. Code. Regs. Ann. tit. 16 §10-2.010(6), Mo. Rev. Stat. § 169.620 and Mo. Code. Regs. Ann. tit. 16 §10-6.020(6).

[12] For a more thorough analysis on sovereign immunity concerns related to Subscription Facilities, see Mayer Brown's November 2012 Legal Update "Sovereign Immunity Analysis In Subscription Credit Facilities."

Leverage and Liquidity Requirements Under Basel III

On January 12, 2014, with the concurrent endorsement of the Group of Central Bank Governors and Heads of Supervision (GHOS), the Basel Committee on Banking Supervision (BCBS) issued additional information regarding the leverage and liquidity requirements under Basel III, including the following:

- The full text of Basel III's leverage ratio (Leverage Ratio) framework and related disclosure requirements that modifies the earlier consultative proposal issued in June 2013;
- Proposed revisions (the Consultative Document) to the Basel III framework's Net Stable Funding Ratio (NSFR) modifying the earlier consultative proposal issued in December 2009 and Basel III agreement of December 2010 (as revised in June 2011);
- Disclosure standards for the Liquidity Coverage Ratio (LCR), including a template for such disclosure, reflecting additional work undertaken at the directon of the GHOS;
- Guidance for supervisors on market-based indicators of liquidity; and
- Modification of the LCR to permit (with national discretion) restricted-use committed liquidity facilities (RCLFs) provided by central banks to be included in the LCR's high-quality liquid assets (HQLA).

The effect of these changes and additional guidance on the US rules to implement Basel III[1] is unclear. In particular, the reaffirmation by BCBS of a minimum three percent Leverage Ratio is not consistent with the US proposed minimum requirement of five percent in the case of large, systemically important banking organizations that would be subject to the supplementary leverage ratio. Also, in light of current reports of ongoing discussions among international regulators regarding a more restrictive leverage ratio, it is perhaps significant that the BCBS states that, based on the parallel run period, final adjustments to the definition and calibration of the ratio will occur by 2017 when the requirement will migrate to a Pillar 1 treatment on January 1, 2018.

Leverage Ratio

The Basel III framework introduced a simple, transparent, non-risk-based leverage ratio to act as a credible supplementary measure to the risk-based capital requirements. The leverage ratio is intended to:

- Restrict the buildup of leverage in the banking sector to avoid destabilizing deleveraging processes that can damage the broader financial system and the economy; and

- Reinforce the risk-based Basel III requirements with a simple, non-risk-based "backstop" measure.

BCBS is of the view that:

- A simple leverage ratio framework is critical and complementary to the risk-based capital framework; and
- A credible leverage ratio is one that ensures broad and adequate capture of both the on- and off-balance sheet sources of banks' leverage.

The Leverage Ratio implementation began with bank-level reporting to national supevisors from January 1, 2013, with required disclosure starting from January 1, 2017 with expected migration to mandatory Pillar 1 treatment (minimum capital requirement) from January 1, 2018.

The Basel III leverage ratio is defined as the capital measure (the numerator) divided by the exposure measure (the denominator), being the following ratio (expressed as a percentage):

Leverage ratio =
Capital measure/Exposure measure

with the requirement being a minimum of three percent during the parallel run period (i.e, from January 1, 2013 to January 1, 2017).

- **Capital Measure** means Tier 1 capital under the risk-based capital framework (as defined in paragraphs 49-96 of the Basel III framework), taking into account permissible transitional arrangements under Basel III.
- **Exposure Measure** generally follows the accounting value, subject to the following:
  - » on-balance sheet, non-derivative exposures are included in the exposure measure net of specific provisions or accounting valuation adjustments (e.g., accounting credit valuation adjustments); and
  - » netting of loans and deposits is not allowed.

Unless otherwise specifically provided, banks must not take account of physical or financial collateral, guarantees or other credit risk mitigation techniques to reduce the exposure measure.

A bank's total exposure measure is the sum of the following: (i) on-balance sheet exposures; (ii) derivative exposures; (iii) securities financing transaction (SFT) exposures; and (iv) off-balance sheet (OBS) items. The specific treatments for these four main exposure types are defined below.

- **On-Balance Sheet** - Banks must include all balance sheet assets in their exposure measure, including on-balance sheet derivatives collateral and collateral for SFTs (other than on-balance sheet derivative and SFT assets covered under Derivative Exposures below); however, for consistency, balance sheet assets that are deducted from Tier 1 capital (as set forth in paragraphs 66 to 89 of the Basel III framework) may be deducted from the exposure measure, while liability items (for example, any fair value or similar accounting value adjustments for gain or loss on derivative or other liabilities due to changes in the bank's own credit risk) must not be deducted.
- **Derivative Exposures** – Generally, banks must calculate their derivative exposures,[2] including where a bank sells protection using a credit derivative, as the replacement cost (RC) for the current exposure plus an add-on for potential future exposure (PFE). If the derivative exposure is covered by an eligible bilateral netting contract, an alternative treatment may be applied. Written credit derivatives are treated the same as cash instruments (e.g., loans or bonds). Generally, collateral received does not reduce the derivative exposure. Similarly, a bank must gross up its derivative exposure for collateral provided if the collateral reduced the accounting value of the exposure.
- **Securities Financing Transaction Exposures** – Generally, the gross exposure adjusted by (i) excluding the value of the securities received if the bank reported the securities as an asset in its balance sheet,

(ii) netting all cash payables and receivables with the same SFT counterparty as long as all related SFTs have the same final settlement date, set-off is legally enforceable and the parties have agreed to net settlement, and (iii) a counterparty credit risk measure (being the current exposure without a PFE add-on).

- **Off-Balance Sheet Items** – OBS items include commitments (including liquidity facilities), whether or not unconditionally cancellable, direct credit substitutes, acceptances, standby letters of credit and trade letters of credit. As under the risk-based capital framework, OBS items are converted to credit exposure equivalents by using specified credit conversion factors (CCFs) applied to the related notional amounts.

Banks are required to publicly disclose their Leverage Ratios from January 1, 2015 using a consistent and common disclosure of the main components of the Leverage Ratio and including a summary comparison table on a common disclosure template included in the full text.[3]

Net Stable Funding Ratio

The net stable funding ratio (NSFR) is defined as the amount of available stable funding (ASF) relative to the amount of required stable funding (RSF). While many of the components of the NSFR are the subject of international agreement, some remain subject to national discretion. In addition, the NSFR is to be supplemented by supervisory assessment that may result in more stringent requirements to reflect a bank's funding risk profile.

"Available stable funding" is defined as the portion of capital and liabilities expected to be reliable over the time horizon considered by the NSFR, which extends to one year. The amount of such stable funding required of a specific institution is a function of the liquidity characteristics and residual maturities of the various assets held by that institution as well as those of its off-balance sheet (OBS) exposures.

The NSFR requirement is expressed as follows:

Amount of ASF/Amount of RSF ≥ 100%

With underlying concepts that are similar to those used for the LCR, the amount of ASF is measured based on the broad characteristics of the relative stability of an institution's funding sources, including the contractual maturity of its liabilities and the differences in the propensity of different types of funding providers to withdraw their funding.

The amount of ASF is calculated by first assigning the carrying value of an institution's capital and liabilities to one of five categories as presented in the table in Annex A. The amount assigned to each category is then multiplied by an ASF factor, and the total ASF is the sum of the weighted amounts. Carrying value represents the amount at which a liability or equity instrument is recorded before the application of any regulatory deductions, filters or other adjustments. For maturity determinations, investors are assumed to exercise a call option on the earliest possible date and, for funding options at the bank's discretion, banks must assume that they do not exercise such options.

Similar to ASF, the amount of RSF is measured based on the broad characteristics of the liquidity risk profile of an institution's assets and OBS exposures. The amount of required stable funding is calculated by first assigning the carrying value of an institution's assets to the RSF categories listed. The amount assigned to each category is then multiplied by its associated RSF factor and the total RSF is the sum of the weighted amounts added to the amount of OBS activity (or potential liquidity exposure) multiplied by its associated RSF factor as set forth in Annex B.

The NSFR also assigns an RSF factor to certain OBS as shown in Annex C.

Comments on the Consultative Document were due by April 11, 2014.

Liquidity Coverage Ratio Disclosure

The LCR disclosure standards are to apply to all internationally active banks on a consolidated basis and are expected to apply no later than January 1, 2015. Apart from the quantitative LCR components,[4] the standards require sufficient qualitative discussion to facilitate an understanding of the data provided.

The disclosure is to be public and to follow the template,[5] but the standards also require disclosure of additional quantitative information relating to internal liquidity risk measurement and management. While not requring their use, the standards refer approvingly to the several monitoring tools for assessing liquidity risk that are included in the Basel III liquidity risk framework.

Market-Based Liquidity Indicators

The guidance on the use of market-based indicators of liquidity reflects additional work directed by GHOS in January 2013 and is intended to assist supervisors in their evaluation of the liquidity profile of assets held by banks and to promote greater consistency in HQLA classifications across jurisdictions for purposes of the LCR.

Restricted Committed Liquidity Facilities Conditionally Permitted as HQLA for the LCR

The BCBS has decided to modify the LCR[6] to permit national regulators to modify the definition of HQLA to include greater use of committed liquidity facilities (CLFs) provided by central banks. Previously, the LCR only permitted CLFs in jurisdictions that lacked suffcient HQLA. The BCBS has determined that, subject to certain conditions and limitations, regulators in any jurisdiction may allow banks to use a restricted version of a CLF as HQLA. ◆

ANNEX A

AVAILABLE STABLE FUNDING (ASF)	ASF FACTOR
• Regulatory risk-weighted capital[1] before deductions (other than Tier 2 instruments with a maturity of less than one year); • Any other capital instrument with an effective residual maturity of one year or more (excluding any instruments with explicit or embedded options that, if exercised, would reduce the maturity of the instrument to less than one year); and • The total amount of secured and unsecured borrowings and liabilities (including term deposits) with effective residual maturities of one year or more (paragraph 18[2])	100%
• "Stable"[3] non-maturity (demand) deposits and term deposits with residual maturities of less than one year provided by retail[4] and SME[5] customers (paragraph 19)	95%
• "Less stable"[6] non-maturity (demand) deposits and term deposits with residual maturities of less than one year provided by retail[7] and SME[8] customers (paragraph 20)	90%
• Funding (secured or unsecured) with a residual maturity of one year or less provided by non-financial corporate customers; • Operational deposits;[9] • Funding with residual maturity of less than one year from sovereigns, public sector entities (PSEs) and multilateral and national development banks; and • Other funding (secured and unsecured) not included in the categories above with residual maturity of not less than six months and less than one year, including funding from central banks and financial institutions (paragraph 21)	50%
• All other liabilities and equity not included in above categories, including liabilities without a stated maturity and, if positive, derivatives payable net of derivatives receivable	0%

ANNEX B

REQUIRED STABLE FUNDING (RSF)	RSF FACTOR
• Coins and banknotes immediately available to meet obligations; • Central bank reserves (including required and excess reserves); and • Unencumbered loans to banks subject to prudential supervision with residual maturities of less than six months (paragraph 29)	0%
• Unencumbered Level 1 assets,[10] excluding assets receiving a 0% RSF as specified above, including marketable securities representing claims on or guaranteed by sovereigns, central banks, PSEs, the Bank for International Settlements, the International Monetary Fund, the European Central Bank and European Community, or multilateral development banks that are assigned a 0% risk-weight under the Basel II Standardized Approach for credit risk; and • Certain non-0% risk-weighted sovereign or central bank debt securities as specified in the LCR (paragraph 30)	5%
• Unencumbered Level 2A assets,[11] including marketable securities representing claims on or guaranteed by sovereigns, central banks, PSEs or multilateral development banks that are assigned a 20% risk weight under the Basel II Standardized Approach for credit risk and corporate debt securities (including commercial paper) and covered bonds with a credit rating equal or equivalent to at least AA– (paragraph 31)	15%
• Unencumbered Level 2B assets,[12] including: residential mortgage-backed securities (RMBS) with a rating of at least AA; corporate debt securities (including commercial paper) with a credit rating of between A+ and BBB–; and exchange-traded common equity shares not issued by financial institutions or their affiliates; • Any HQLA[13] that are encumbered for a period of six months or more and less than one year; • All loans to banks subject to prudential supervision with residual maturity of six months or more and less than one year; • Deposits held at other financial institutions for operational purposes, as outlined in LCR paragraphs 93–104, that are subject to the 50% ASF factor in paragraph 21 (b); and • All other non-HQLA not included in the above categories that have a residual maturity of less than one year, including loans to non-bank financial institutions, loans to non-financial corporate clients, loans to retail customers (i.e., natural persons) and small business customers, and loans to sovereigns, central banks and PSEs (paragraph 32)	50%
• Unencumbered residential mortgages with a residual maturity of one year or more that would qualify for a 35% or lower risk weight under the Basel II Standardized Approach for credit risk and other unencumbered loans not included in the above categories, excluding loans to financial institutions, with a residual maturity of one year or more, that would qualify for a 35% or lower risk weight under the Basel II Standardized Approach for credit risk (paragraph 33)	65%
• Other unencumbered performing loans that do not qualify for the 35% or lower risk weight under the Basel II Standardized Approach for credit risk and have residual maturities of one year or more, excluding loans to financial institutions; • Unencumbered securities that are not in default and do not qualify as HQLA according to the LCR including exchange-traded equities; and • Physical traded commodities, including gold (paragraph 34)	85%
• All assets that are encumbered for a period of one year or more; • If positive, derivatives receivable net of derivatives payable; and • All other assets not included in the above categories, including non-performing loans, loans to financial institutions with a residual maturity of one year or more, non-exchange-traded equities, fixed assets, pension assets, intangibles, deferred tax assets, retained interest, insurance assets, subsidiary interests and defaulted securities (paragraph 35)	100%

ANNEX C

OFF-BALANCE SHEET ITEMS (OBS)	OBS FACTOR
• Irrevocable and conditionally revocable credit and liquidity facilities to any client	5% of the currently undrawn portion
• Other contingent funding obligations, including products and instruments such as: • Unconditionally revocable credit and liquidity facilities; • Trade finance-related obligations (including guarantees and letters of credit); • Guarantees and letters of credit unrelated to trade finance obligations; and • Non-contractual obligations such as > potential requests for debt repurchases of the bank's own debt or that of related conduits, securities investment vehicles and other such financing facilities; > structured products where customers anticipate ready marketability, such as adjustable rate notes and variable rate demand notes (VRDNs); and > managed funds that are marketed with the objective of maintaining a stable value (paragraph 38)	National supervisors can specify based on national circumstances

Endnotes

1 Described in our earlier related Legal Update.

2 The BCBS notes that the specified approach refers to the Current Exposure Method (CEM) under Basel II and that it is considering alternatives to the CEM.

3 See p. 11 of the full text for the template.

4 A template for LCR common disclosure is also included in the standards at p. 4.

5 See Annex 1 included in the standards for an explanation of the disclosure template.

6 See our earlier related Legal Update for a description of the US LCR implementation proposal.

NOTES

1 Meeting all requirements under Basel III and only including amounts after any transitional arrangements have expired under fully implemented Basel III (i.e., as in 2022).

2 Unless otherwise specified, references to paragraphs in these Annexes are to numbered paragraphs in the BCBS consultative document for the NSFR.

3 Defined in LCR paragraphs 75-78.

4 Defined in LCR paragraph 73.

5 Defined in paragraph 273 of the Basel II framework.

6 Defined in LCR paragraphs 79-81.

7 Defined in LCR paragraph 73.

8 Defined in paragraph 273 of the Basel II framework.

9 Defined in LCR paragraphs 93-104.

10 Defined in LCR paragraph 50.

11 Defined in LCR paragraph 52

12 As defined and subject to the conditions set forth in LCR paragraph 54.

13 As defined in the LCR.

Structuring Credit Facilities for Defined Contribution Plan Funds

Over the last ten years, there has been a steady trend transition from defined benefit plans to defined contribution plans. As further evidence of this trend, as recently as the end of the fourth quarter of 2013, defined contribution plan ("DC") assets amounted to $5.9 trillion, compared to just $3.0 trillion in assets for private-sector defined benefit ("DB") plans.[1] At the same time, DC plan fiduciaries are seeking to achieve the historically higher returns of DB plans by venturing into alternative investments (real estate, private equity and hedge funds). In the face of the large amounts of capital now being funded to DC plans and the desire by DC plan fiduciaries to improve returns, fund sponsors have been actively courting such DC plans and establishing investment vehicles tailored to the needs of such DC plans (such investment vehicles are referred to herein generally as "DC Funds").

Access to a line of credit offers a number of benefits to both DC plan fiduciaries and DC Fund sponsors. A credit facility can help DC plan fiduciaries and DC Funds manage the daily liquidity required by DC plan participants and fiduciaries, as well as provide bridge capital to fund DC Fund investments. While alternative investments (real estate, private equity and hedge funds) are typically illiquid, the higher rates of return offered by such investments may offset the risks to DC plans and fiduciaries caused by such illiquidity, particularly when a credit facility can mitigate much of the illiquidity concerns.

This Legal Update provides background on a number of issues for DC Fund sponsors and for lenders (each, a "Lender") in connection with a credit facility to a DC Fund (such credit facilities referred to herein generally as "Facilities"). It also proposes structural solutions for certain of those issues.

Facility Size and Uses

Compared to credit facilities provided to typical private equity funds or private equity real estate funds, Facilities for DC Funds tend to be rather small in relation to the total size of the DC Fund. While Facilities may vary, they are often 10-20% of the total DC Fund size. While there is potential for Facilities to grow in size relative to DC Fund size as Lenders get more comfortable lending to DC Funds and DC Funds continue to find new ways to take advantage of the liquidity provided by a Facility, limitations on collateral (discussed below) and the DC Fund's need for liquidity may prevent such Facilities from reaching the relative size of credit facilities traditionally sought by other types of private equity funds or real estate funds.

Historically, DC Funds have relied upon Facilities primarily for standby funding to match redemption requests of DC plan participants to the timing of redemption windows of the DC Fund's underlying investments. Accordingly, such Facilities have generally been used infrequently, and have not typically maintained long-term outstanding balances beyond redemption windows of the DC Fund's underlying investments. For DC Funds that have longer track records and historically reliable streams of participant cash in-flows, Facilities could potentially be

used to fund investments in advance of capital contributions from DC plan participants. Fiduciary concerns related to increased leverage and potential losses for DC plan participants, however, may prevent the use of Facilities as a means to further leverage investments.

Structuring / Security Issues

BORROWER STRUCTURES

DC Funds rely on a number of different legal structures and pooling vehicles, including separate managed accounts, collective investment trusts and insurance company separate accounts. A description and summary of these structures and vehicles is beyond the scope of the Legal Update, but it is important to recognize that each of these structures and vehicles carries distinct legal consequences that shape a Facility's structure. It is important for Lenders to fully understand the relationship between DC Funds and the actual borrower under the Facility. Some structures used by DC Funds do not utilize a separate legal entity for the borrower, rather the borrower consists solely as a specific set of assets or funds within a larger legal entity. It is important to consult with legal counsel not only to ensure that Lenders have sufficient legal recourse with respect to a Facility's borrower, but also to protect corporate formalities of the DC Fund related to distinct pools of assets belonging to one or more related legal entities.

SECURITY AND COLLATERAL

While a subscription-backed credit facility looks to a fund's investors for repayment and as the ultimate collateral, the participant-funded nature of DC Funds is not compatible with such an approach.[2] Instead, Lenders can rely upon a variety of security packages tied to a DC Fund's investments for collateral. Collateral packages for Facilities typically fall into three categories: illiquid investments, liquid investments and distributions proceeds. A pledge of illiquid investments, such as interests in private equity funds, real estate funds or hedge funds may be complicated by transfer restrictions applicable to such interests. Moreover, any such pledge may also require additional consents from third-party entities. An indirect pledge of such interests could be structured with a pledge of the equity of an aggregating vehicle that holds such underlying investments. Careful review of the underlying investment documentation must then be undertaken to ensure that the indirect pledge does not breach any transfer restrictions or require any third-party consents.

In addition to illiquid investments, DC Funds typically hold certain liquid investments in the form of cash/cash equivalents or other liquid securities. DC Funds rely upon such liquid investments to support liquidity requirements of DC plan participants and to aggregate cash in-flows pending new investments. Liquid investments are unlikely to be subject to transfer restrictions or consent requirements and, to the extent such liquid investments are held in one or more securities accounts with the Lender, perfecting rights in the collateral is usually straightforward.

Lastly, the collateral package could include a pledge of distribution proceeds from a DC Fund's underlying investments, along with one or more account(s) held with the Lender into which such proceeds are deposited. Again, careful review should be undertaken to ensure that such a pledge does not breach any of the underlying investment documentation.

Of course, given the creditworthiness of the borrower, the reliability of DC plan contributions, the value of the underlying DC Fund investments and the multiple sources of repayment, a Lender may also be comfortable offering a Facility on an unsecured basis.

ERISA CONCERNS[3]

Facilities for DC Funds may present different ERISA[4] concerns as compared to credit facilities for more traditional private equity funds or real

estate funds. Unlike other fund-financing products where ERISA issues are focused on seeking comfort that loan parties will not be deemed to hold "plan assets,"[5] DC Funds, by their nature, may hold "plan assets" and accordingly are subject to ERISA, including ERISA's prohibition on party-in-interest transactions. In a Facility, the primary concern under ERISA arises with respect to any relationships between the Lender, the DC Fund itself and/or the underlying DC plans taking part in DC Funds, due to the fact that such relationships may give rise to prohibited transaction excise tax penalties for the Lender.

Conclusion

While to date Facilities for DC Funds have been relatively rare, as more fund sponsors seek to establish DC Funds, the opportunity is ripe for new market participants. With a careful review of the legal structure of a DC Fund, including with respect to the borrowing entity for the Facility, and attention to the collateral package, a Facility can be structured to provide important and often vital liquidity to a DC Fund while still satisfying the Lender's credit criteria. Please contact any of the authors with questions regarding DC Funds and the various structures for effectively establishing Facilities for such entities. ◆

Endnotes

1. Investment Company Institute, "The US Retirement Market, Fourth Quarter, 2013." Table 1.
2. For a more detailed description of the subscription facility market and features of the subscription credit facility product in general, please see "*Summer 2013 Market Review*," *Fund Finance Market Review*, Mayer Brown, Summer 2013, on page 19.
3. For a general description of ERISA issues related to lending to real estate, private equity and other investment funds, please see "Subscription Credit Facilities: Certain ERISA Considerations," *Fund Finance Market Review*, Mayer Brown, Summer 2013, on page 38.
4. Employee Retirement Income Security Act of 1974, as amended, and the rules and regulations promulgated thereunder by any US governmental authority, as from time to time in effect.
5. "Plan Assets" has the meaning given in 29 C.F.R. §2510.3-101, *et seq.*, as modified by Section 3(42) of ERISA.

US Securities and Exchange Commission Clarifies and Expands Its Interpretation of "Knowledgeable Employee" Under the US Investment Company Act

On February 6, 2014, the Staff of the Division of Investment Management of the Securities and Exchange Commission ("SEC") issued the Managed Funds Association (the "MFA) a no-action letter (the "MFA Letter") clarifying and expanding the SEC's interpretation of the defined term "Knowledgeable Employee" in Rule 3c-5 under the Investment Company Act of 1940 (as amended, the "Investment Company Act").

Many hedge funds, private equity funds, and other types of pooled investment vehicles rely on exclusions from the definition of "investment company" provided under Sections 3(c)(1) or 3(c)(7) (each, a "Covered Fund") of the Investment Company Act. Rule 3c–5 under the Investment Company Act permits a knowledgeable employee of such Covered Funds, and a knowledgeable employee of certain Affiliated Management Persons,[1] to invest in a Covered Fund that relies on Section 3(c)(1) without being counted toward the 100-person limit imposed upon a Section 3(c)(1) fund. The rule also permits such employees to invest in a Covered Fund that relies on Section 3(c)(7) without having to be a qualified purchaser with respect to a Section 3(c)(7) Fund and without being counted for purposes of determining whether a Section 3(c)(7) fund is owned exclusively by qualified purchasers.

Rule 3c–5 defines the term "knowledgeable employee" to include two categories:

- "Executive officers," which term includes the "president, any vice president in charge of a principal business unit, division or function (such as sales, administration, or finance), and other officers who performs a policy making function, or any person who performs similar policy making functions" for a Covered Fund or an Affiliated Management Person of the Covered Fund; and
- Non-executive employees (other than those performing solely clerical, secretarial or administrative functions) who regularly participate in the investment activities of a Covered Fund or an Affiliated Management Person of a Covered Fund, provided such employee has been performing such functions and duties on behalf of the Covered Fund or Affiliated Management Person or substantially similar functions or duties for or on behalf of another company for least 12 months.

Principal Business Units

In respect of whether an activity or function rises to the level of principal status, the SEC Staff confirmed its view that:

- The principal status of an adviser's unit, division, or function depends on the relevant facts and circumstances of a particular investment manager's business operations;

- Several business units, divisions, or functions within an adviser may each be considered a principal unit, division, or function; and
- The unit, division, or function of an adviser need not be part of the investment activities of a Covered Fund to be considered a principal unit, division, or function.

While the Staff's confirmation of these considerations is helpful, perhaps more notable is the Staff's stated belief that Rule 3c–5 is intended to provide "flexibility in determining whether an individual is in charge of a principal business unit, division, or function." In its request letter, the MFA suggested that activities could be "principal" if they were "high value" and integral to the investment manager's operations. Certain examples were provided by the MFA in respect of certain information technology ("IT") and investor relations functions, including, in the case of IT professionals, professionals (i) charged with building models and systems that translate into certain quantitative trade orders and (ii) who build performance and risk monitoring systems that interact with the investment program.

An investor relations function could be a principal unit if investor relations personnel conduct substantive portfolio reviews with investors and respond to substantive due diligence inquiries. The Staff agreed that such functions could be determined to be "principal," while reiterating the fairly direct and critical ties to the investment manager's investment program and investor due diligence, as opposed to inconsequential assistance.

The Staff's guidance also seems to provide that the heads of certain functions may qualify as knowledgeable employees in addition to the heads of the business units in which they report. For instance, if IT reports to operations, and investor relations to the sales department, the heads of IT and investor relations may potentially qualify as knowledgeable employees in addition to an investment manager's chief operating officer and director of sales and marketing.

Further, the flexibility shown by the Staff, together with a framework for arguing that other functions may be integrally involved with the investment program, may prove particularly beneficial for smaller, flatter organizations where a certain individual may supervise few, if any, others, or may be the only individual (and, by default, the executive officer) leading such function. It is important to emphasize, however, that merely acting in such capacities alone will not make an individual a "knowledgeable employee." The Staff indicated that such individuals "could" be determined to be knowledgeable employees, which is intended to emphasize that status alone will not make an individual a knowledgeable employee. A separate and independent determination is required to be made that such persons generally have such financial knowledge and sophistication and sufficient access to information about the Covered Fund in question in order to understand the strategy and risks inherent in such investments. As noted by the SEC Staff, an investment manager should be able to explain "the basis in [Rule 3c–5] pursuant to which the employee qualifies as a knowledgeable employee."

Policy-Making Functions

With regard to policymaking functions, the MFA Letter essentially provides clarity around a "function over title" approach: regardless of their titles, employees can have a policy-making function and can meet the relevant standard either individually or as part of a committee or group. The MFA Letter clarifies that an employee need not even be an "officer" per se, and that policy-making may be viewed broadly, and can include active members of a group or committee that develops and adopts a manager's policies, such as a valuation committee. Such logic arguably might be extended to active members of other committees, including best execution, risk, operating and other committees that make policies on behalf of the investment manager, which may potentially significantly increasing the pool of potential knowledgeable employees.

Participation in Investment Activities

The MFA Letter significantly expands the SEC Staff's guidance set forth in the 1999 no-action letter addressed to the American Bar Association (the "ABA Letter"). In the ABA Letter, the SEC stated that Rule 3c–5 is intended to cover non-executive employees only if they actively participate in the investment activities of the Covered Fund and certain other investment companies. The SEC further stated that the rule is intended to encompass persons who actively participate in the management of a fund's investments, and not employees who merely obtain information regarding the investment activities of these funds.

The Staff noted that analysts, who research all potential portfolio investments and provide recommendations to the portfolio manager, could be determined to be knowledgeable employees. The Staff also noted that non-executive marketing and investor relations professionals, attorneys (even those who provide advice with respect to, or who participate in, the preparation of offering documents and the negotiation of related agreements), certain brokers and traders affiliated with the Covered Fund or an Affiliated Management Person, and financial, compliance, operational and accounting officers of a fund (including those who have management responsibilities for compliance, accounting and auditing functions of funds) would not qualify as knowledgeable employees under Rule 3c–5.

The MFA Letter makes clear that research analysts may qualify as knowledgeable employees, even if they provide analysis or advice to a portfolio manager with respect to only a portion of a Covered Fund's portfolio (as opposed to the entire portfolio, which was suggested in the ABA Letter) and, importantly, that certain non-investment, non-executive personnel may qualify as knowledgeable employees if they regularly participate in the management of a Covered Fund's portfolio (or a portion thereof).

While the ultimate determination is based on facts and circumstances, and must be made on a case-by-case basis, the SEC Staff noted explicitly that the following non-investment personnel may be knowledgeable employees:

- A member of the analytical or risk team who regularly develops models and systems to implement a Covered Fund's trading strategies by translating quantitative signals into trade orders or providing analysis or advice that is material to the investment decisions of a portfolio manager[2] (in contrast to someone who merely writes the code to a program used by the portfolio manager);
- A trader who is regularly consulted for analysis or advice by a portfolio manager during the investment process and whose analysis or advice is material to the portfolio manager's investment decisions based on the trader's market knowledge and expertise (in contrast to a trader who simply executes investment decisions made by the portfolio manager);
- A tax professional who is regularly consulted for analysis or advice by a portfolio manager typically before the portfolio manager makes investment decisions, and whose analysis or advice is material to the portfolio manager's investment decisions, such as when a tax professional's analysis of whether income from an offshore fund's investment may be considered "effectively connected income" is material to a portfolio manager's decision to invest in certain debt instruments (in contrast to a tax professional who merely prepares the tax filings for the Covered Fund); and
- An attorney who regularly analyzes legal terms and provisions of investments, and whose analysis or advice is material to the portfolio manager's investment decisions, such as where the attorney's legal analysis of tranches of a distressed debt investment is material to a portfolio manager's decision to invest in the loan (in contrast to an attorney who negotiates agreements that effectuate

transactions evidencing the investment decisions of the portfolio manager or an attorney or compliance officer who evaluates whether an investment is permitted under a Covered Fund's governing documents).

Treatment of Separate Accounts

The MFA Letter also provides that an employee can be regarded as participating in the investment activities of a Covered Fund if his or her functions relate to a portfolio, or portion of a portfolio, of a separate account for clients that are "qualified clients" and are otherwise eligible to invest in the private funds managed by the adviser and whose accounts pursue investment objectives and strategies that are substantially similar to those pursued by one or more of those private funds.

Employees of Relying Advisers in Control Relationships

The MFA Letter provides that knowledgeable employees of a filing adviser, or any of its relying advisers (as set out in the ABA's 2012 no-action letter regarding which adviser entities have to file a Form ADV), may be treated as a knowledgeable employee with respect to any Covered Fund managed by the filing adviser or its relying advisers, provided that the employees meet the other conditions of the rule.

Other Employees

The SEC Staff emphasized that employees of an adviser other than those described in the MFA Letter may also qualify as knowledgeable employees for purposes of Rule 3c–5 depending on the relevant facts and circumstances relevant to an investment manager's particular business. ◆

Endnotes

1. The term "Affiliated Management Person" is defined in Rule 3c–5 to mean an affiliated person that manages the investment activities of a fund relying on Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act. The SEC Staff has also permitted Section 3(c)(1) and Section 3(c)(7) funds to treat employees who participate in the investment activities of a company that is excluded from the definition of investment company by Section 3(c)(2), 3(c)(3) or 3(c)(11) as a knowledgeable employee. See PPM America Special Investments CBO II, L.P. SEC No-Action Letter (pub. Avail. April 16, 1998) and the ABA Letter.

2. Whether an individual provides analysis or advice that is material to the investment decisions of a portfolio manager is a facts-and-circumstances determination based on whether a reasonable person would consider such analysis or advice to be important to the investment decision. See *TSC Industries, Inc. v. Northway, Inc.*, 426 US 438 (1976). Generally, however, the analysis or advice must be material to the merits of buying, selling, or holding an investment. The SEC Staff does not believe that reviews, analysis or advice as to whether a potential investment is merely eligible for investment by the Covered Fund would be material to the investment decisions of a portfolio manager.

Does Volcker + Vickers = Liikanen?

EU Proposal for a Regulation on Structural Measures Improving the Resilience of EU Credit Institutions

1. On 29 January 2014 the European Commission published a proposal for a regulation of the European Parliament and of the Council "on structural measures improving the resilience of EU credit institutions."[1] This proposed legislation is the EU's equivalent of Volcker[2] and Vickers.[3] It was initiated by the Liikanen report[4] published on 2 October 2012 but the legislative proposal departs in a number of ways from the report's conclusions. There are two significant departures: the legislative proposal contains a Volcker-style prohibition, which also departs from the individual EU Member States' approach and, although the proposal contains provisions which mirror the Vickers 'ring-fencing' approach, they are not, in direct contradiction to Liikanen's recommendation, mandatory.

Background

2. Post financial crisis, various jurisdictions have started to overhaul bank regulation and supervision. Bank structural reform is part of that agenda and involves separating retail and commercial banking from wholesale and investment banking, as well as outright prohibitions. The objective is to protect core banking activities and depositors from the 'riskier' trading activities, which have been deemed as 'socially less important', by reducing the risk of contagion spreading from trading activities to traditional retail banking and protecting the deposits of individuals and small businesses in the case of bank failure. In addition, bank structural changes are intended to reduce complexity and so improve the resolvability of banking groups. The EU has been concerned about banks which it terms "too big to fail," "too big to save" and "too complex to manage, supervise and resolve." It has been concerned that failure of these banks would be detrimental to the financial system in the EU as a whole. The EU also believes that these banks have an unfair advantage over smaller banks: it believes that the presumption that they would be bailed out rather than be allowed to fail provides an implicit guarantee which impacts their funding costs and leads to moral hazard and excessive risk-taking. These concerns and beliefs have led to a variety of legislative proposals and legislation.

3. Different jurisdictions have taken different approaches to bank structural reform. Reference has already been made to the UK and US legislation but France[5] and Germany[6] have also adopted legislation and the Belgian coalition government reached a political agreement in December 2013 on structural reform of its banking sector which it aims to finalise before elections in May 2014.[7] One of the fundamental differences between the US and the approaches of the individual EU Member States has been the US preference for prohibition (or owner separation) as opposed to the EU Member States' preference for ring-fencing (or functional separation/subsidiarisation). This difference means that the activities which the US has prohibited cannot be carried out within a banking group at all whereas the activities on which the EU Member States have focused can be carried out within a distinct trading entity which is separate from the retail and commercial bank entity. The EU's legislative proposal, by including elements of both approaches, blurs this distinction and creates a third approach to bank structural reform which is consistent with neither the US approach nor the approaches of the individual EU Member States.

4. The second significant difference in the approaches taken to date relates to the activities which the different jurisdictions have regulated. Broadly speaking, the US approach has prohibited proprietary trading, sponsoring private equity and hedge funds (known as "covered funds"), investing in covered funds and loans (known as "covered transactions") to covered funds with which the banking group is involved. Proprietary trading is defined widely but there are a number of helpful exclusions and exemptions which narrow the scope of the prohibition, including a number of exclusions and exemptions to reduce the extraterritorial impact on non-EU banks, although, of course, there are conditions with which compliance is necessary before reliance can be placed on the exclusions and exemptions. There are similar exclusions and exemptions relating to the prohibitions on sponsoring and investing in covered funds and on covered transactions with covered funds. The Volcker rule is examined in detail in our legal reports "Final Regulation Implementing the Volcker Rule"[8] and "The Volcker Rule—Application to Securitization Transactions."[9]

5. The UK approach (Vickers) focuses on a wider range of investment and wholesale banking. By prohibiting deposit-taking entities from 'dealing in investments as principal,'[10] it requires most of the derivative and trading activity currently carried out by wholesale and investment banks to be carried out by a trading entity wholly separate from the retail bank. The French and German approach follow the ring-fencing approach of the UK but, like the US, have a narrower focus. Their approaches reflect the agreement reached by the two countries to push forward arrangements in the EU for the separation of "speculative activities" from deposit-related and customer-orientated activities. Thus the French legislation provides that proprietary trading and unsecured financing to alternative investment funds ("AIFs") above a certain threshold (the "speculative activities") must be carried out by a trading subsidiary separate from the retail banking entity. Similarly, the German legislation specifies certain high-risk activities (above a certain threshold in terms of overall trading activity), including proprietary trading, credit and guarantee business with certain AIFS (or equivalent funds which are high-leveraged or engaged in short selling) and certain forms of trading in one's own name with the exception of market-making that must be ring-fenced and transferred to a separate trading entity.

6. Finally and amongst those jurisdictions that have chosen the ring-fencing approach, there is some difference in the strength of the ring-fence or the degree of functional separation required. The UK requires the ring-fenced body ("RFB") to be legally, economically and operationally independent, to interact with the rest of the banking group on an arm's length basis and to have its own capital and liquidity resources. The Prudential Regulation Authority ("PRA") will make additional rules to ensure the integrity of the ring-fence and the independence of the RFB. The German legislation requires the RFB to be legally, economically and operationally independent, to interact with the rest of the banking group on an arm's length basis and to have its own capital and liquidity resources, but does not give any guidance on how this should be achieved or should interact with German corporate law.

Liikanen...But Not As We Knew It

7. At the same time as individual jurisdictions were considering bank structural reform to deal with the issues summarised at paragraph 2 above, the EU was considering action, believing that inconsistent national legislation increases the possibility of distortions of capital movements and investment decisions, serves to make the structure and operation of cross-border banks more complex and increases fragmentation. In February 2012, the Commission established a High-level Expert Group to examine possible reforms to the structure of the EU's banking sector, appointing Erkki Liikanen, Governor of the Bank of Finland and a former member of the European Commission, as the chairman. The Group presented its final report to the Commission on 2 October 2012, the Commission examined the possible reform options and their implications and, on 29 January 2014, it adopted a proposal for a regulation on structural measures improving the resilience of EU credit institutions plus a proposal on transparency of securities financing transactions aimed at increasing transparency in the shadow banking sector. This note focuses on the former proposal.
8. The UK government had considered adding a Volcker-style prohibition to the Vickers ring-fence established in the Banking Reform Act 2013 but rejected it because of concerns that defining proprietary trading as opposed to activities such as market-making was too problematic, the "technical challenges" that the US was experiencing in implementation and the fear that it would distract regulatory attention from the ring-fence. The EU, however, clearly did not share these concerns as their proposal departs from the approach taken by individual EU Member States and contains a Volcker-style prohibition, as well as provisions on ring-fencing. The main points of note are set out in the table below.

The main provisions of the EU proposal:

Scope

(a) It is proposed that the Volcker-style rule will apply to:
   (i) EU G-SIIs (and all their branches and subsidiaries regardless of their location); and
   (ii) banks that for three years have total assets of at least 30 billion euro and trading assets of 70 billion euro or 10% of total assets.

(b) The proposal does not make ring-fencing mandatory but requires national regulators to consider the possibility in relation to each individual deposit-taking bank (termed "core credit institution") depending upon its risk profile. There is a wide definition of core credit institution.

(c) The EU proposal intends to have extraterritorial effect and apply to non-EU subsidiaries of EU banks, as well as effectively to non-EU banking groups with EU branches, unless the Commission deems the relevant non-EU

jurisdiction equivalent to the EU regime but, although the stated intention is to create a level playing field in the EU, these provisions raise questions of legality and enforcement. National regulators may exempt a non-EU subsidiary of an EU bank from the ring-fencing requirements of the EU proposal in the absence of an equivalence decision if the relevant national regulator is satisfied that the subsidiary's resolution strategy has no adverse effect on the financial stability of the Member State(s) where the parent and other group entities are established. There is no such additional exemption for EU branches of non-EU banks or in respect of the Volcker-style prohibition.

The Rules

(d) The EU Volcker-style rule prohibits proprietary trading (which is said to be narrowly defined), investments in AIFs save for closed-ended and unleveraged AIFs and investments in other entities which themselves engage in proprietary trading or investment in AIFs. This rule is considered in more detail at paragraphs 9–19 below.

(e) Unlike Liikanen, the EU proposal does not make separation of trading activities from retail and commercial banking mandatory. Instead it provides that national regulators must consider separation of trading activities (which is very widely defined to include almost all activities save those related to retail and commercial banking) from retail and commercial banking depending on the risk each individual core credit institution presents. The assessment of risk will be carried out on the basis of metrics set out in further legislation drafted by the European Banking Authority ("EBA") and the Commission. Where the risk levels are exceeded and the national regulator determines that there is a threat to financial stability then the national regulator must impose a ring-fence on that particular bank, unless the bank can demonstrate that the regulator's conclusions are not justified. These provisions are considered in more detail at paragraphs 20–39 below.

Individual Member State Derogations

(f) The Commission may grant individual deposit-taking banks within Member States (not individual Member States) a derogation from the ring-fencing requirements set out in the proposal where national legislation is equivalent to the EU legislation. At the time of writing, it appears that only the UK legislation is likely to meet the requirements of equivalence but that may depend on secondary legislation, which the UK has yet to adopt, which will provide the technical detail of the Vickers rule.

Timing

(g) On the basis that the final text of the Regulation is adopted by the European Parliament and Council by June 2015, it is proposed that the provisions will be phased in over a number of years: the Volcker-style prohibition will come into effect on 1 January 2017 and the provisions on ring-fencing will come into effect on 1 July 2018.

The Volcker-Style Prohibition

9. The introduction of a prohibition on proprietary trading, investment in AIFs and certain other entities is a major departure from the Liikanen recommendations. As noted above, none of the EU Member States which have introduced legislation to address bank structural reforms have adopted a Volcker-style prohibition. Although the US legislation is clearly the influence behind the provisions, the Commission has not taken exactly the same approach as Volcker.

Scope

10. The first thing to note is that, unlike the US rule, the EU Volcker-style rule is not intended to apply to all deposit-taking institutions. It is intended to apply to around 30 of the largest banks in the EU, those being:

(a) EU G-SIIs (and all their branches and subsidiaries regardless of their location); and

(b) banks that for 3 consecutive years have had total assets of at least 30 billion euro and trading assets of 70 billion euro or 10% of total assets.

The rule is intended to apply to the following entities within category (b):

(i) EU banks which are neither parent institutions nor subsidiaries, plus all their branches regardless of their location;

(ii) EU parent institutions, plus all their subsidiaries and branches regardless of their location, when one of the group entities is an EU banks; and

(iii) EU branches of non-EU banks.

The intention appears to be that the assessment of total assets and trading assets is made at each individual entity level, including at branch level,[11] rather than that an assessment should be made on a consolidated basis. It appears that the presence of an EU bank within a group could bring entities whose assets would not otherwise have to be assessed within the scope of the EU prohibition. The proposal contains some detail on how trading activities are to be calculated and the EBA shall be mandated to draft legislation to set out the exact methodology.

11. The EU prohibition will not apply to non-EU subsidiaries of EU banks and to EU branches of non-EU banks if the Commission deems the relevant non-EU jurisdiction equivalent to the EU regime. In considering equivalence, however, the Commission will look at whether the non-EU jurisdiction has requirements equivalent to both the Volcker-style and ring-fencing provisions. It is questionable whether any jurisdiction has requirements equivalent to both these provisions in the draft EU legislation. Like the Volcker rule, the effect of the EU rule is to prevent the prohibited activities being carried out within the banking group in its entirety. Thus bringing EU branches of non-EU banks within the scope of the EU prohibition is an attempt to bring the entire non-EU banking group within scope, unless it has equivalent legislation which is not currently likely. Whereas the objective is sensible — to create a level playing field in the EU and not give non-EU banking groups a competitive advantage — this raises questions and could precipitate a clash with the US, particularly if the EU rule imposes additional or different prohibitions to the Volcker rule.

12. Without an equivalent decision, the draft EU legislation provides that its Volcker-style prohibition will apply to non-EU subsidiaries of EU banks and effectively to non-EU banking groups that have an EU branch, within scope, but such purported extraterritorial application raises questions as to its legality and enforcement. In order for the prohibition to be effective, it, like the US Volcker prohibition, must apply throughout the whole banking group. How this will be applied to banking groups headquartered outside the EU and, arguably, subsidiaries established outside the EU is far from clear, particularly if there are significant differences with Volcker. It is also worth noting that the UK and the Council Legal Services have questioned the purported extraterritorial application of other recent pieces of EU legislation. In its legal challenge to the remuneration provisions of CRD IV,[12] the UK has alleged that, to the extent that the cap on bankers' bonuses is required to be applied to employees of institutions outside the EU, it infringes Article 3(5) of the Treaty on European Union and the principle of territoriality found in customary international law.[13] A similar issue is currently being debated in the context of the financial transaction tax. The UK has issued proceedings arguing the decision permitting the adoption of the tax by a subset of the EU is unlawful because it authorises the adoption of an FTT with extraterritorial effects for which there is no justification in customary international law[14] and the Council Legal Services has supported this argument. Thus the

question of extraterritorial application is likely to be a contentious issue in the context of this dossier also.

The Prohibitions: Proprietary Trading

13. Chapter II of the proposal prohibits the largest banks and entities within their group from carrying out the following:

    (a) proprietary trading, which is defined as using own capital or borrowed money to purchase, sell or otherwise acquire or dispose of a financial instrument or commodity "for the sole purpose of making a profit for own account, and without any connection to actual or anticipated client activity or for the purpose of hedging the entity's risk as a result of actual or anticipated client activity" through specifically dedicated desks, units, divisions or individual traders;

    (b) with their own capital or borrowed money and for the sole purpose of making a profit for own account:

        (i) acquiring or retaining units or shares in AIFs;

        (ii) investing in financial instruments the performance of which is linked to shares or units in AIFs; and

        (iii) holding any units or shares in an entity that engages in proprietary trading or acquires units or shares in AIFs.

There are some very limited exemptions to both the prohibitions at (a) and (b) above.

14. The Commission has indicated that it has learned from the US experience of implementing the Volcker rule. Rather than adopting a wide definition of proprietary trading with a number of specific exclusions and exemptions, it claims to have opted for a narrow definition with limited exclusions. Careful analysis will be required to assess both whether the definition is as narrow as the Commission claims and whether the EU approach achieves the same result as the more detailed Volcker rule.

15. The narrow definition of proprietary trading is intended to satisfy France and Germany who were concerned to ensure that market-making was not restricted. It appears that both underwriting market making and it would fall out with the definition of proprietary trading as it will be argued that they are connected to client activity and does not have the sole purpose of making a profit for the bank. Trading in EU sovereign debt is expressly permitted.[15] Entities can also trade in cash or defined cash equivalent assets (money market instruments) if they use their own capital as part of their cash management processes but concerns have been expressed that it does not seem that securities transactions for the purpose of liquidity management and riskless principal transactions will be permitted. Hedging for own purposes is permitted but only as set out in the definition of proprietary trading and so is limited to hedging as a result of actual or anticipated client activity.

16. The differences in approach between the US and EU rules are marked. The US approach is more sophisticated and consists of detailed and lengthy rules setting out exclusions and exemptions individually tailored to specific activities and situations, as well as the conditions with which there needs to be compliance in order to rely on the exclusions and exemptions. Setting out so much detail has been both challenging and time-consuming. It has also led to some unforeseen, and perhaps unintended, consequences. The EU approach is the diametric opposite: it consists of about a page and a half of relevant rules. Interestingly, there is no provision in the draft for significant level 2 legislation to add further detail to the high-level prohibitions set out in the proposal.

17. It could be said that the EU has taken a more pragmatic approach, opting for a principle-based, as opposed to the US rule-based, approach. It could be argued that a vast range of activities which could otherwise fall under the heading of 'proprietary trading,' including securities transactions for the purpose of liquidity management, riskless principal transactions and hedging activities, are ultimately connected to actual or anticipated client activity, even if indirectly. The lack of specified exemptions and exclusions in the EU rule could be said to create uncertainty and the possibility of regulatory arbitrage, as much will depend on individual national regulator's interpretation of the provisions, and to require individual consideration of each bank's different activities but it does give banks a degree of latitude and flexibility by not setting out a finite set of permitted activities. This lack of certainty may make it difficult to draw exact comparisons with the Volcker rule in the abstract and in the absence of some indication as to how broadly — or narrowly — the national regulators will enforce the EU prohibitions.

The Prohibitions: Investment in AIFs and Other Specified Entities

18. In order to prevent evasion of the prohibition on proprietary trading, the proposal also provides that banks subject to the prohibition are prohibited from using their own capital or borrowed money to invest in or hold shares in AIFs (or certificates/derivatives linked to such shares) or entities that themselves engage in proprietary trading or invest in AIFs. The sole purpose of the banks' activity must be to make a profit for their own account: this provision may give some additional flexibility. Unleveraged and closed-ended AIFs established in the EU or, if not established in the EU, marketed in the EU (arguably mainly private equity funds), venture capital funds, social entrepreneurship funds and the proposed European Long-Term Investment Funds are exempted from this prohibition as they are regarded as supporting the financing of the real economy. The Commission has stated that this provision is targeted at hedge funds but, as drafted, it has a far wider application as it would capture all leveraged and open-ended AIFs (plus AIFs which are unleveraged but not closed-ended) which could include, for example, a real estate fund, a fine art or wine fund, a retail investment fund or an investment company which is established or marketed in the EU. Banks to which these EU prohibitions apply will be able to continue providing banking/custody services to the AIFs within the scope of the prohibition.

19. Although the second prohibition again appears to have been mirrored on Volcker, there are disparities. The potential exemption of private equity funds from the prohibition is in direct contrast to the Volcker rule which prohibits investment in private equity and hedge funds. There is no equivalent in the EU rule to the Volcker prohibition on covered transactions with covered funds with which the banking group has other relationships. Further, the EU legislation does not, unlike earlier drafts and the Volcker rule, prohibit the sponsorship of AIFs. On the other hand, the limited exclusions as opposed to the myriad US exclusions and exemptions, means that this investment prohibition appears to go further than the Volcker rule in certain respects. In addition, and in a broader fashion than the Volcker rule, the EU rule has an indirect effect: it prohibits investment in any entity that itself engages in proprietary trading or invests in AIFs. This

provision is exceptionally wide and its practical effect is questionable: it is not clear whether the Commission expects banks to carry out extensive due diligence of all entities into which they have already invested or into which they are considering investing. These disparities will be of particular concern to those banks — for example, EU branches and subsidiaries of US banks and US branches and subsidiaries of EU banks but also other third-country banks with a presence in both the EU and US — which are likely to have to comply with both Volcker and the EU prohibitions.

The Ring-Fencing Provisions

20. The discretionary nature of the ring-fencing provisions is another departure from the Liikanen Report. Chapter III of the proposal only mandates national regulators to review the trading activities of each individual deposit-taking bank (termed "core credit institution") in the EU and decide whether those activities create a threat to the financial stability of the core credit institution ("CCI") itself or to the EU financial system as a whole.[16] If so, the national regulator must prohibit the CCI from carrying out the specific risky trading activities, unless that institution convinces the regulator that such a decision is not justified. Such a decision would not prevent the identified trading activities being carried out elsewhere within the banking group.

Scope

21. A significant difference between the EU rules on ring-fencing and the UK legislation is that the EU rules are generally intended to apply to all banks that take deposits eligible under the Deposit Guarantee Scheme as provided for in the Deposit Guarantee Schemes Directive.[17] This includes all deposits held by individuals and small, medium and large businesses but not financial institutions and public authorities. The UK approach has been to apply its ring-fencing legislation to deposit-taking banks but it intends to exempt the deposits of specified types of depositors in secondary legislation, as well as provide for a de minimis exemption. The draft secondary legislation provides that deposits of high net worth individuals who have chosen to deposit outside the ring-fence, deposits of large organisations and deposits of other financial institutions are not 'core deposits.' The EU approach is, therefore, to protect a wider range of deposits than the UK which may cause a problem when the UK seeks to apply for a derogation — see paragraphs 35–39 below.

22. As with the Volcker-style prohibitions, these provisions have extraterritorial effect. In the same way as set out at paragraph 10 above, they are intended to apply to an EU parent, and all its branches and subsidiaries regardless of their location, of a CCI, as well as to an EU branch of a non-EU bank.[18] Thus the same issues as described in paragraphs 11 and 12 above apply. Non-EU subsidiaries of EU banks and EU branches of non-EU banks will be exempt from the ring-fencing provisions if the Commission has made an equivalence decision regarding the non-EU jurisdiction: we have already commented (at paragraph 11 above) on the likelihood of an equivalence decision given that it demands equivalence as to Chapter II (the EU Volcker-style prohibition) and Chapter III (the ring-fencing provisions). There is an additional option, however, for non-EU subsidiaries of EU banks: a national regulator may exempt the subsidiary if it is satisfied that there is a group-level resolution strategy agreed between the EU group level resolution authority and the third country authority and that strategy for the subsidiary does not have an adverse effect on the financial stability of the Member State(s) where the EU parent and other group entities are established. This

exemption, therefore, necessitates the cooperation of the relevant EU resolution authority, although it does not make clear which authority ought to make the discretionary decision as to the effectiveness of the resolution strategy.

The Potential Ring-Fencing of Certain Trading Activities

23. National regulators appear to be given a significant degree of discretion in Chapter III. This does raise the issue of inconsistent approaches[19] but the discretion conferred on regulators is not as wide as it initially appears. National regulators are required to assess the trading activities of CCIs. A wide definition of "trading activities" is given so that it essentially means all activities other than taking deposits eligible for deposit insurance, lending, retail payment services and a number of other retail and commercial banking activities. Trading in EU sovereign debt is exempt from the obligation to review (and thus the power to separate) and the Commission has the same power as described in footnote 15 to adopt further secondary legislation to exempt trading in the sovereign debt of third countries. The regulators are directed to give specific attention to market-making (as it is closely related to proprietary trading), investing and sponsoring securitisations and trading in derivatives other than those that are specifically permitted for the purpose of prudent risk management (as the Commission believes that these latter activities played a key role during the financial crisis).

24. The national regulator must carry out its assessment of individual CCIs at least yearly and must use prescribed metrics when doing so. These metrics are:

    (a) relative size and leverage of trading assets;

    (b) relative levels of counterparty credit risk and market risk;

    (c) relative complexity of trading derivatives;

    (d) relative profitability of trading income;

    (e) interconnectedness; and

    (f) credit and liquidity risk arising from commitments and guarantees provided by the CCI.

    The EBA will draft secondary legislation specifying how the metrics should be measured, giving further detail of the metrics and setting out a methodology for consistent measurement and application of the metrics. The Commission will also specify a limit for each metric above which the risk level of the relevant trading activity is deemed "individually significant" and set out the conditions which will trigger the exercise of the national regulator's power to separate. Finally, the Commission will also draft legislation specifying certain types of securitisations which are not considered a threat to the financial stability of the CCI or the EU as a whole. It is, therefore, important that the proposal contains metrics which accurately measure the risks associated with trading activities and also takes into account risk mitigation techniques. The proposal does not, however, currently have regard to risk mitigation techniques such as netting, offsetting, diversification and portfolio compression nor prudent risk management and hedging techniques. It is also important that the Commission sets the limits and conditions at the correct level as these will determine the application of ring-fencing.

25. When the national regulator has carried out its assessment and concludes that the limits and conditions set out in the secondary legislation have been surpassed, a threat to the financial stability of the CCI or the financial system of the EU is deemed to exist and the regulator must commence the process whereby the CCI would be prohibited from carrying out the trading activities in respect of which the limits and conditions have been exceeded. Indeed, even where the limits and conditions are not exceeded, the national

regulator may commence to consider such a prohibition if its assessment leads it to conclude that any trading activity, save trading in those derivatives that are specifically permitted for the purpose of prudent risk management, poses the threat outlined above. The regulator must consult with the EBA and communicate its conclusions to the relevant CCI, which is given two months to comment. Unless the CCI demonstrates that the conclusions are not justified, the national regulator shall prohibit the CCI from carrying out the specified trading activities.

26. The drafting of the provisions gives the national regulators little discretion to do other than make a decision to ring-fence the relevant trading activities away from the CCI when the limits and conditions set out in the secondary legislation are surpassed. The regulators do, however, appear to have considerable discretion as to whether they are satisfied by the representations of the CCI concerned. This could lead to further inconsistencies of approach across different jurisdictions and even across banking groups. Once a decision to ring-fence any trading activity has been made by a national regulator, however, further provisions are triggered which mean that any CCI which has been subject to a ring-fencing decision, regardless of which or how many trading activities are ring-fenced or the extent to which the limits and conditions have been exceeded, can only use or sell derivatives to manage its own risk or to provide risk management services to customers as set out in the proposal. These provisions seem to render a national regulator's decision to ring-fence only certain trading activities nugatory.

27. The proposal provides that a CCI that has been subject to a ring-fencing decision by a national regulator may use only credit, FX and interest rate derivatives[20] which are eligible for clearing to hedge its overall balance sheet risk. This seems to link the derivatives that a ring-fenced CCI can use or sell to ESMA's decision under EMIR on which class of derivatives are subject to the clearing obligation. Given that ESMA's decision cannot be anticipated and that it is not clear that the clearing obligation will apply to any FX derivatives, this cross-reference appears peculiar. The CCI must also demonstrate to the national regulator that such hedging demonstrably reduces or significantly mitigates specific identifiable risks of its individual or aggregated positions. This wording mirrors the wording found in the Volcker rule and does not per se prohibit portfolio hedging.

28. A CCI that has been subject to a ring-fencing decision is permitted to use a slightly wider range of derivatives when selling them to clients for their risk management purposes. It can use credit, FX, interest rate and commodities (including emissions allowances) derivatives (but again only those eligible for clearing) provided that the sole purpose of the sale is to hedge credit, FX, interest rate or commodity risk and subject to caps on the resulting position risk which the Commission will set out in further secondary legislation. There are also restrictions on the range of types of 'real economy' clients that could benefit from such risk management services.

29. The intention behind these provisions is not entirely clear but the drafting provides that using derivatives for their own risk management purposes and selling derivatives to clients for their risk management purposes are the only trading activities that can be carried out by a CCI subject to a ring-fencing decision. Article 11(1) provides that "A core credit institution that has been subject to a [ring-fencing] decision...may carry out trading activities to the extent that the purpose is limited to only prudently managing its capital, liquidity and funding." The following article, which provides for the provision of risk management services to

clients, is arguably inconsistent with the word "only" in Article 11(1) but it does appear that CCIs which have been subject to a ring-fencing decision cannot engage in any other trading activities save those specifically set out in Articles 11 and 12. For the avoidance of doubt, this would mean that those CCIs could not engage in market-making, underwriting, securitisation activities and trading in derivatives other than those set out in Articles 11 and 12 of the proposal. As a result, irrespective of the decision taken by the national regulator who may decide to separate only certain trading activities, the effect of Article 11(1) is to prevent the CCI subject to the ring-fencing decision from carrying out any trading activity other than the use of certain derivatives for the specified risk management purposes. This restriction is consistent with the UK approach to ring-fencing, which prohibits the RFB from dealing in investments as principal which means that it cannot engage in market-making, underwriting and most of the derivative and trading activity currently being carried out by wholesale and investment banks.

30. The synergies with the UK legislation become even more apparent when consideration is given to the UK draft legislation published for consultation in July 2013 that permits RFBs to deal in derivatives to hedge their own balance sheet risks and to sell simple derivatives as risk management products to customers subject to safeguards. It ought to be noted, however, that the UK draft legislation includes additional exemptions from the excluded activity of dealing in investments as principal: these permit own asset securitisation and acquiring and selling shares in companies through debt-equity swaps. The EU draft legislation does not currently go so far.

31. France and Germany have not taken the same approach as the UK, however, but have focussed more specifically on prohibiting their RFBs from proprietary trading, trading for their own accounts in certain circumstances and lending to certain AIFs. The German law also provides for a number of exceptions, including hedging and market making.

Rules on Ring-Fencing

32. Unlike the Volcker-style prohibition, the effect of a ring-fencing decision does not prevent the trading activities that have been separated being carried out elsewhere in the banking group. Under the EU proposal, the separated trading activities may be carried out by a trading entity which is legally, economically and operationally separate from the CCI. The proposal contains provisions to achieve this level of separation including the following:

(a) a group which contains CCIs and trading entities shall be structured so that on a sub-consolidated basis two distinct sub-groups are created, only one of which contains CCIs;

(b) CCIs may only hold capital instruments or voting rights in a trading entity in prescribed circumstances and with the consent of the national regulator;

(c) CCIs and trading entities shall issue their own debt, provided this is consistent with the group's resolution strategy;

(d) contracts between CCIs and trading entities shall be agreed on a third party basis;

(e) requirements regarding members of the management bodies of both types of entities;

(f) the names of CCIs and trading entities shall make clear whether they are CCIs or trading entities;

(g) limits on the intra-group exposure a CCI has to any entity outside its sub-group; and

(h) limits on the extra-group exposure a CCI can have to financial entities.

The proposal also provides that the trading entity may not carry out certain activities, those being taking deposits eligible for protection under deposit guarantee schemes and providing retail payment services as defined in the Payment Services Directive.[21] It appears that, if an EU branch of a non-EU banking group is within the scope of the EU legislation, these provisions are intended to apply to the non-EU banking group.

33. When a CCI has been subject to a ring-fencing decision, or an entity has decided to separate trading activities on its own initiative, it or its EU parent must submit a separation plan to the national regulator within six months of the ring-fencing decision or at the start of the national regulator's assessment period. The national regulator has six months to approve the plan or require changes to be made. If a separation plan is not submitted, the national regulator shall adopt its own plan.

34. When consideration is given to the existing EU domestic legislation, the UK requirements on ring-fencing are most consistent with these provisions. The Banking Reform Act 2013 is a framework piece of legislation which sets out the key political choices which will give effect to Vickers but much of the technical detail will be found in subsequent secondary legislation and regulatory rules. Thus the Act requires the PRA to make rules governing the degree of separation between the RFB and the rest of the group, including rules to limit the shares and voting powers a RFB may have in another company, to ensure independence of decision-making in the RFB, to ensure the RFB does not rely on the provision of capital and liquidity resources of other members of the group, to restrict payments the RFB may make to other group members and to enter contracts with other members of the group on an arm's length basis. In addition, the UK government has published draft legislation which prohibits RFBs having exposures to certain financial institutions.

Derogations from the Ring-Fencing Provisions

35. The EU proposal provides for the possibility of the Commission granting a derogation from the ring-fencing provisions at the request of a Member State which had in place on 29 January 2014 primary legislation which fulfils the criteria set out on the proposal. This means that only the UK, France and Germany would qualify for the derogation as they are the only EU Member States which have already adopted legislation. The Belgian coalition government has, however, committed to finalising its legislation on bank structural reform before the elections in May 2014 and other Member States may want an opportunity to introduce their own legislation. The Commission's choice of cut-off date may, therefore, be challenged.

36. The EU proposal provides that, in order to qualify for a derogation, the aim of the domestic legislation, its material scope and provisions referring to the legal, economic and governance separation of deposit-taking entities must have an equivalent effect to the provisions of the draft EU legislation. For reasons set out above, it appears that the UK legislation is most likely to satisfy these requirements but, also as pointed out above, not all of the UK's draft secondary legislation is consistent with the EU provisions. In addition to the exemptions mentioned at paragraph 30 above which permit RFBs to engage in their own asset securitisation and to acquire and sell shares in companies through debt-equity swaps, the UK's draft legislation also provides for a *de minimis* threshold below which institutions will be exempted from ring-fencing and exemptions which will permit the deposits of larger organisations and high net worth individuals

to be held outside the ring-fence.[22] It is not clear whether these exemptions would prevent the UK's legislation meeting the criteria necessary for a derogation. There is thus a risk that the UK will have to change its draft secondary legislation if it wishes to benefit from the derogation.

37. Even within France and Germany, it is considered that the French and German domestic legislation is less likely than the UK's legislation to qualify for the derogation as the scope of the French and German ring-fencing provisions is less extensive than the EU proposal. The French banking market is already expressing concern at the possibility that UK banks may be the only banks which benefit from a derogation.

38. There are two other points of controversy as regards the derogation. First, it appears the intention of the Commission that, despite the fact that a Member State must apply for it, any derogation should be granted on an individual deposit-taking bank basis, not on a jurisdictional basis. Article 21(1) provides that a derogation may be granted "to a credit institution taking deposits from individuals and SMEs that are subject to national primary legislation adopted before 29 January 2014 when the national legislation complies with the" requirements set out within the Article. Article 21(2) envisages a derogation being withdrawn from a bank after the Commission has decided that the national legislation is not incompatible because that legislation no longer applies to a particular credit institution. Taking the UK's legislation as an example and supposing that the exemptions referred to in the above paragraph are maintained, it is not clear whether a deposit-taking bank which takes advantage of the proposed de minimis exemption, for example, would be regarded as "subject to national primary legislation" so as to qualify for the derogation. It would be argued, of course, that such a bank is subject to the Banking Reform Act and is merely relying upon an exemption granted in accordance with it but, if that argument is valid, it is not clear why it would be necessary for derogations to be granted on an individual bank basis and not to all banks within a jurisdiction which has adopted national legislation having equivalent effect: the provision for a derogation on an individual bank basis presupposes that different decisions can be reached in respect of different banks within the same jurisdiction. Subsequent drafting does suggest that a Member State can apply for derogations in respect of a number of deposit-taking banks at the same time and that one single derogation would be granted. Further, if domestic legislation is to be regarded as equivalent to the EU legislation, it would seem inconsistent for a decision to be reached that it is only equivalent for certain banks but the drafting and intent requires clarification to ensure certainty.

39. The second point of controversy is that the draft EU legislation gives the Commission a discretion to decide whether or not to grant the derogation. It is for the Commission to decide whether the domestic legislation is compatible with the EU legislation and it also appears that the Commission is required to consider the potential impact of a derogation on the financial stability of the EU and the functioning of the internal market. Conferring such a discretion on the Commission will raise political and legal questions concerning whether and how the Commission can be given such a power.

40. The effect of the provision on derogations is that an EU cross-border banking group with a number of CCIs in different Member States (or potentially a number of CCIs in the same Member State) could obtain a derogation for some of those CCIs but could still be required to develop a separation plan that applies across its group if a derogation is not granted to all its CCIs.

What Happens Next?

41. The proposal must be adopted by the European Parliament and Council under the ordinary legislative procedure. Under this procedure, the Council and the Parliament are placed on an equal footing as the co-legislature. Both institutions will consider the Commission's proposed text and reach an internal agreement as to a version that they can accept. Once they have reached this agreement, they and the Commission enter a process known as trial-ogues in an attempt to reach an agreed text for adoption as legislation. The agreed text must be adopted by a qualified majority of the Council and a simple majority of the Parliament.

42. The process for adopting EU legislation is thus both complex and lengthy. France, Germany and Italy have already made clear their objection to the proposal as a whole and the UK is likely to be concerned both at the Volcker-style prohibition it contains and the process necessary to obtain a derogation from the ring-fencing provisions. Given these concerns, significant amendments to the proposal, in Council at least, are to be expected. It is less clear how the new Parliament will view the proposal.

43. Agreement on a final version of the legislation is not expected before June 2015 and, on this basis, the Commission's proposed timetable would see the prohibition on proprietary trading applying from 1 January 2017 and the provisions on separation of the trading activity applying from 1 July 2018. This timetable is not dissimilar to that which is expected to apply in the UK but is significantly behind the Volcker timetable: the Volcker conformance period ends on 21 July 2015 and banking entities must make good faith efforts to be in compliance by that date.

44. When considering the operational changes required by Volcker, Vickers, the French law on the separation and regulation of banking activities and the Trennbankengesetz, it would be prudent to bear in mind the likelihood of additional EU requirements, although there is as yet no certainty as to exactly what those requirements may be. In addition, banks which expect to be within the scope of the EU's proposal should commence lobbying their own governments, the Commission and, after elections, the new European Parliament if, as appears likely, they are concerned by the EU proposal.

45. As currently drafted, the EU proposal is not consistent with any of the existing domestic legislation on bank structural reform, in the EU or in the US. The possibility of duplicative and conflicting requirements will be a concern for banks which are active cross-border as it raises the question whether a single banking model can be designed that complies with the legislative requirements in all relevant jurisdictions. If a single model is not possible, the cost of banking, and thus bank lending, could be increased and this will impact on the real economy and EU's economic recovery. The EU's legislative proposal could, therefore, adversely affect the very people who it is designed to protect. It is also hard to see how the EU's proposal addresses the problem that the Commission itself identified of inconsistent national legislation. The EU legislation could itself increase the possibility of distortions of capital movements and investment decisions, make the structure and operation of cross-border banks more complex and increase fragmentation. In these circumstances, the necessity for this legislation may well be questioned: is EU legislation for bank structural reform necessary and proportionate in addition to banking union, CRD IV, the soon-to-be-adopted bank recovery and resolution directive and the domestic legislation already in place? ◆

Endnotes

1. See here http://ec.europa.eu/internal_market/bank/structural-reform/index_en.htm.
2. As implemented in section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, which created a new section 13 of the US Bank Holding Company Act of 1956.
3. As implemented in section 4 of the Financial Services (Banking Reform) Act 2013 which inserts Part 9B (sections 142A–142Z1) into the Financial Services and Markets Act 2000.
4. See here http://ec.europa.eu/internal_market/bank/docs/high-level_expert_group/report_en.pdf.
5. French law no. 2013-672 of 26 July 2013 on the separation and regulation of banking activities.
6. Trennbankengesetz (German Bank Separation Law) which is included in Article 2 of the Gesetz zur Abschirmung von Risiken und zur Planung der Sanierung und Abwicklung von Kreditinstituten und Finanzgruppen (Law concerning Separation of Risks and Restructuring and Winding-Up of Credit Institutions and Financial Groups), BGBl. 2013 I Nr. 47, 3090. The law was announced on 7 August 2013 and Article 2 entered into force on 31 January 2014, although most of the rules in Article 2 are not applicable until 1 July 2015.
7. The text is not yet available but was approved in second reading on 14 February 2014 by the Belgian Federal Government.
8. See here http://www.mayerbrown.com/files/Publication/f95121f8-0c01-40f8-b14b-46379c2b118d/Presentation/PublicationAttachment/ddaf0395-d75d-4456-b143-6a026db6be71/Final-Regulation-Implementing-the-Volcker-Rule.pdf.
9. See here http://www.mayerbrown.com/files/Publication/b2ff45c7-4252-4bb4-8bc0-899c2914b6a8/Presentation/PublicationAttachment/9b7da3f6-47a6-4da5-8dfb-05f7f0893a0f/UPDATE-VolckerRule-Application_131219.pdf.
10. Dealing in investments as principal includes buying, selling, subscribing for or underwriting securities or contractually based investments.
11. As a strict matter of law, a branch does not have a legal identity separate to its parent but, although the drafting is not wholly clear, it does not appear to be the intention that branch assets are consolidated with those of its parent.
12. The Fourth Capital Requirement Directive which consists of a directive (2013/36/EU) and a regulation (575/2013).
13. Case C-507/13 *United Kingdom of Great Britain and Northern Ireland v European Parliament, Council of the European Union*.
14. Case C-209/13 *United Kingdom of Great Britain and Northern Ireland v Council of the European Union*.
15. The Commission may adopt further secondary legislation to exempt trading in the sovereign debt of third countries which have equivalent supervisory and regulatory requirements, exposures to which have 0% risk weighting under the Capital Requirements Regulation.
16. The drafting of Chapter III is currently ambiguous. Whereas the majority of Articles in Chapter III (for example, Articles 10(2), 10 (3), 11 and 12) refer to the subject of a ring-fencing decision being the EU core credit institution, Article 9(1) currently mandates the national regulator to assess the trading activities of a far wider group of entities, including the EU parent and all branches and subsidiaries in a group which contains a core credit institution, as well as EU branches of all credit institutions established in third countries.
17. Directive 94/19/EC.
18. There is no requirement for the branch or the non-EU bank to fall within the definition of a CCI. Thus it appears that EU branches of a non-EU bank may be within the scope of this provision when they would not be (because they would not fall within the definition of a CCI) if they were established in the EU as a subsidiary.
19. Although the ECB will assume its full supervisory tasks from 4 November 2014 and would thus be the relevant prudential regulator for the purposes of this proposal, national regulators will be responsible for the direct supervision of "less significant" banks and will assist the ECB in the ongoing day-to-day supervision of "significant supervised" banks. As a result, the possibility of inconsistent national approaches must remain.
20. The Commission may adopt secondary legislation adding to these classes of derivatives, including those that are not cleared.
21. Directive 2007/64/EC.
22. The draft Order provides that banks whose 'core deposits' do not exceed £25 billion will not be RFBs. It also provides that deposits of high net worth individuals who have chosen to deposit outside the ring-fence, deposits of large organisations and deposits of other financial institutions are not core deposits.

WINTER 2015

In this Winter 2015 edition of our *Fund Finance Market Review*, we discuss some of the more noteworthy trends impacting the subscription credit facility and fund finance markets, including our views of the challenges and opportunities created by an increasingly prominent regulatory framework.

We also explore some of the new and accelerating sources of capital for funds, potential new facility products in response thereto and the shifting legal landscape affecting facility lenders.

Winter 2015 Market Review

Capital call subscription credit facilities (each, a "Facility") continued their post-crisis growth and positive credit performance in 2014, again achieving an excellent year as an asset class. Anecdotal reports from many of the key Facility lenders (each, a "Lender") indicate substantial portfolio growth last year, and the Mayer Brown Facility practice closed more than 100 new transactions for the year, a first for our practice. Investor capital call (each, a "Capital Call") funding performance continued its near-zero delinquency percentage, and, correspondingly, we were not consulted on any Facility payment events of default in 2014. Below we set forth our views on the state of the Facility market and current trends likely to be relevant in 2015.

Fund and Facility Growth

Fundraising in 2014

Overall, 2014 was a very positive year for private equity funds (each, a "Fund"). Fundraising, although down slightly from the marks set in 2013, was relatively robust. Globally, 994 Funds held their final close last year, raising $495 billion in investor (each, an "Investor") capital commitments ("Capital Commitments"). This surpassed the fundraising levels seen in 2008-2012 but was down slightly from the 1,203 Funds raising $528 billion in 2013. The "flight to quality" trend we noted in our Summer 2014 Fund Finance Market Review (the "Summer Review") has continued, with fewer Funds being formed but on average raising more capital. In fact, the average Fund size in 2014 was $544 million, the largest average ever recorded.[1]

Facility Growth

While the Facility market still lacks an industry-accepted data reporting and tracking service to pinpoint exact numbers, the market undoubtedly expanded by double digits in 2014. Multiple Lenders grew their portfolios extensively, with several reporting a growth rate in revolving commitments in the neighborhood of 50%. Mayer Brown represented Lenders and Funds in new money transactions reflecting in excess of $25 billion of Lender commitments, without counting accordion upsizes or increase amendments. We believe this growth rate is at a minimum consistent with, if not in excess of, that in 2013.

Interestingly, one of the theories behind the 2014 fundraising decline involves the growth of separate accounts (each, a "Separate Account"). As Separate Accounts are often structured to obtain their own Facilities, that may explain in part how we are seeing Facility growth despite a nominal decline in fundraising. While perhaps a factor, we continue to believe that Facility growth over the past several years is most attributable to increased market penetration; that is, Fund families that in the past rarely used Facilities are awakening to their benefits. In 2014, we saw several top 30 Fund sponsors (each, a "Sponsor") obtain their first Facility for a Fund and then look to procure additional Facilities across their platforms. Many

additional Sponsors also explored and consummated their first Facility. This market penetration has clearly seeded Facilities growth over the past few years and in our view has been the primary growth driver.

Looking forward, we continue to forecast outpaced growth for Facilities in 2015, although we do expect the growth rate to slow somewhat from the double-digit and perhaps unsustainable growth rate of the recent past (especially in the United States). Absent a Facility default or a major macro-economic event, there are too many positive data trends not to be cautiously bullish. For example, at the beginning of 2015, a record 2,235 Funds were on the road fundraising, an all-time high. Dry powder increased by $128 billion in 2014 to a record $1.2 trillion. Even if one were to assume that the Facility market has hit $200 billion in global Lender commitments, we are still looking at a global advance rate of less than 17% on available dry powder. Many Lender portfolios have an average funded advance rate of 25% to 30% of uncalled Capital Commitments ("Uncalled Capital"), suggesting there is still a fair amount of growth opportunity remaining. Furthermore, with the record levels of distributions to Investors in 2013 and 2014 (nearly $200 billion ahead of Capital Calls for each year) and the continued positive investment performance of Funds as an asset class, it is hard not to forecast extensive fundraising success in 2015. These trends are all likely to combine and result in additional Facility growth in 2015.[2]

Facility Market Trends

Not surprisingly, many of the trends we noted in the Summer Review continued and in some cases accelerated in the latter half of 2014. We highlight these below along with a few other trends likely to be impactful in 2015.

Continuing Trends

Extensive Refinancing Activity. As predicted, we saw significant amend-and-extend volume over the course of 2H 2014 and that trend has continued its momentum thus far in 2015. Facilities of the 2011-12 vintages are increasingly coming up for renewal. In some cases, Funds are even renewing early to take advantage of the lower pricing that is generally available. While we are seeing Facilities reduce in commitment size, very few are being repaid and terminated. Facilities extending long into the Fund's harvest period are increasingly common.

Fund Structural Evolution. Separate Accounts and parallel funds of one Investor have continued to permeate the Facility market as Investors (frequently sovereign funds and large institutional Investors) seek investment flexibility, lower fees, greater control and structuring alternatives for regulatory and tax relief. Many Lenders have gotten comfortable with these single Investor exposures and the Separate Account Facility market is flourishing. Investor credit linkage, transparency and a continuous education on the evolving structures will be key as Lenders pivot to serve this growing sub-market in 2015.

Umbrella Facilities. Facilities encompassing multiple sub-facilities for unrelated Funds advised by the same Sponsor continue to gain increased traction in the market. Mayer Brown has advised on nearly as many umbrella facilities to date in early 2015 as in all of 2014. We expect the efficiencies created by these structures to support their continued expansion.

Hedging Mechanics. Lenders and Funds increasingly want to secure trading activities with Facility collateral and several Lenders have been successful in accommodating this construct in syndicated Facilities. We expect that these secured hedging mechanics, embedded within the Facility documentation, will continue to be a popular request in 2015.

Newer Trends

CREDIT CONTINUUM

Throughout 2013, Facility structures and covenant packages were clearly drifting in favor of Funds as Lenders were becoming

increasingly comfortable going further down the risk continuum. In early 2014, that trend seemed to accelerate. For example, Facilities were being consummated that included advances for Investors that would never have previously been included in a borrowing base. Lenders were far more lenient with respect to Fund partnership agreement language, Investor credit linkage and sovereign risks, as additional examples. That downward trending, however, seemed to level out somewhat toward year-end. Other than a few instances of extended tenors, Facility structures seemed to largely stabilize. Facility structure and credit trending will be interesting to watch in 2015.

HNW and Family Office Facilities. During 2H 2014 and thus far into 2015, we have seen a notable uptick in the establishment of Facilities for Funds comprised mostly or exclusively of high net worth and family office Investors ("HNW Investors"). This trend has emerged not only for middle-market Sponsors but also for some of the largest Sponsors in the market. For Funds where the HNW Investors invest directly, the transparency of the Investor, the number of Investors and the granularity of the pool have in some cases actually been credit positives for certain Lenders. For Funds where the HNW Investors invest indirectly through managed platforms of wealth management institutions, comfort with the managed institution and some level of negotiated look-through rights or bespoke exclusion events related to the platform have been present. Many of these Facilities have been bilateral and generally smaller in overall Lender commitment size, but we do expect this market to develop going forward.

Hybrid Facilities. Funds that are approaching or have passed their investment period often have ongoing liquidity needs. Lenders have historically offered "after-care" Facilities for seasoned Funds with appropriately drafted partnership agreements. The after-care Facility approach, however, offers little utility if a Fund has nearly exhausted its Uncalled Capital. Hybrid Facilities are structured on a case-by-case basis but typically include a pledge of whatever Uncalled Capital remains, as well as some form of a pledge of the Fund's investments. The hybrid borrowing bases are typically comprised of the standard 90%/65% advance rates on the tiered credit quality of the Investors and a much lower advance rate on the NAV of the investments after a reduction for concentration limit excesses. Each hybrid Facility is structured differently and a pledge of the assets and evaluation of the collateral package will require enhanced diligence and differing underwriting criteria. Interest in hybrid Facilities, and NAV-based lending generally is clearly on the upswing.

Open-End Fund Facilities. Facilities for open-end Funds, which permit Investors to redeem their equity interests at their election (typically following a "lock-up" period and sufficient notice to the Fund), are on our list as a product to watch in 2015 and beyond. While Facilities for open-end Funds have been somewhat slower to catch steam than we originally forecast, Mayer Brown advised on a number of opportunities for open-end Fund financings in 2H 2014.

LIBOR Floors of Zero. Recent activity by central banks has resulted in periodic negative LIBOR rates for certain currencies. In order to prevent unintended consequences of a negative index rate, many Lenders are now including LIBOR floors of zero in their loan agreements. The floor will specify that if LIBOR is below zero, it shall be deemed to be zero for purposes of calculating the rate under the loan agreement.

Energy Sector Watch. While 2014 represented a strong year in terms of Fund performance generally, falling crude oil and related commodity prices are stressing certain investments in energy Funds. The press has reported Investor Fund losses of greater than $12 billion in value in 2H 2014 alone.[3] We think we are still in the early innings of volatility in the energy markets. While it is quite likely that the sharp downward movements to date have and will create some

meaningful losses on investments for certain Funds, it may also create more realistic pricing and attractive investment opportunities for the very same Funds incurring the recent losses. The energy sector certainly warrants considerable attention in 2015.

Legal and Regulatory Developments

LSTA Model Credit Agreement Provisions

On August 8, 2014, the Loan Syndications and Trading Association (the "LSTA") published a revised version of its Model Credit Agreement Provisions ("MCAPs") that addresses, among other topics, prohibitions on lender assignments to so-called "disqualified institutions" (commonly also referred to as "ineligible institutions" or "disqualified lenders") which specifically contemplate limitations on assignments to the borrower's competitors. The revised MCAPs allow the borrower to establish a list of entities that cannot own its debt, which may include both competitors and entities that the borrower desires to "blacklist" (such as an entity with which the borrower has previously had a bad experience). For a complete summary of the revised MCAPs, please see the Mayer Brown article, *Limitations on Lender Assignments to Competitors in Subscription Credit Facilities and Other Fund Financings*, at page 13 hereto.

Liquidity Coverage Ratio: Final Rule

On September 3, 2014, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency (collectively, the "Agencies") each adopted a final rule (the "Final LCR Rule") to impose a quantitative liquidity coverage ratio ("LCR") requirement on US banking organizations with total consolidated assets of $250 billion or more and certain other institutions (collectively, "Covered Companies"). The Final LCR Rule went into effect for Covered Companies as of January 1, 2015.

Last year, at the time the Agencies circulated the proposed regulations to address this LCR requirement (the "Proposed Rule"), Mayer Brown released the Legal Update "*Capital Commitment Subscription Facilities and the Proposed Liquidity Coverage Ratio*" in which we expressed our view that Facilities are most appropriately classified as "credit facilities" rather than "liquidity facilities" and addressed other aspects of the regulations that could affect traditional fund finance products. The Final LCR Rule as adopted by the Agencies did not change the Proposed Rule in a manner that we believe changes this analysis for Facilities. For more information, please see the Legal Update available at http://www.mayerbrown.com/Capital-Commitment-Subscription-Facilities-and-the-Proposed-Liquidity-Coverage-Ratio-12-20-2013/.

Extension of Volcker Rule Conformance Period for Legacy Funds

Section 619 of the Dodd-Frank Act, commonly referred to as the Volcker Rule, remains an area of focus for many Lenders. On December 18, 2014, the Federal Reserve Board (the "FRB") responded to industry concerns regarding conformance with the Volcker Rule by extending the conformance period for investments in and relationships with "covered funds" and "foreign funds" that were in place prior to December 31, 2013 ("legacy covered funds") through July 21, 2016. The FRB announced that next year it intends to further extend the conformance period for investments in and relationships with these legacy covered funds to July 21, 2017.

In our related Legal Update from August 2014, we described our belief that traditionally structured Facilities should not cause Lenders to run afoul of the Volcker Rule's prohibition on acquiring ownership interests in a "covered fund."[4] Lenders must be aware of certain terms or structures which could give rise to an "ownership interest" under the regulation's broad definition, but the traditional Facility structure, including the collateral and remedies associated

therewith, should not rise to this level. The extension granted for conformance of legacy covered fund relationships should help mitigate risks in certain existing Facilities to covered funds where the Fund Sponsor itself is a Covered Company subject to the Volcker Rule.[5]

Conclusion

We forecast continued growth of the Facility market in 2015, riding a projected positive wave of fundraising for Funds, further penetration into new Fund families and expanded use of Facilities by Funds throughout their harvest periods. Facility structures are likely to continue to evolve commensurate with the growth of Separate Accounts, Open-end Funds and similar alternative investing structures. We also anticipate growth in hybrid Facilities and NAV-based lending as Lenders search for yield and utilization and Funds seek leverage and liquidity later in their lifecycles. Of course, there are a fair number of material uncertainties in the greater financial markets currently, especially in the energy sector, the Middle East and Eastern Europe, all of which could potentially spook Investors and change the fundraising landscape rather abruptly. But while these risks are real and should be monitored closely in 2015, we expect that the 2015 Facility market will trend favorably and comparably to the uptick in 2014. ◆

Endnotes

1. *See 2015 Preqin Global Private Equity and Venture Capital Report ("Preqin PE 2015")*, p. 4; for our Summer Review, please go to page 97.
2. *See,* Preqin PE 2015, p.4.
3. Dezember, Ryan, "Buyout Shops Caught in Crude Exposure," *The Wall Street Journal*, December 4, 2014.
4. For more information, please see Mayer Brown's Legal Update, *Federal Reserve Board Issues Volcker Rule Conformance Period Extension*, available at http://www.mayerbrown.com/Federal-Reserve-Board-Issues-Volcker-Rule-Conformance-Period-Extension-12-19-2014/.
5. For more information about the Volcker Rule's impact on Lenders, please see Mayer Brown's Legal Update, *Subscription Credit Facilities and the Volcker Rule*, on page 103. For an in-depth analysis of the Volcker Rule's final regulation, please see Mayer Brown's White Paper, *Final Regulation Implementing the Volcker Rule*.

Developing Side Letter Issues

Introduction

A subscription credit facility (a "Facility") is an extension of credit by a bank, financing company, or other credit institution (each, a "Lender") to a private equity fund (the "Fund"). The defining characteristic of such a Facility is the collateral package securing the Fund's repayment of the Lender's extension of credit, which is composed of the unfunded commitments (the "Capital Commitments") of the limited partners to the Fund (the "Investors") to make capital contributions ("Capital Contributions") when called upon by the Fund's general partner, not the underlying investment assets of the Fund itself.

The documents establishing a Facility contain provisions extending credit to the Fund and securing the related rights of the Lender. Additional documentation governs Investors' rights and obligations to the Fund as they relate to the Facility. Specifically, Investors' rights and obligations largely arise under the Fund's limited partnership agreements and Investors' subscription agreements. However, individual Investors also frequently negotiate and enter into a letter agreement with the Fund ("Side Letters"), separate and apart from other Investors, which interprets, supplements, and alters the terms of that Investor's rights, duties, and obligations under the related limited partnership agreement or subscription agreement. Side Letters can and do have a significant impact on Facilities.

Traditionally, Side Letters have been used to address unique economic issues between Funds and their Investors (e.g., family and friends or late-closing investors) and/or issues specific to particular Investors (e.g., governmentally regulated investors). That tradition has matured with the Facility market and, as such, the frequency, sophistication and size of Side Letters have grown dramatically. With that growth, issues arising in Side Letters have continued to develop, each of which holds significance for Funds, Lenders, and Investors. As discussed in greater detail below, Side Letters can impact every aspect of a Facility, including its very existence. Nevertheless, with prior review by experienced legal counsel, nearly every issue discussed in this article arising in Side Letters can be effectively mitigated or resolved.

To that end, we recommend that Funds disclose all Side Letters to their Lenders as part of the Lenders' due diligence review of the Investors' documents while negotiating a Facility. It has been our experience that such a review is most constructive when begun prior to the execution of any Side Letter. During such initial review, Lenders have the opportunity to identify, analyze, and resolve any potential issue with the Fund, a scenario far preferable to renegotiating finalized Side Letters with Investors based upon Lenders' subsequent review and comment.

In this article we discuss a number of developing issues in Side Letters and their potential impact[1] on Funds and their Lenders, including (1) placement agent regulations; (2) investor documents and deliverables; (3) transfers; (4) sovereign immunity; (5) excuses; and (6) overcall and concentration limits.

Placement Agent Regulations

In response to investigations into alleged corrupt practices involving the use of placement agents in connection with public pension funds, retirement systems, and other government fund entities (collectively, "Government Investors"), a growing number of governmental authorities have taken measures to restrict the use of placement agents and curb so-called "pay-to-play" abuses.[2] A number of the resulting rules regulate the investment activities of Government Investors by banning the use of placement agents, registered lobbyists, and other intermediaries (collectively, "Placement Agents") in obtaining investments by Government Investors. A common manifestation of such regulations requires a Fund to represent and warrant to a Government Investor that it did not use a Placement Agent to obtain such Government Investor's investment and that no benefit was paid or promised to the Government Investor's employees, affiliates, or advisors to obtain its investment. While the severity of a breach of Placement Agent regulations varies from jurisdiction to jurisdiction, the strictest form of remedy provides a Government Investor the unilateral right to cease making Capital Contributions to the Fund or to withdraw from the Fund altogether.

Although many Funds may be comfortable making such representations, both Lenders and Funds should be apprehensive of the consequences of potential breaches for several reasons. First, the ability of a Government Investor to unilaterally withdraw from a Fund based on its determination of the Fund's compliance with policy or applicable law is at odds with the underwriting standards applied by Lenders when entering a Facility. Typically, such underwriting decisions are based on an analysis of Investors' creditworthiness without accounting for the consequences of a breached Placement Agent regulation. Second, the failure of an Investor to honor a capital call is virtually always an "exclusion event" under a Facility, which could result in the removal of such Investors from the Facility borrowing base and trigger a mandatory prepayment by the Fund.

We have seen Funds and Lenders take precautions to mitigate the impact of Placement Agent regulations in Government Investors' Side Letters. For instance, in Side Letters allowing an Investor to cease making Capital Contributions if a Placement Agent regulation is breached, Lenders may include language making clear that the termination of an Investor's obligation to fund further Capital Contributions does not apply to liabilities relating to, and Capital Contributions called in respect of, indebtedness of the Fund incurred prior to the Government Investor's withdrawal or cessation of Capital Contributions. In other instances, we have seen Funds make conforming representations and warranties to their Lenders that provide the Lenders with recourse to the Fund in the event that the Fund breaches its Placement Agent-related representations and warranties to its Government Investors. Alternatively, a Lender and Fund may agree that the Lender will advance a lower rate under a Facility against the Capital Commitments of Government Investors subject to Placement Agent regulations in recognition of the additional risk undertaken.

Investor Documents and Deliverables

Because Lenders are not party to a Fund's limited partnership agreement and subscription agreements, Lenders may require Funds to deliver additional documentation from each Investor acknowledging, representing, and covenanting to certain undertakings related to the Facility for the Lenders' benefit. For instance, we are familiar with requests from Lenders to Funds for financial statements, annual reports, investor letters, and investor opinions, among other documents and deliverables, with respect to the Fund's Investors. Many Investors, however, have used Side Letters to resist such obligations to deliver additional documentation. Such limitations are of consequence to both Lenders and Funds because they can impact a Lender's willingness to extend credit in a Facility based on the Investor's unfunded Capital Commitment. As a result, Funds may find that their anticipated borrowing base and credit availability under a Facility is unexpectedly diminished should such deliverable carve-outs remain in their Side Letters.

While the consequence of a problematic limitation in an Investor's Side Letter on its obligation to deliver investor documents can be drastic, the remedies for such situations are readily attainable. For example, in lieu of actually delivering additional documentation, Funds may incorporate the substance of such items, including the relevant acknowledgements, representations, and covenants, in the Fund's limited partnership agreement. Such streamlining efforts can address both Lenders' desire for additional comfort from Investors and Investors' hesitation at providing additional documentation and deliverables.

Transfers

One of the structural issues addressed in a Fund's formation documents is an Investor's right to transfer its interest in the Fund. In negotiating that issue, competing interests exist. On one hand, Investors prefer that their interest in a Fund be unfettered and fluid in order to facilitate any desirable or necessary transfer. On the other hand, Funds and Lenders prefer consistency among the Fund's Investors and Lenders may be reluctant to extend credit based on the Capital Commitments of a subsequent Investor who is unfamiliar to the Lender.

The preferred mechanics of achieving that consistency vary among Lenders. Some Lenders prefer that transfers of an Investor's interest in the Fund be subject to the preapproval of the Fund's general partner. Other Lenders, however, prefer that they themselves retain pre-approval and consent rights. In either case, Lenders may require a prepayment of the transferring Investor's Capital Commitment prior to such transfer.

The impact of an unrestricted transfer of Investors' interests in the Fund, while delayed, can nevertheless be severe. For example, although an Investor may retain its entire interest in a Fund for the majority of the Fund's existence, a transfer of that interest months or years after a Facility is in place can trigger a borrowing base deficiency, requiring the Fund to make sizeable repayments. In light of those lurking consequences, Lenders and Funds are well-served to be mindful of provisions in Side Letters addressing Investors' right to transfer their interests. To prevent the potential negative consequences of a transfer, Investors typically agree in a Side Letter to give their Fund the right to preapprove any transfer of the Investor's interest in the Fund and, in turn, Funds agree not to unreasonably withhold such approval.

Sovereign Immunity

In addition to Government Investors, sovereign wealth funds and various other instrumentalities of foreign and domestic governments may become Investors in Funds. Such Investors often possess certain sovereign immunity rights that protect them against enforcement proceedings, which in their

broadest form, shield the Investor from all liability, including a Lender's attempt to collect Capital Commitments contractually due and payable under a Facility.[3] For that reason, Lenders evaluating the creditworthiness of an Investor's Capital Commitment are well-served to analyze the effect of any applicable sovereign immunity rights. To the extent that such analysis becomes problematic, Funds can address the potential complications arising from the Investor's sovereign immunity rights in a Side Letter.

An Investor's sovereign immunity rights are commonly addressed in a Side Letter through two mechanics. First, Funds begin by expressly acknowledging that the Investor retains all of the rights inherent in sovereign immunity. Then, however, the Investor agrees to limiting language making clear that the Investor's sovereign immunity rights do not relieve it of its obligations under the relevant partnership agreement, subscription agreement, and other fund documents. The cumulative effect of those maneuvers is to acknowledge both the Investor's sovereign immunity rights and its obligation to make Capital Contributions when called upon by the Fund.

Excuses

To meet their ongoing fundraising desires, Funds are turning to certain non-traditional Investors that may have unique investment constraints. Such non-traditional Investors may bring cultural, religious, and/or jurisdictional investment preferences to a Fund that prevent the Fund from using the Investor's Capital Contributions to fund certain investments. Frequent examples of such preferences include prohibitions on investing in gambling facilities, tobacco or alcohol products, and the like. To balance their desire to expand their sources of capital to non-traditional Investors with such Investors' investment preferences, Funds have often provided "excuse rights" to such Investors.

Excuse rights permit, under certain circumstances, an Investor to elect not to fund a capital call relating to a particular investment that conflicts with the Investor's investment preferences. In such an arrangement, an Investor who is excused from funding a capital call often cannot be relied upon to fund the repayment of an extension of credit under a Facility used by a Fund to acquire an excused investment. The implication for Lenders of such excuse rights is that their collateral under a Facility may be diminished based solely on the investment preferences of an Investor. To mitigate that potential consequence, Funds should clearly designate how a legitimately excused Investor's unfunded Capital Commitment will be treated after such an excuse is made. Such a designation is appropriately made in connection with the documentation of excuse rights in an Investor's Side Letter.

Overcall and Concentration Limits

As the Facility market has expanded into the buyout and private equity industries, Lenders have more frequently encountered overcall and concentration limitations. Overcall limitations constrain 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.[4] Similarly, concentration limitations may restrict the percentage that a single Investor's Capital Commitment and/or Capital Contributions may comprise of a Fund's aggregate Capital Commitments and/or Capital Contributions. For instance, an Investor may require that its Capital Commitment not represent more than 20% of a Fund's aggregate Capital Commitments.

From the Lenders' perspective, overcall and concentration limitations fundamentally conflict with their expectation that Investors in a Facility are jointly and severally obligated to fund capital calls up to each Investor's respective Capital Commitment. The effect of such limitations upon Lenders is clear: they may not be able to rely on the support of the entire pool

of Capital Commitments for repayment of any extension of credit under a Facility if the Fund's Investors have successfully negotiated overcall or concentration limitations. Not surprisingly, Lenders generally take a negative view of the credit implications of such limitations.

While overcall and concentration limitations are still relatively rare in Funds' formation documents, they require Lenders to evaluate not just the entire borrowing base of a Facility, but also the Fund and Investors themselves in order to adequately analyze the risk of Investor default. Fortunately, as rare as overcall and concentration limitations are, Investor defaults have been even more infrequent in the Facility market. That said, whenever possible, Funds should narrowly tailor overcall and concentration limitations to carve out Facility-related items, including the obligation to fund capital calls related to indebtedness incurred under a Facility.

Conclusion

This article highlighted certain issues that Lenders and Funds should consider when reviewing and/or negotiating Side Letters in connection with a Facility. For more information about those issues and the various options for effectively resolving them, please contact the authors of this article. ◆

Endnotes

1. We note that each issue discussed in this article should be considered within the context of a most-favored nation provision as discussed in our MFN article *Winter 2015 Fund Finance Market Review* on page 141.

2. For a discussion of certain of these restrictions, see our Legal Update dated October 28, 2010 *"California Imposes Lobbyist Registration Requirement and Contingency Compensation Prohibition on Certain Placement Agents,"* available at http://www.mayer-brown.com/publications/california-imposes-lobbyist-registration-requirement-and-contingency-compensation-prohibition-on-certain-placement-agents-10-28-2010/; see also our Legal Update dated July 29, 2010 "SEC Adopts Advisers Act Pay-to-Play Rule Relating to Government Plans", available at http://www.mayer-brown.com/publications/sec-adopts-advisers-act-pay-to-play-rule-relating-to-government-plans-07-29-2010/; see also our Government Relations Update dated April 28, 2009 "New York State Comptroller Bans Placement Agents, Paid Intermediaries and Lobbyists in Investments with Common Retirement Fund," available at http://www.mayerbrown.com/publications/new-york-state-comptroller-bans-placement-agents-paid-intermediaries-and-lobbyists-in-investments-with-the-common-retirement-fund-04-28-2009/.

3. For a more thorough explanation of the historical basis of sovereign immunity and the related implications for Funds and Lenders in a Facility, see our Legal Update *"Sovereign Immunity Analysis in Subscription Credit Facilities"* dated November 27, 2012, on page 9.

4. A more fulsome examination of the several varieties of overcall limitations and their unique implications on Facilities is beyond the scope of this Legal Update. For further treatment of the subject, see our Legal Update *"Subscription Facilities: Analyzing Overcall Limitations Linked to Fund Concentration Limits"* dated June 29, 2013, on page 24.

Limitations on Lender Assignments To Competitors In Subscription Credit Facilities and Other Fund Financings

In a typical syndicated credit facility, the lenders are generally prohibited from assigning their rights and obligations under the credit agreement without the borrower's consent (typically not to be unreasonably withheld) unless the borrower is in default of its obligations under the credit agreement or the assignment is made to an existing lender, an affiliate of a lender or a non-natural person that meets certain other specified criteria[1] (each such person, an "Eligible Assignee"). Many credit agreements provide the borrower with additional rights with respect to assignments; for example, by giving the borrower a consent right to lender assignments at all times other than if a payment or bankruptcy event of default exists, by prohibiting assignments to competitors of the borrower or its financial sponsor (if relevant) regardless of whether a default exists, by permitting assignments of term loans to the borrower's debt-fund or other affiliates, by allowing term loan buy-backs by the borrower or by omitting any "deemed consent" provisions where the borrower's failure to object to a request for an assignment within a short time frame constitutes consent. The nature and extent of any such borrower rights, and the degree to which lender participations are similarly restricted, will depend on many factors, including the borrower's credit profile, industry, whether a financial sponsor is involved, general market conditions and the administrative agent's and initial lenders' preferences and policies.

One of the key underlying tensions in negotiating lender assignment provisions is balancing the lenders' desire to maximize the pool of potential assignees in the event a lender needs to liquidate its position to manage its loan portfolio or otherwise, and the borrower's desire to manage the identity and number of its lending partners and maintain the confidentiality of its proprietary information, particularly from the borrower's (or its sponsor's and affiliates') competitors if they are potential assignees or participants. The administrative agent will also have practical operational concerns about the extent to which it may be asked to administer bespoke provisions governing the composition of the syndicate on an ongoing basis. As more fully described below, when a private equity real estate or private equity fund (a "Fund") directly enters into a credit facility as a borrower or other obligor, the Fund's need to limit assignments to

competitors may be heightened as potential competitors of the Fund, such as credit funds, debt funds, hedge funds and other pooled investment vehicles, are potential assignees or participants with respect to the Fund's debt. Accordingly, care must be taken to address the Fund's business needs while taking the administrative agent's and lenders' competing objectives into account.

Background

A subscription credit facility, also frequently referred to as a capital call facility (a "Subscription Facility"), is a secured loan made by a bank or other credit institution to a Fund. What distinguishes a Subscription Facility from other secured lending arrangements is the collateral package: the Fund's obligations are typically not secured by the underlying assets of the Fund, but instead are secured by the unfunded capital commitments (the "Capital Commitments") of the limited partners of the Fund (the "Investors") to fund capital contributions when called from time to time by the Fund or the Fund's general partner (the "General Partner"), and certain related rights including collection and enforcement thereof, in each case pursuant to the Fund's constituent documents.

Thus, the collateral package of a Subscription Facility by its very nature includes proprietary information related to the Fund and its Investors. This information includes the Fund's Investor list and Investor details, the Fund's constituent documents (principally the limited partnership or other operating agreement), subscription agreements, any side letters entered into between the General Partner and an Investor in connection with the Investor making its Capital Commitment to the Fund and information concerning the Fund's overall investment and management structure. Side letters in particular have the potential to contain highly sensitive information about a Fund, such as additional or special economic, informational or other concessions the General Partner made to a specific Investor to secure its Capital Commitment.[2] Because Funds and their General Partners invest significant time and resources in developing Investor relationships and negotiating constituent document and side letter terms with Investors and potential Investors, ensuring that such sensitive information is not obtained by competitors (through a debt assignment or otherwise) is of paramount importance to a Fund. If a Fund's competitor obtained its Investor list, Investor Capital Commitment information, and other Fund documents as a result of an assignment or participation by a lender under a Subscription Facility, the competitor would instantly gain an informational and competitive advantage and could use the Fund's trade secret information in its own business to the detriment of the Fund and the benefit of the competitor. Therefore, controlling which entities may gain access to the Fund's non-public information through lender assignments and participations is an important business concern for a Fund. It is worth noting that these concerns may arise not only in a traditional Subscription Facility but also with other types of Fund financings,[3] such as hybrid facilities, unsecured lines of credit with a Fund obligor, financings structures where a Fund provides a guaranty or other credit support and other arrangements where a lender would need to conduct due diligence on the Fund's constituent documents, assess a Fund's Investors from an underwriting perspective or undertake "know your customer" or similar checks on the Fund and its equity holders.

LSTA's Model Credit Agreement Provisions

There are a variety of ways market participants may address lender assignments to competitors in Subscription Facilities and other Fund financings.[4] The Loan Syndications and Trading Association (the "LSTA") recently published a revised version of its Model Credit Agreement Provisions ("MCAPs") on August 8, 2014 that address, among other topics, prohibitions on lender assignments to so-called "disqualified institutions" (commonly also referred to as "ineligible institutions" or "disqualified lenders") (a "Disqualified Institution"), which specifically

contemplate limitations on assignments to the borrower's competitors. The LSTA's new assignment provisions create a structure (the "DQ Structure") that may be useful to Funds, their lenders and respective counsel in negotiating assignment provisions in Subscription Facilities.

In brief, prior to closing, the MCAPs DQ Structure allows the borrower to establish a list of entities that cannot own its debt (which may include both competitors and entities that the borrower desires to "blacklist"; for example, an entity with which the borrower has previously had a bad experience). After closing, the MCAPs permit the borrower to update the list of Disqualified Institutions (a "DQ List") on an ongoing basis with entities that are "Competitors." The MCAPs do not, however, include a definition of "Competitors," and it is left up to the parties to negotiate how "Competitors" should be defined for the particular borrower. Assignments and participations to Disqualified Institutions are prohibited at all times, even if the borrower is in payment default. The MCAPs authorize (but do not obligate) the administrative agent to distribute the DQ List and any updates thereto to each lender and to post the DQ List to the electronic transmission platform for all lenders; the precise mechanics governing who must receive the DQ List and the amount of advance notice the borrower is required to give of a change in the DQ List, however, are left to the parties to determine. The consequences of a lender becoming a Disqualified Institution, or if an assignment is made to a Disqualified Institution, are described in detail in the MCAPs.[5] The MCAPs provide that the borrower is permitted (x) to terminate the revolving commitments of the Disqualified Institution, (y) prepay or repurchase the Disqualified Institution's term loans at the lowest of par, the amount the Disqualified Institution paid for the assignment [or the "market price"][6] and/or (z) require the Disqualified Institution to assign its commitments and loans to an eligible assignee.[7] In addition, the DQ Structure sets forth various limitations on Disqualified Institutions, including prohibiting Disqualified Institutions from receiving information provided by the borrower to the lenders, barring the Disqualified Institution from attending lender-only meetings and effectively limiting the Disqualified Institution's voting rights both before and after the commencement of a bankruptcy proceeding of the borrower.

Considerations in Applying the MCAPs DQ Structure to a Subscription Facility

In applying the LSTA's DQ Structure to a Subscription Facility determining who counts as a "Competitor," the extent to which the Fund is permitted to update the DQ List post-closing and who receives the DQ List will be areas of intense scrutiny for the transaction parties. For a Fund, defining "Competitor" as expansively as possible to include any private equity fund, hedge fund or other pooled investment vehicle or any entity whose primary business is the management of such entities and their affiliates, would be appealing and highly protective of the Fund as it would permit the Fund to designate a wide universe of potential assignees as Disqualified Institutions under the DQ Structure. The lenders, however, would object that such a definition is unduly broad and would cover commercial banks that have fund affiliates (including debt funds) and many secondary market participants, in particular, credit funds, hedge funds and similar institutional investors that are likely potential purchasers of bank debt but with whom the Fund may not truly be competing in terms of investment strategy and potential Investors. Including carve-outs to expressly exclude commercial banks regardless of whether the commercial bank sponsors pooled investment vehicles or private equity funds or make private equity investments in the normal course of its/its affiliates' business from such a definition would ensure that the borrower cannot designate commercial banks as Disqualified Institutions post-closing simply because they may have affiliates conducting private equity-type activities.

Another potential alternative would be to limit the definition of "Competitors" solely to private

equity funds with the same primary investment strategy as the Fund (e.g., buyout, energy, real estate, infrastructure, etc.), which would allow for assignments to commercial banks, hedge funds and private equity funds of a type different from the Fund (which are less likely to be competing for Capital Commitments from the same Investors as the Fund). With credit funds especially, this may be a less palatable solution for the lenders, since it would enable the borrower to deliver an exhaustive DQ List that includes many likely secondary market investors. In such a case (and generally), limiting the total number of entities that may be set forth on the DQ List at any time, prohibiting the borrower from updating the DQ List after closing without required lender consent and/or otherwise limiting the frequency with which the borrower may update the list may be ways to balance the Fund's need to limit assignments to competitors against the lenders' interest in ensuring that most of the likely secondary market purchasers are not on the DQ List.

The transaction parties may also consider whether dispensing with the DQ List element of the DQ Structure altogether is appropriate, and instead simply prohibit assignments to all "Competitors" without specifically naming those entities on a list. While this approach may be attractive to a Fund that views its DQ List as trade secret information and does not want it shared with the lending syndicate, it injects an element of uncertainty into the deal to the extent the lenders and prospective assignees and participants are not readily able to confirm whether an assignment or participation would comply with the credit agreement. Where such heightened sensitivities exist, the transaction parties may decide to give the borrower the right at all times to review each proposed assignee or participant to determine if they are a "Competitor" prior to the effectiveness of any trade, thus giving the borrower a (limited) veto right even when the borrower is in default. At the other end of the spectrum (and in the approach outlined in the MCAPs), the parties would agree to the parameters defining "Competitors" and the administrative agent would be authorized to post the DQ List to the electronic transmission platform for all lenders to access. Where participations are subject to the same restrictions as assignments, the lenders will argue that it is only fair for a specific DQ List to be made easily accessible to them with reasonable advance notice.

In addition to determining how to handle the scope and mechanics around updating and distributing the DQ List, the transaction parties will also want to decide whether the remedies and consequences of assigning or participating in a loan to a Disqualified Institution outlined in the MCAPs are appropriate. For example, while the MCAPs include the remedies and consequences outlined above (including yank-a-bank provisions), the Fund may prefer to specify different rights and consequences or provide that offending assignments are *void ab initio*. Taking such an approach, however, may result in confusion later, particularly if there are multiple assignments following a trade to a Disqualified Institution that need to be unwound.

Conclusion

In negotiating lender assignment provisions in Subscription Facilities, the transaction parties may look to the MCAPs for guidance on how to structure limitations on assignments and participations to Disqualified Institutions, including a Fund's competitors. In applying the MCAP's DQ Structure to a particular Subscription Facility, care must be taken in balancing the competing business and operational needs of the borrower, the lenders and the administrative agent. A slight modification to one element of the DQ Structure may have unintended consequences in other areas of the credit agreement. As a result, Funds and their lenders will want to seek guidance from counsel well-versed in Subscription Credit facilities and the unique needs of Funds when negotiating limitations on assignments and participations in Subscription Facilities. ◆

Endnotes

[1] Assignments to entities commonly referred to as "Approved Funds" that are (a) engaged in making, holding, purchasing or otherwise investing in commercial loans, bonds and similar credit extensions in the ordinary course of their business and (b) managed or administered by a lender, an affiliate of a lender or an entity or an affiliate of an entity that manages or administers a lender, are often included within the scope of Eligible Assignees in a credit agreement to an operating company.

[2] See article *Developing Side Letter Issues* for additional information about select topics commonly addressed in side letters, on page 146.

[3] For more detailed discussions of other types of Fund financings, please see Mayer Brown's *Summer 2013, Winter 2013* and *Summer 2014 Fund Finance Market Reviews* on pages 19, 59 and 97.

[4] For simplicity, as used herein, "Subscription Facilities" includes all such Fund financings.

[5] The MCAPs provide that assignments may not be made to any entity "that was a Disqualified Institution as of the date (the "Trade Date") on which the assigning lender entered into a binding agreement to sell and assign all or any portion of its rights and obligations under this Agreement." Thus, retroactive effect is not given to the designation of an assignee as a Disqualified Institution after the Trade Date, and the parties may settle their trade without violating the credit agreement; the borrower, however, has certain rights against the Disqualified Institution assignee.

[6] The reference to market price is bracketed in the MCAPs. This is an acknowledgement that it may be difficult to establish a market price for a particular loan at any given time, and the parties may prefer to remain silent on this issue in the credit agreement.

[7] Note that an assignment to a Disqualified Institution under the MCAPs would not render the assignment void; instead, the enumerated consequences would apply.

Most Favored Nations Clauses: Potential Impact on Subscription-Backed Credit Facilities

Introduction

The terms of the business arrangement between a private equity fund (a "Fund") and an investor (an "Investor") are generally contained in the constituent documents of the Fund, often a limited partnership agreement (an "LPA"), which sets forth the rights and obligations of the general partner and each Investor. An LPA typically will address, among other things, capital commitments, the general partner's right to call capital, each Investor's right to partnership distributions, transfer and withdrawal rights, and indemnification obligations. In addition to the LPA, an Investor will likely execute a subscription agreement that often includes, among other terms and provisions, a power of attorney over the Investor, which permits the general partner to execute the LPA on the Investor's behalf. The subscription agreement and the LPA form the basis of the Investor's commitment to the Fund and are generally consistent among all Investors in a Fund.

In certain negotiations with potential Investors where the Fund does not want to alter the LPA or subscription agreement, the Fund and an Investor will execute a side letter that will serve, separate and apart from any other Investor's agreement with the Fund, to modify the terms of that Investor's subscription agreement and/or the LPA. A side letter generally grants an Investor additional rights or privileges or otherwise limits the applicability of certain LPA provisions as applied to the Investor. While side letters are, by design, Investor-specific, the inclusion of a Most Favored Nations clause ("MFN") changes that dynamic and potentially could make every provision of all side letters available to every other Investor.

MFNs have become more common with the proliferation of side letters and side letter requests from Investors. For the reasons discussed below, MFNs can have significant, negative effects on a Fund's subscription-backed credit facility (a "Credit Facility"). In such a Credit Facility, the lenders (the "Lenders") are granted a security interest in the uncalled capital commitments of the Fund's Investors, and the Lenders rely on the Investors' obligations to fund capital contributions as the primary source of repayment. The Lenders' rights under a Credit Facility are derivative of

the rights of the Fund and its general partner and, therefore, depend significantly on the substance of the Fund's LPA and any side letters. Because of an MFN's potentially disastrous impact on a Credit Facility's borrowing base or viability, as discussed below, it is very important to carefully review and understand not only the MFN, but also each provision of every side letter between a Fund and its Investor where the Investor has an MFN in its side letter.

MFNs Generally

At its most basic, an MFN serves to protect an Investor's interest by ensuring the Fund does not offer better terms to another Investor in a side letter. Accordingly, in a side letter's MFN, the Fund agrees that the Investor will be entitled to elect any more-favorable right or privilege granted to other Investors in separate side letters. Thus, an MFN potentially allows an Investor to obtain benefits under any other Investor's side letter. Typically, however, MFNs contain some limits, or "carve-outs," curtailing the provisions that an Investor can elect from such side letters.

While not necessarily included within the text of an MFN, the process by which an Investor can elect provisions from other Investors' side letters varies from Fund to Fund. Some Funds will provide that each Investor with an MFN receives copies of all other side letters, other Funds will provide a list of all side letter provisions and other Funds will circulate a list of only those provisions that an Investor is eligible to elect. In addition, Funds differ both in what is distributed to Investors eligible to make an MFN election and when such an MFN election can be made. Most Funds permit an Investor with an MFN in its side letter to make an election only after the final Fund closing.

Impact on Subscription-Backed Credit Facilities

MFNs can negatively impact, or even completely preclude, a Credit Facility in a number of ways. Because an MFN permits an Investor to elect terms and provisions from other Investors' side letters, the presence of an MFN can have far-reaching effects, particularly on the Fund's borrowing base. In a Credit Facility with the absence of an MFN, an Investor with one or more problematic provisions in its side letter simply can be excluded from the borrowing base. While Investor exclusion is hardly ideal, excluding one Investor is rarely fatal to a Credit Facility's viability. If, however, a similar scenario arises and an MFN exists in one or more side letters, thereby permitting other Investors to elect such problematic side letter provisions, large swaths of the borrowing base could be excluded, thus jeopardizing the feasibility of a Credit Facility.

For example, if a side letter permitted an Investor to opt out of LPA provisions requiring it to fund its capital commitment without counterclaim, defense or set-off, a Lender may decide to exclude that Investor from the borrowing base.[1] If there are no MFNs in other side letters, or if any such MFNs are drafted to include applicable carve-outs discussed below, other Investors will be precluded from electing such provisions for their own side letters. The Fund and Lender thus can limit the negative impact on the borrowing base. If the above scenario occurs, however, and one or more other Investors have an MFN in their side letters that allows them to elect the same provision, the ramifications could be catastrophic for the borrowing base.

The potentially far-reaching effects of MFNs on a Credit Facility mean that each provision in every side letter matters. The best practice for both Funds and Lenders, therefore, is to review any proposed side letters prior to their execution to ensure that an MFN will not impair the Fund's borrowing base or a contemplated Credit Facility. Early and clear discourse between the Fund and Lender with respect to side letters will provide the opportunity to negotiate side letter provisions, especially MFNs. To be sure, renegotiating already-executed side letters is a difficult process for all parties, and there is no

guarantee that doing so will adequately resolve potential issues. As a result, Funds and Lenders alike should consult with experienced counsel to help review each side letter, to advise and assist in negotiating a side letter's terms, and to ensure that an MFN is well-drafted to include sufficient carve-outs to ensure the viability and success of a contemplated Credit Facility.

Carve-Outs

The most effective way to limit the potentially negative effects of an MFN is through the use of "carve-outs," or restrictions, in the MFN that limit the types of provisions that an Investor with an MFN may elect from other Investors' side letters. As side letters have grown in length and as more Investors have requested MFNs, Funds have sought to limit the applicability of MFNs and associated potential Credit Facility issues by including a number of MFN carve-outs, thereby prohibiting the election of certain types of provisions. Because carve-outs vary in scope and substance, an MFN should be crafted and reviewed with the assistance of experienced legal counsel to meet the unique requirements of each transaction and to limit the potential negative effects on a Credit Facility. There are a number of typical MFN carve-outs discussed below that can be helpful to both Funds and Lenders in connection with their Credit Facilities.

One very common MFN carve-out links an Investor's ability to elect more favorable rights to the size of the Investor's capital commitment. Such a carve-out precludes a small Investor from electing provisions that a Fund's larger Investors may have negotiated. Such capital commitment-based carve-outs can be structured in a number of ways, including setting a minimum commitment threshold for any Investor to have an MFN in its side letter, permitting an Investor to elect side letter provisions of any Investor with an equal or lesser commitment, or establishing a commitment threshold above which an Investor may elect any provision from any other Investor, regardless of the other Investor's commitment.

Another typical MFN carve-out imposes policy/jurisdictional/regulatory limits on side letter-electable provisions. Certain Fund Investors, by virtue of their written policies or guidelines or by jurisdictional or regulatory status, may be entitled to certain accommodations on account of such status that the Fund may not want to extend, or are otherwise inapplicable, to other Investors. Such an MFN carve-out would allow an Investor to elect additional rights only if the Investor is subject to similar policies, guidelines, or jurisdictional and regulatory schemes.[2] Investors subject to the same policy, jurisdictional or regulatory regimes thus will be able to elect such provisions, but the Fund and Lender will still be protected from having to offer the same rights to additional, non-qualifying Fund Investors with an MFN. There is some debate among practitioners as to whether the broad use of policy/jurisdictional/regulatory status language to preclude election under an MFN would be enforceable in all circumstances, but such carve-outs nevertheless are utilized widely in side letters to try to limit MFN risk exposure.

Potentially most important for facilitating a Credit Facility is a carve-out prohibiting any Investor from electing additional rights that may affect provisions of the LPA related to the Fund's ability to enter into a Credit Facility. Such a carve-out would apply to, among other things, provisions regarding funding without counterclaim, defense, or setoff, agreement to produce or deliver financial statement, investor acknowledgments, investor letters, and/or investor opinions. By preventing all Investors from electing provisions so closely linked to a Credit Facility, a Fund and a Lender can effectively limit negative impacts to the borrowing base and thus ensuring feasibility of a Credit Facility.

Conclusion

As discussed above, MFNs in side letters can have a potentially significant and negative impact on a Credit Facility. Although Investors may insist upon an MFN in their side letters, a Fund and a Lender can take reasonable steps, such as adding carve-outs to the MFN's applicability, thereby protecting the Fund's borrowing base from problematic provisions in a side letter and, by extension, the viability of a Credit Facility. Early review and, if necessary, negotiation of proposed side letter provisions by both the Fund and the Lender with the assistance of experienced and skilled counsel is the recommended best practice. In doing so, a Fund can ensure its borrowing base remains intact, and a Lender can get comfortable relying on the capital commitments of the Fund's Investors for repayment. ◆

Endnotes

1 For a detailed discussion of some current problematic side letter issues, see the article, *"Developing Side Letter Issues", Winter 2015 Fund Finance Market Review* on page 146.

2 Common examples include (i) inapplicability of waiver of defenses or counterclaim for tax purposes, (ii) reservation of rights with respect to sovereign immunity, and (iii) variation from confidentiality restrictions.

Infrastructure Funds Update

Among private investors, the term "infrastructure" denotes a wide range of physical assets that facilitate a society's principal economic activities — transportation, energy and utility, communications and "social" infrastructure, for example. Historically, funding for these projects has been the domain of governments, multilateral institutions, official lenders, and large commercial banks providing debt alongside such other institutions. However, with an estimated $57 trillion needed to finance infrastructure development around the world through 2030, according to a report from McKinsey & Co., private investors have an unprecedented opportunity to fill some of the gap created by public-funding shortfalls, and the last decade has been witness to a flurry of innovation in private funding methods and structures, with varying degrees of success. As the asset class matures, some infrastructure funds—private equity vehicles that attract capital commitments from investors and deploy that capital to invest in these assets—will need to explore new ways to create and demonstrate value in order to capture some of that capital.

Fewer unlisted infrastructure funds reached final close in 2014 than in 2013, and the level of institutional investor capital secured by those funds fell by almost 16% when compared to 2013; however, the aggregate $37bn raised by unlisted infrastructure fund managers was still 23% higher than the $30bn raised in 2012, and the amounts raised by funds reaching interim close increased for the twelve-month period ending January 2015. An increasing proportion of that capital is concentrated among a few large players, and the market remains crowded, with 144 unlisted infrastructure funds in market as of January 2015, targeting aggregate capital commitments of $93bn. And while the average fundraising lifecycle shortened to 19 months in 2014, as of January 2015 40% of funds in market had been fundraising for over two years.[1]

Although fund managers face increased competition, investor appetite for infrastructure remains strong, with investors continuing to indicate an interest in expanding their allocations to this asset class. Many have increased their target infrastructure allocations to 3-8% of total assets under management over the next decade, up from

around 1% today. There has also been an influx of new entrants. Preqin now tracks more than 2,400 institutional investors actively investing in infrastructure, more than double the figure from 2011 when it began tracking the asset class.[2] While the main route to market for investors, especially new entrants, is through unlisted vehicles,[3] some larger investors are opting for direct investments. According to a survey conducted in the second quarter for Aquila Capital Concepts GmbH, about 57% of institutional investors said direct ownership is the best way to invest in real assets, including infrastructure.[4] While the avoidance of expensive management fees is certainly an incentive, the driving force behind direct investments seems to be control over the portfolio. In addition to concerns over time horizon and liquidity, the use of leverage can be an issue of contention, especially after the recent financial crisis. Investors disappointed in the performance of infrastructure assets during the financial crisis pointed to high leverage and lack of transparency in financing arrangements as reasons for their disappointment.[5]

In addition to adding infrastructure teams to their staffs in order to make unilateral direct investments, large investors are also looking at new and more sophisticated ways to club together and increase investment power. Theoretically, the benefits from club investing relative to those of investing through a conventional fund manager include improved alignment of interest with other, similarly situated investors, including with respect to investment horizon and fees, larger average commitments and local knowledge, and the spread of risk relative to unilateral direct investment.[6] Consequently, club investment platforms and research groups have started to emerge. Examples include The Long Term Investors Club (Global), Pension Infrastructure Platform (UK), Global Strategic Investment Alliance (Canada HQ), and the Fiduciary Infrastructure Initiative (USA).[7] The most recent example is the California State Teachers' Retirement System (CalSTRS), which announced plans to develop a multibillion-dollar global syndicate for infrastructure investing. The syndicate is intended to be comprised of public pension funds and to invest in North American infrastructure, similar to the IFM (Investors) model, which invests on behalf of institutional investors and is owned by 30 major Australian superannuation funds.[8] With total funds under management of A$23bn and control of 44 board seats across 29 infrastructure investments with operations on four continents, IFM is one of the largest infrastructure investors in the world.

Another example, the Global Strategic Investment Alliance (GSIA), was launched by the Ontario Municipal Employees Retirement System (OMERS), one of Canada's largest pension funds with more than C$65bn (US$59.8bn) in net assets. The alliance, a US$12.5bn-plus infrastructure club investment program, has an investment period of five years followed by a holding period of 15 years, and then an exit period of five years,[9] and allows its investors to choose the deals in which they wish to participate on a transaction-by-transaction basis.[10] The investment opportunities are sourced and actively managed by OMERS through its various investment arms—Borealis Infrastructure will originate and manage the investments, and Rosewater Global will provide administrative support services. Marketed at 50 basis points and a carried interest fee for performance at a later date,[11] the platform offered limited partners the opportunity to put their money to work at a rate structure more favorable than what a fund manager would offer. However, collaboration with like-minded investors and size of investment power were touted as the main drivers. By targeting "alpha assets" of $2bn plus, the thought process was that these assets would be out of reach for almost anybody else, and therefore GSIA would be able to get superior returns. While theoretically

appealing, there are typically only two or three such assets that are put on the market each year, and with a typical five-year investment period, GSIA will need to close at least one or two deals a year, which could undermine its leverage with sellers. The alliance's maiden transaction was the acquisition from OMERS of a one-third stake in Midland Cogeneration Venture (MCV), a US combined-cycle gas-fired power plant. OMERS retained the remaining two-thirds equity in MCV. This strategy, where OMERS buys the asset first and then syndicates the equity to its GSIA partners, is expected to be repeated.[12]

With increased capital flowing into direct and club investment platforms, and a crowded fundraising market continuing with well-established managers garnering the majority of investor commitments, opportunities for fund managers to create and demonstrate value do exist. However, they may require creativity and a willingness to depart from the traditional closed-end infrastructure fund model with 10- to 15-year "lockup" periods. While providing a known investment period with defined entry and exit dates — which are well-suited to higher-risk investment strategies that don't provide stable, predictable cash flow — this structure is not ideal for all investors or all infrastructure assets. Open-end funds, on the other hand, offer periodic opportunities for acquisition or redemption of shares and the absence of a fixed investment horizon. The in-place income streams associated with traditional infrastructure assets are thus often a better fit for the open-end structure. Though infrastructure fundraising for closed-end funds has increased in recent years, industry observers believe that the lack of open-end funds has kept on the sidelines significant additional capital that would otherwise be committed to infrastructure investments.[13]

In addition to the open-end model, some fund managers are addressing investor liquidity concerns by taking their private equity infrastructure funds public. Not only does this allow investors to liquidate their investments at any time, the funds are also not forced to sell at a time when valuations may be unfavorable. Fortress Investment Group LLC (NYSE: FIG), for example, plans to convert its Fortress Worldwide Transportation and Infrastructure Investors private equity infrastructure fund into a publicly traded vehicle with the prior approval of the fund's limited partners. We expect smaller fund managers to continue to innovate.

In prior years, we have noted the growth of infrastructure funds focused on providing debt rather than equity investments, which arose during a prolonged period of diminished bank liquidity and concerns over the impact of new capital maintenance requirements. Investment opportunities for debt funds, however, have been scarcer than anticipated as a result of increased bank liquidity and shrinking margins. Further, debt funds are not able to offer the same flexibility as banks due to stricter investment parameters, and borrowers have found that their pricing and fees are often higher. New debt fund entrants are trying to complement banks instead of competing with them by entertaining subinvestment grade type transactions and offering longer terms. In addition, many of these funds are buying debt in the secondary market, which is pushing up the price.[14] The impact of new capital maintenance requirements are just beginning to take effect, however, and they are likely to present opportunities for infrastructure debt funds, albeit somewhat later and perhaps less broadly than anticipated. Further, as infrastructure continues to mature as an asset class in the United States, we anticipate that sponsors of infrastructure projects will demand – and be willing to pay for – debt other than the traditional, senior secured structures that continue to be most prevalent, including mezzanine debt, term loan B, and other subordinated loans. Infrastructure debt funds will be particularly well positioned to take advantage of such opportunities.

Despite movement toward open-end funds, direct investments, and club deals, the majority of private equity infrastructure investments continue to be made through closed-end structures. Within such funds, we see room for growth in the subscription-based financing structures that have been so successful in other private equity asset classes, and we likewise anticipate that substantial opportunities will develop to finance the alternative structures as they continue to develop. ◆

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SPRING 2016

In this Spring 2016 edition of our *Fund Finance Market Review*, we discuss some of the more noteworthy developments impacting the subscription credit facility and fund finance markets, including our views of the challenges and opportunities created by an increasingly prominent regulatory framework.

We also analyze some of the trends in private investment fund structuring, how the facility market may be able to adjust thereto and the evolving (international and domestic) legal landscape impacting facility lenders.

Spring 2016 Market Review

The past year was an active year for Fund Financings, with positive growth and strong credit performance through 2015 as an asset class. Capital call subscription credit facilities (each, a "Facility") continued steady growth and followed the uptick of closed funds and capital raised through Q3 and Q4 2015. Additionally, anecdotal reports from many of the major Facility lenders (each, a "Lender") and Mayer Brown's practitioners noted a substantial increase in alternative fund financings, including unsecured Facilities looking to the assets of private equity funds, such as hybrid and NAV Facilities, a trend that seems to be continuing through 2016 ("Alternative Fund Financings"). Additionally, Investor capital call (each, a "Capital Call") funding performance continued its near-zero delinquency status, and we were not aware of any Facility events of default in 2015 that resulted in losses. Below we set forth our views on the state of the Facility market and current trends likely to be relevant in 2016.

Fundraising and Facility Growth

Fundraising In 2015

Overall, 2015 was a positive year for private equity funds (each, a "Fund"). Fundraising was up slightly from 2014 levels, which were the highest levels seen prior to 2008. Globally, through Q3 2015, Funds raised over $391 billion in investor (each, an "Investor") capital commitments ("Capital Commitments"), higher than the same period in 2014 with $389 billion of commitments raised.[1] Continuing the prior year's trend of flight to quality, Investor capital was attracted to larger sponsors. During the same periods, fewer Funds were formed, with 760 Funds in 2015 as contrasted to 889 in 2014, resulting in a larger average Fund size. We note that the focus of such fundraising appears to be in the more mature North American and European markets as well as in the buyout, real estate and infrastructure sectors.[2] Additionally, anecdotal reports from Mayer Brown practitioners point to Europe in particular having a good early 2016 in terms of Funds and amount of capital raised.

Moreover, Investors have expressed continued interest in private equity, and the majority of Investors in 2015 expressed that they were below their target allocation to private equity, which is encouraging for the prospects of new commitments in 2016.[3] Given that Facility growth typically follows fundraising activity, this appears to bode well for the coming year.

Facility Growth

Although the Fund Finance market lacks league tables or an overall data and reporting and tracking service, it is clear that the market continued to expand in 2015. In respect of Fund Financings, Mayer Brown represented Lenders and Funds in new money transactions reflecting in excess of $30 billion of Lender commitments, a significant increase from $25 billion in 2014. We believe this growth to be steady, and initial indications are that this will be sustained into 2016. Notably, we are seeing growth not only from the continued penetration of Facilities with Funds and sponsors who have traditionally not

utilized them but also from the continued diversification in product offerings in the Facility market (including hybrid, umbrella and unsecured or "second lien" Facilities). We note that the active European market has also been focused on product diversification (perhaps even more so than in the United States), and we have seen growth in respect of unsecured Facilities in that market as well. Such diversification makes Facilities more attractive to a broader spectrum of Funds and increases the utility and lifespan of the product for Funds. Separately, throughout 2015, we have also seen a proliferation of interest in Alternative Fund Financings such as fund-of-hedge-fund financings, management fee lines and facilities based on net asset value ("NAV") of a Fund's underlying assets with our representing Lenders and Funds in approximately $5 billion of transactions closed during 2015. We believe that Alternative Fund Financings will be a key driver of growth in the Fund Finance market in 2016 and beyond.

Trends and Developments

Monitoring and Technical Defaults

We are aware of a handful of technical defaults over the course of 2015, arising primarily out of reporting failures in respect of borrowing base calculations and components thereof (including failures to timely report the issuance of Capital Calls). While none of these defaults resulted in losses, some resulted in temporary borrowing base deficiencies requiring cure through prepayments. Facility covenants providing for monitoring of collateral (including prompt delivery of Capital Call notices, notices of transfers, Investor downgrades and similar requirements) could have properly identified such issues. As a result we may, and probably should, see renewed focus by Lenders on Capital Call monitoring procedures and borrower reporting.

Nav And Secondary Fund Facilities

The private equity secondary market continues to grow as Investors review their portfolio allocations and seek to tailor their investments, either to diversify their exposure to particular asset classes or to free up capital for investment in newer Funds. Additionally, various financial institutions have sought to respond to regulatory capital pressures through the sale or adjustment of investment portfolios, which has led to a robust secondary market in the recent past.[4]

As a result, we have seen continued interest from both Investors and lenders in finding ways to provide either for financing of the acquisition of such assets on the secondary market or financing of Investors' current portfolios. In a number of cases, the desire for leverage has also been undertaken in order to provide for capital relief. These financings are generally NAV financings, as the borrowing base is comprised of the reported NAV of such private equity investment portfolios as may be adjusted for certain factors. Such financings tend to be bespoke in nature and based upon the particular basket of investments the borrower seeks to finance, requiring significant due diligence by the lending institution and the incorporation of concentration and other limitations in respect of the assets being financed. We believe this type of Facility will continue to grow in popularity as the secondary market remains strong and those acquiring or holding such investment portfolios desire leverage to enhance returns or obtain capital relief.

Hedging Mechanics

The inclusion of hedging and swap collateralization mechanics ("Hedging Mechanics") in Facilities was a significant trend in 2015. Hedging Mechanics offer a means for borrowers to secure hedging and swap obligations under existing Facilities, rather than posting cash or other collateral. Typical Hedging Mechanics allow borrowers to request that hedging or swap agreements entered into with Lenders ("Hedging Agreements") be allocated a portion of the borrowing base (a "Trade Allocation") for purposes of collateralizing such Hedging Agreements. The borrower's obligations under an applicable Hedging Agreement are then deemed

a part of the borrower's obligations under a Facility, reducing the borrowing base and the borrower's availability by the amount of the Trade Allocation. In the event the termination value of an applicable Hedging Agreement moves against the borrower, the borrower may be permitted to request that an additional Trade Allocation be made for such Hedging Agreement.

A number of other Hedging Mechanic components may require consideration on both a business and a legal level. For example, while Hedging Agreements secured by a Trade Allocation are typically pari passu with the Facility obligations (in each case up to the full amount of the Trade Allocation), Lenders will need to determine where amounts owing pursuant to obligations exceeding a Trade Allocation will fall in the payment waterfall. Additionally, Lenders and borrowers should also consider the impact that existing Trade Allocations should have on a Lender's ability to assign its interest under the Facility. From a legal perspective, counsel must consider the impact of certain regulatory requirements applicable to Hedging Agreements (e.g., the Commodity Exchange Act). The foregoing provides only a brief overview of some of the key components of Hedging Mechanics, and other aspects should be considered on a deal-by-deal basis. Given the increase in the popularity of Hedging Mechanics in Facilities, we expect to see continued development and innovation in this area during the 2016 year.

Bail-In Provisions

In 2015, the European Union adopted the EU Bank Recovery and Resolution Directive ("BRRD") with the aim to curtail future tax-payer-funded bail-outs of banks. The BRRD provides that, among other things, unsecured liabilities of a failing EU bank or other covered market participants governed by certain EU member states (a "Covered Institution") may be written down or canceled in order to recapitalize the Covered Institution. According to the Loan Market Association ("LMA"),[5] the powers to write down and cancel liabilities extend to commitments the Covered Institution has to fund loans under a credit facility and could result in the cancellation of a Covered Institution's ongoing commitment in a Facility and excuse from making its pro rata share of a loan).[6] The BRRD also provides that any contract that a Covered Institution enters into, including those that are governed by the law of non-European jurisdictions (such as New York law), must include a provision providing notice of the bail-in requirements and an acknowledgement by the other contract participants that the Covered Institution's obligations can be written down or cancelled via the BRRD (the "Contractual Recognition Provision"). These new rules take effect as early as January 1, 2016 for some European jurisdictions; and the LMA has further taken the position that transactions pre-dating such date should add the Contractual Recognition Provision if (a) a Covered Institution joins the facility (including as an increasing or assignee Lender), (b) the document is materially amended, or (c) new liabilities arise under the facility document.[7] In response to these new requirements, the main US loan trading organization, the Loan Syndications and Trading Association ("LSTA") has adopted form bail-in provisions including a suggested Contractual Recognition Provision and amendments to the LSTA standard "Defaulting Lender" provisions to pick up the possibility of the application of such write-down and cancellation powers. While these provisions are not technically needed unless a Covered Institution is a party to the Facility, in an effort to freely and quickly syndicate (both before and after a default), we have seen Lenders request these provisions in deals going forward and believe they will become standard in all syndicated credit facilities in 2016.

Management Fees and Overcalls

Last year we saw the proliferation of provisions in Fund partnership agreements that prohibited making overcalls[8] to pay management fees. From an Investor's perspective, the rationale of not paying another Investor's management fee seems

reasonable. However, this creates issues for Facility Lenders as the use of proceeds section of most Facilities permits borrowings to pay management fees. By creating such an overcall limitation, if the Fund uses the Facility to front management fees, a Lender could theoretically face a situation where any Capital Contribution default (including a default made by Investors not included in the borrowing base) would result in a dollar-for-dollar loss. Lenders have largely responded to the rise of this provision by either prohibiting the use of Facility proceeds to front management fees or creating other limits in respect of such borrowings to limit exposure to such risks such as periodic cleandown or other requirements.

Confidential Investors

In 2015, we saw more Funds agree to confidentiality provisions with Investors that prevented them from disclosing the identity of such Investor to Lender. The presence of a confidential Investor creates a number of issues for a Facility, even if such Investor is not included in the borrowing base. Lenders may face challenges with respect to confidential Investors given the often-required "know your customer" and "anti-money laundering" checks, particularly where such Investors make up a significant portion of a borrower's commitments. However, such issues relate not only to Investor due diligence, but also Capital Call mechanics. In particular, the need to make pro rata Capital Calls on all Investors as required under the Fund partnership agreement would not be possible if such Investor's identity was unknown. This would pose issues in respect of an exercise of remedies by a Lender. While Lenders vary on the solutions they may find acceptable with respect to Investor due diligence issues, there are a number of methods that are being used to address the issue of making pro rata Capital Calls including the insertion of various provisions in side letters permitting such a call or the potential structuring of such Investor's commitments through a feeder fund so that a call upon the actual Investors of the Fund would only require a call upon the feeder fund through which such confidential Investors invest, in order to satisfy the pro rata Capital Call requirement.

Sovereign Wealth Funds and the Energy Sector

It is estimated that sovereign wealth funds ("SWFs")[9] currently hold investments exceeding $7 trillion (more than all of the world's hedge funds and private equity funds combined) and have significant uncalled commitments to private equity funds.[10] Most SWFs are energy dependent (the Institute of International Finance suggests that almost 60% of their assets are within the energy sector), and thus, the recent market volatility and drop in oil prices has strained their liquidity. In 2015, many SWFs liquidated assets to counteract the poor portfolio performance. From a subscription finance perspective, SWFs have traditionally been difficult to underwrite as very few publicly disclose financials or issue any annual report. With that said, in the last few years we have seen Lenders become increasingly comfortable lending against SWFs at reduced advance rates or subject to certain concentration limits. While this approach logically makes sense given the historical performance of the subscription facility space, in light of the energy crisis, we suspect Lenders will take a harder look at advancing against SWFs in 2016.

As the commodities market values continue to slide, we have also seen a number of market participants seek additional collateral to secure new and existing asset-level facilities in the energy sector, including traditional Facility collateral. While such efforts have differed in their scope and structure, including whether such collateral was provided on a secured or unsecured basis, this trend may continue to the extent commodities markets remain volatile.

Conclusion

As noted above, 2015 was a year of steady growth in the Facility market accented by both penetration into new Funds as well as product diversification of both Facilities and Alternative Fund Financings. We are cautiously optimistic that such trends will continue in the near future through 2016, and while the recent volatility in the greater financial markets provides a number of uncertainties, especially in the energy sector and with respect to Investors who are focused on such returns, we believe that such uncertainties also provide opportunities for savvy Investors and Lenders in providing necessary financing. ◆

Endnotes

1 *Preqin Quarterly Update Private Equity* Q3, 2015, p. 6.

2 *Preqin* at p. 6.

3 *Preqin* at p. 8.

4 *Preqin. Private Equity Spotlight November 2015*, p. 3.

5 The LMA is the leading industry organization for loan trading in Europe.

6 In addition to writing down or canceling lender commitments, other liabilities of a Covered Institution can be compromised by the BRRD, including (a) indemnities typically given by the Covered Institution to the administrative agent; (b) requirements of the Covered Institution to share or turn over recoveries made from the borrower; (c) confidentiality duties; (d) requirement of the Covered Institution to obtain borrower or administrative agent consent prior to transferring its interest; (e) restrictions on a creditor's actions typically found in intercreditor documentation; (f) administrative obligations, such as notifications of tax status or requirements to make other notifications or to supply or forward information; and (g) potential noncontractual liability under loan market documentation such as potential claims in negligence or misrepresentation. *See The LMA Recommended Form of Bail-in Clause and Users Guide*, Dec. 22, 2015, http://www.lma.eu.com/documents.aspx?c=170.

7 *See* Id.

8 "Overcalls" are capital calls on non-defaulting Investors to resolve a shortfall caused by an Investor that defaults on its obligation.

9 Sovereign wealth funds are special purpose investment funds sponsored by governments and/or sovereigns that typically hold, manage, or administer assets of their sponsor.

10 *See* Simon Clark, Mia Lamar & Bradley Hope, "The Trouble With Sovereign-Wealth Funds," *Wall Street Journal*, December 22, 2015.

Feeder Funds

A feeder fund ("Feeder") is an investment vehicle, often a limited partnership, that pools capital commitments of investors and invests or "feeds" such capital into an umbrella fund, often called a master fund ("Master"), which directs and oversees all investments held in the Master portfolio. A Master/Feeder structure is commonly used by private equity funds or hedge funds ("Funds") to pool investment capital. The Master's profits may be split on a *pro rata* basis among its Feeders in proportion to their investment. A Feeder is a separate legal entity from the Master and is relevant to both lenders and Funds when discussed in the context of lending relationships, particularly in structuring a subscription-backed credit facility ("Facility").

Investment managers choose to form Feeders for a variety of reasons. For example, Feeders offer flexibility with respect to investor tax status, ERISA status, minimum capital investments, fee structures or other administrative features that can be tailored to the specific needs of any investor. In this article, we will focus on certain tax, ERISA and aggregation issues as they relate to the Master/Feeder structure of Funds.

Tax Concerns[1]

Tax-exempt investors and foreign investors are two significant sources of capital in the United States and both groups invest heavily in Funds. Most tax-exempt investors will want to minimize or eliminate the realization of unrelated business taxable income ("UBTI") with respect to their investments. Similarly, most foreign investors will want to minimize or eliminate the realization of effectively connected income ("ECI") and structure their investments in a manner that does not require them to file US income tax returns. If a Fund makes its investments in or through pass-through entities, the Fund's tax-exempt investors may realize UBTI or its foreign investors may realize ECI and have to file US tax returns if the Fund is engaged in a trade or business in the United States.

In order to attract UBTI- or ECI-sensitive investors, many Funds offer Feeders through which such investors may participate in the Master's investments. Properly structured, these Feeders operate to "block" UBTI and ECI with minimal tax leakage.

Although Feeders formed to act as blockers are usually formed in a low tax jurisdiction (such as the Cayman Islands), the domicile and precise structure and tax classification of the Feeder will depend on the nature of the Fund and its investments, as well as the tax structuring objectives and/or regulatory requirements applicable to the prospective investor(s). A variety of UBTI and ECI blocking strategies exist, including the use of debt and equity to capitalize the Feeder and forming separate Feeders for each fund investment. In addition, tax treaties may reduce the overall tax cost of a Feeder formed for foreign investors. Each approach to the structuring and implementation of Feeders to accomplish tax objectives carries with it advantages and disadvantages that a Fund sponsor should discuss with its tax advisors.

ERISA Concerns[2]

Once a Fund or a Feeder accepts investors that are subject to the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), or Section 4975 of the Internal Revenue Code of 1986, as amended (the "Code"), the entity could itself become subject to the fiduciary and prohibited transaction rules under ERISA and Section 4975 of the Code if the assets of such Fund or Feeder are deemed to be "plan assets" of such investors.

The rules governing when the assets of an entity are treated as plan assets are generally set forth in Section 3(42) of ERISA and a regulation, known as the "plan asset regulation," published by the US Department of Labor.[3] The plan asset regulation sets forth a number of exceptions on which a Fund may rely to avoid plan asset treatment. The exceptions most commonly relied upon for Funds are the "less than 25% exception" and the "operating company" exception.[4]

In a Master/Feeder structure, it may be difficult for a Feeder to satisfy an exception to holding plan assets because (i) the Feeder may be too passive to qualify as a "venture capital operating company" ("VCOC") or a "real estate operating company" ("REOC") and (ii) investment by benefit plan investors in the Feeder may be too significant to satisfy the less than 25% exception. In such a case, a Fund manager may permit the Feeder to operate as a plan asset vehicle that is subject to Title I of ERISA and/or Section 4975 of the Code. The Master, which will aggregate capital from all of its Feeders and investors, may still be able to rely on the less than 25% exception or may be able to qualify as a VCOC or REOC. If a Feeder is operated as a plan asset vehicle, such Feeder is typically "hard-wired" to invest in the Master, so that all investment activities will take place (and all fees and expenses will be calculated) at the Master level. Accordingly, although the Feeder may be subject to ERISA, the manager of the Feeder will not be acting as an ERISA fiduciary with respect to the investment of the Feeder's assets.

If a Master satisfies one or more exceptions under the plan asset regulation, it would not be subject to the prohibited transaction rules of ERISA and Section 4975 of the Code. A plan asset Feeder, however, would nonetheless be subject to such prohibited transaction provisions.

Except where specifically exempted by statute or by the US Department of Labor, ERISA and Section 4975 of the Code impose prohibitions on specified transactions between benefit plan investors and a wide class of persons (alternately referred to as "parties in interest" or "disqualified persons") who, by reason of position or relationship, might be in a position to influence a plan fiduciary's exercise of discretion. One of the specified transactions is any loan or other extension of credit.

With respect to lenders, financial institutions often have relationships with benefit plan investors that cause them to become parties in interest or disqualified persons, as applicable, such as providing trustee, custodian, investment management, brokerage, escrow or other services to such benefit plan investors. A party in interest or disqualified person that enters into a nonexempt prohibited transaction with a

benefit plan investor is subject to initial excise tax penalties under the Code equal to 15 percent of the amount involved in the transaction and a second tier excise tax of 100 percent of the amount involved in the transaction if the transaction is not timely corrected. In order to correct the transaction, the transaction must be unwound, to the extent possible, and the benefit plan investor must be made whole for any losses. In addition, if a transaction is prohibited under ERISA, it may not be enforceable against the benefit plan investor.

In the case of a plan asset Feeder, there may not be a prohibited transaction exemption available to permit an extension of credit between such Feeder and a lender that is a party in interest or disqualified person. In such circumstances, a cascading pledge structure, which is described in more detail below, may be used to avoid an extension of credit transaction between a plan asset Feeder and a lender.

High Net Worth Individuals

Feeders may also allow Funds to tap into an increasingly relevant investor segment: high net-worth individuals ("HNWI"). A HNWI is defined as an individual that has investible assets in excess of $1 million and these individuals are increasingly seeking the opportunity to invest in Funds.[5] Minimum capital requirements for Funds are customarily in amounts that even HNWI may have difficulty satisfying, often requiring a minimum capital commitment of $5 million. In an effort to bridge the gap between the traditional minimum capital requirements that Funds require and the desire of HNWI to have access to the investment portfolio that Funds offer, Feeders that aggregate the capital commitments of HNWI ("HNW Aggregator Funds") have become an increasingly popular investment vehicle.

A HNW Aggregator Fund may be organized by a private bank or brokerage firm; it allows HNWI to commit assets held in a traditional brokerage or retirement account in amounts as little as $50,000 to an investment that will ultimately be aggregated with similar commitments from other HNWI and pooled into a HNW Aggregator Fund. The popularity of such HNW Aggregator Funds can be seen in the increased level of capital pouring into them. In the 12 months ending September 2014, Blackstone raised $10 billion through such HNW Aggregator Funds run by brokers and through its other retail offerings, out of a total of $54.8 billion Blackstone raised. This represented a sharp increase from 2011, when Blackstone raised just $2.7 billion through these channels out of a total of $49.5 billion.[6] Sensing the growing demand for the HNW Aggregator Fund product, the broker-dealer arms of financial institutions, such as Goldman Sachs, Citibank, Morgan Stanley and Merrill Lynch, are offering opportunities for HNWI to participate in such Feeders.

Challenges Facing Lenders and Funds in a Facility with a Feeder

The variety of Feeders (and their related investors) that ultimately invest in a Master have important implications for both lenders and Funds in structuring a Facility where the borrowing base is directly correlated to the lender's reliance on the ability of investors to fund capital commitments. In a typical Facility, for instance, a lender will advance cash to a Fund on the basis that the Fund can make a capital call with respect to the capital commitment of its investors in order to satisfy its repayment obligations. The borrowing base of the Fund will be calculated based on such lender's view of the probability that the investors in such Fund (and therefore the ability of the investors in each Feeder) will make capital contributions when required by the Fund.[7]

When developing a borrowing base formula for any given Fund, a lender will be focused on the sufficiency of the "know-your-customer" ("KYC") and financial reporting information that it receives with respect to the investors in a Feeder. As part of the diligence process that all

lenders undertake when establishing a Facility with any borrower, a lender will customarily gather KYC and financial information that allows such lender to make both regulatory and commercial decisions regarding a potential borrower. Such information may include the tax status of such entity or individual, sources of income or funds for purposes of repayment of any obligations owing to the lender, the intended use of any loan proceeds and the assets, liabilities and financial strength of the investor. The ability of a lender to collect KYC and financial information is critical for such lender not only to ensure compliance with any regulations applicable to it, such as the Foreign Corrupt Practices Act of 1977 or the Foreign Account Tax Compliance Act, but also to properly underwrite the investor pool forming the borrowing base.

Gathering KYC and financial information with respect to investors in an HNW Aggregator Fund may present additional challenges to both lenders and Funds. Collecting KYC information with respect to HNWI in a Feeder requires lenders (and to a certain extent, the Fund itself) to rely primarily on the HNW Aggregator Fund sponsor (i.e., the broker-dealer that has established the Feeder comprised of HNWI) to provide KYC information with respect to relevant HNWI. The HNW Aggregator Fund sponsor must be able to properly gather KYC information that the lender will rely on to make a commercial decision about the liquidity and financial strength of such HNWI and their ability to meet capital commitments to the HNW Aggregator Fund, but also to ensure that such lender is in compliance with applicable regulations. In some cases, lenders rely on HNW Aggregator Fund sponsors to make representations with respect to HNWI creditworthiness. Lenders may find it difficult to place such a high reliance on a third-party HNW Aggregator Fund sponsor to provide such critical information.

An additional area of concern for lenders with respect to Feeders is the ability to directly enforce capital calls related to the investors that comprise such Feeder. In a typical Facility, if a Fund defaults on its obligations to the lender, the lender has the ability to enforce the Fund's rights to make capital calls on investors in the Feeder. The ability of a lender, however, to exercise this right when facing a Feeder may be limited, if not entirely restricted, due to the relationship that the Feeder has with the Fund and/or the Fund sponsor. A Feeder may be unwilling or unable to grant a lender the ability to enforce capital calls related to the capital commitment of its investors. Removing this important security feature from the remedies available to a lender in the event of a default by a Fund creates uncertainty for a lender when relying on investors in a Feeder as a source of repayment under a Facility.

Potential Structures for Feeder Funds in Subscription Facilities

There are a few different approaches that can be taken with respect to integrating a Feeder into a Facility. The specific approach can be determined by Funds and lenders, with input from experienced legal counsel, depending on a number of factors, including the borrowing base needs of the Fund. Below, we detail a few common approaches.

Treat as a Non-Included Investor and Disregard. A lender and Fund may choose to exclude a Feeder from the borrowing base under a Facility and disregard the capital commitment of the investors in such Feeder for purposes of repaying any obligations thereunder. This approach, while not preferable from the standpoint of a Fund, might be the easiest solution if the Fund determines that the borrowing base would not be significantly increased by the inclusion of such Feeder, or that any increase in the borrowing base is not desirable given the Fund's anticipated borrowing needs.

Treat as an Included Investor with a Reduced Advance Rate. Instead of electing to exclude a Feeder from the borrowing base entirely, the concerns of a lender may be mitigated by negotiating a lower advance rate

against the capital commitment of any investor that is included in a Feeder. For example, a lender under a Facility may advance against the commitments of an HNW Aggregator Fund based upon representations of the sponsor of such HWN Aggregator Fund as to the identity and financial strength of the investors.

Add to the Facility as a Loan Party. Beyond borrowing base concerns related to Feeders, lenders and Funds will also need to consider how best to structure the security package to accommodate the Feeder and give borrowing base credit to the investors in such Feeder. The security package that a lender may receive in connection with a Facility that includes Feeders will typically be structured as that of a direct guarantor or a cascading pledge.

Direct Guarantor. In a direct guarantor structure, each Feeder will make a direct guaranty in favor of the lender of the obligations of the Master, as borrower, under the Facility. This approach will create privity between the lender and each Feeder with respect to the obligations under the Facility. Documenting this security structure will require a guaranty issued by each Feeder in favor of the lender and creates joint and several liability among the Master and the Feeders for the Facility obligations. In the event that a default occurs under a Facility, the lender would have the ability to call on the investors of each direct guarantor Feeder to repay the obligations of the Master.

Cascading Pledge. The ability of a Feeder to give a direct guaranty to a lender under a Facility may not be permitted in some instances, specifically in instances where the assets of a Feeder constitute plan assets under ERISA (as discussed in greater detail above) and prohibit such a direct transaction with the lender under such facility or where there may be tax concerns related to a Feeder. In such instances, a cascading pledge structure may be used instead, whereby each Feeder will separately pledge its rights with respect to the capital call commitments of its investors to the Master, or to any intermediate entity. In turn, the Master will pledge its assigned rights of enforcement to the lender. Such a structure will avoid any direct transaction between the Feeder and the lender under a Facility.

The documentation of a cascading pledge structure typically includes separate security agreements between each Feeder and the Master, with a back-to-back security arrangement between the Master and the lender. The cascading pledge structure will only result in several liabilities on behalf of the individual Feeders, and will ultimately give the lender enforcement rights with respect to the capital commitments of all the relevant investors. In a cascading pledge structure, the obligations of the Feeder will be limited solely to the amount of the capital commitment of such Feeder to the Master or applicable intermediate entity and will not be directly tied to any obligations incurred by the Master (or any other Feeder) under the Facility.

A properly structured security package will allow a Fund to fully leverage the capital commitments of all investors in Feeders and allow lenders to rely on the capital call commitments of all investors in Feeders to secure the obligations of the Master under a Facility.

Conclusion

The growing complexity of Funds and their increased reliance on Feeders requires that lenders and Funds recognize the dynamics of the capital call commitments for investors in Feeders and the implications Feeders can have on the borrowing base and security structure of any Facility. Experienced legal counsel can assist both lenders and Funds in balancing the needs of a lender for adequate security and diligence with respect to investors against the ability of a Fund to utilize the available borrowing base of investors in Feeders to the fullest extent. Properly structuring and documenting these types of Facilities can facilitate and meet the needs of both lender and Fund. ◆

Endnotes

[1] This article is not intended to be used, and should not be used, for tax advice under US tax law.

[2] For a general description of ERISA issues related to lending to real estate, private equity and other investment funds, please see our *Fund Finance Market Review*, Summer 2013, starting on page 19.

[3] See 29 C.F.R. § 2510.3-101. For ease of reference, references to the "plan asset regulation" should be deemed to include Section 3(42) of ERISA.

[4] The "less than 25% exception" is available for an entity if less than 25 percent of each class of equity interests in the entity are owned by "benefit plan investors" (as defined under ERISA). A privately offered investment fund relying on the operating company exception will typically do so by seeking to qualify as either a "real estate operating company" or a "venture capital operating company" (each as defined under ERISA).

[5] Form ADV requires each investment adviser to state how many clients of such investment adviser are "high-net-worth individuals." The Form ADV Glossary of Terms explains that a "high-net-worth individual" is an individual with at least $1 million managed by the reporting investment adviser, or whose net worth the investment adviser reasonably believes exceeds $2 million (or who is a "qualified purchaser" as defined in section 2(a)(51)(A) of the Investment Company Act of 1940).

[6] Alden, William, *"Private Equity Titans Open Cloistered World to Smaller Investors,"* October 20, 2014, *New York Times*, http://dealbook.nytimes.com/2014/10/20/private-equity-titans-open-cloistered-world-to-smaller-investors/?_r=1.

[7] For a more detailed description of the subscription facility market and features of the subscription-backed credit facility product in general, please see our article *"Summer 2013 Market Review,"* in *Fund Finance Market Review*, Summer 2013 on page 19.

Beginner's Glossary to Fund Finance

The following glossary is intended to serve as a reference tool for those that are new to the private equity fund finance space by demystifying some of the more commonly utilized terms in the fund finance industry. Please note that these definitions/explanations are accurate as of the date of publication, but that these terms may evolve as applicable law and market custom change.

Account Pledgor means a loan party that has the right to receive Capital Contributions from Investors and that pledges the deposit account or securities account into which Investor Capital Contributions are to be funded to the lender.

Aftercare Facility means a credit line advanced to a private equity Fund borrower whose Commitment Period has expired. Post-Commitment Period expiration, Fund borrowers typically have significantly reduced borrowing availability under a traditional Subscription-backed Credit Facility borrowing base; as such, Aftercare Facilities often have expanded borrowing base advance rates, limited or no Concentration Limits and/or rely on a net asset value covenant for additional lender protection. Aftercare Facilities are sometimes unsecured, though more frequently they are secured by one or more of a combination of traditional Subscription-backed Credit Facility collateral, distribution proceeds from the borrower Fund's investments, equity interests in holding companies through which the borrower Fund makes investments and the equity interests relating to the borrower Fund's investments themselves.

Bad Boy Carve-Out is an exception to the non-recourse nature of a loan that provides for a loan party to have full or partial personal recourse liability for the loan in the event certain events occur (e.g., filing a voluntary bankruptcy action). In a traditional Subscription-backed Credit Facility, bad-boy carve-outs typically apply to the General Partner of the Fund borrowers/guarantors and are limited to actual damages of the lender arising as a result of the fraud, willful misrepresentation or willful misappropriation of loan or Capital Contribution proceeds on the part of such General Partner.

Blocker is an entity, often a C-corporation, through which Tax-Exempt Investors invest in a private equity Fund so as to shield such Tax-Exempt Investors from having to pay US income tax and file a US federal tax return.

Borrowing Base is used in asset-based lending facilities to calculate the borrowing value of a borrower's assets. The Borrowing Base determines the maximum borrowing availability under the line of credit. Typically, a Borrowing Base is calculated by applying a discount factor to each asset class (often, though not always, constituting the collateral) against which the lender will advance funds (e.g., uncalled Capital Contributions, accounts receivable, inventory, loan assets, etc.).

Capital Call means the legal right of a private equity Fund (or its General Partner) to demand from its Investors that they fund a portion of the money the Investors agreed to commit to the Fund.

Capital Call Notice is a notice issued by a private equity Fund (or its General Partner) instructing its Investors to make a Capital Contribution to the Fund to permit the Fund to make an investment or pay for Fund Expenses or liabilities. Often referred to as a drawdown.

Capital Commitment is the promise by an Investor in a private equity Fund to make Capital Contributions to the Fund over a specified period of time. The Investor receives an interest in the Fund at the time it makes the Capital Commitment.

Capital Contributions means the money or other assets transferred to a private equity Fund by an Investor with respect to the Investor's Capital Commitment.

Cascading Pledge is an alternative tiered-collateral structure employed when tax, regulatory or ERISA concerns prevent a Feeder Fund from guaranteeing and directly pledging collateral to the lender to support a Fund borrower's obligations under a Subscription-backed Credit Facility. In a Cascading Pledge, the Feeder Fund grants a security interest in its Capital Commitments and call rights to a Blocker entity; the Blocker entity in turn grants a security interest in its rights under the security agreement from the Feeder Fund to the Fund borrower; the Fund borrower in turn grants a security interest in its rights, including those under the security agreement, from the Blocker entity to the lender.

Clawback (either General Partner or Limited Partner) means, with reference to a General Partner or manager, a mechanism whereby a private equity manager is obligated to return a portion of its previously received Promote or performance fee payment if as a result of timing and Fund performance, the General Partner receives more carry or performance fee during the life of the Fund than the General Partner would be entitled to receive had profits and losses been allocated on an aggregate basis at the time of dissolution of the Fund. With reference to a Limited Partner, the obligation of an Investor to return previously received distributions to the Fund if the Fund requires such amounts to fulfill its indemnification obligations or satisfy expenses or other liabilities.

Closed-End Fund means a collective investment vehicle in which the total committed capital and Investors are fixed at the end of a proscribed fundraising period, wherein the Investors each commit a specified amount of capital and have limited or no rights to redeem their interest or withdraw invested capital until the dissolution of the Fund.

Collateral Account is a deposit or securities account into which collateral (Capital Contributions) is deposited and over which a lender has a perfected security interest.

Commitment Period is the time frame, typically a period of 3-5 years, during which a private equity Fund is permitted to call capital from Investors to make new investments or additional investments in portfolio companies.

Concentration Limit means, in an asset-based lending facility, a specified percentage of the total eligible Borrowing Base over which no loan value is given with respect to a particular asset or type of collateral, thereby promoting diversification in the Borrowing Base. In a Subscription-backed

Credit Facility, a Concentration Limit may work to limit the aggregate unfunded Capital Commitments that a single Investor or a class of Investors (e.g., High-Net-Worth Investors) can contribute to the overall Borrowing Base.

Defaulting Investor is an Investor in a private equity Fund that has breached the Fund's constituent documents, namely by failing to make a Capital Contribution when required pursuant to a Capital Call Notice. Defaulting Investors are subject to various remedies under a Fund's partnership agreement, which may include a forced sale of the Defaulting Investor's interest at a discount as well as loss of certain rights, such as participating in future investments and voting.

ERISA Fund means a private equity Fund that consists of, or is deemed to hold, plan assets and operates as a plan asset vehicle that is subject to Title I of ERISA and/or Section 4975 of the Internal Revenue Code. In the context of a Subscription-backed Credit Facility, borrowers and lenders have concerns regarding ERISA Funds and potential prohibited transactions with lenders which may subject the Fund and the lender to heavy tax penalties.

ERISA Limited Partner is an Investor that is (i) an "*employee benefit plan*" (as defined in ERISA) subject to Title I of ERISA; (ii) any "*plan*" defined in and subject to Section 4975 of the Internal Revenue Code; or (iii) any other entity whose assets include or are deemed to include the assets of one or more such employee benefit plans in accordance with ERISA and related regulations.

Feeder Fund is an upper-tier special-purpose entity formed by a private equity Fund to facilitate investment in the Fund by one or more Investors, usually to address a tax concern. As such, the Investors to a Feeder Fund invest in the Fund indirectly through the Feeder Fund.

Follow-On Investments are investments in an existing portfolio company of a private equity Fund that are made to protect or enhance the value of the Fund's investment. Follow-On Investments are often permitted to be made throughout the life of the Fund, though the amount of capital that may be called to fund a Follow-On Investment may be limited after the Fund's Commitment Period has expired and Concentration Limits may apply to the overall investment in any given portfolio company that is the subject of a Follow-On Investment.

Fund means a private collective investment vehicle formed to make equity and/or debt investments in accordance with the criteria and investment objectives set forth in the Fund's constituent documents, including a private equity Fund and a Hedge Fund, as the context may require.

Fund Expenses broadly refers to the liabilities incurred in connection with (i) establishing a private equity Fund (frequently referred to as "organizational expenses") and (ii) operating a Fund (frequently referred to as "operating expenses"). Organizational expenses generally include the out-of-pocket costs incurred by the sponsor in forming the Fund, such as legal, accounting, filing, travel and similar expenses; organizational expenses are often capped at a specified amount. Operating expenses generally include liabilities related to acquiring, maintaining and disposing of investments, Management Fees paid to the sponsor, taxes, third-party service providers and borrowing costs, expenses and principal amounts. Both organizational expenses and operating expenses are paid by the Fund's Investors.

Fund of One means a private equity or hedge Fund that has a single dedicated Investor. The General Partner or manager controls the vehicle that holds the assets in a Fund of One and makes investment decisions on behalf of the vehicle. Some primary benefits of a Fund of One over a comingled investment vehicle are that the investment mandate of the Fund can be customized for the Investor and the Investor is protected from co-Investor (default) risk. A Fund of One shares many of the same qualities as a Separate Account.

Funding Ratio is a metric used to measure the financial condition of an Investor that is a retirement system or pension plan for purposes of inclusion (or exclusion) from the Borrowing Base in a Subscription-backed Credit Facility. The Funding Ratio is often defined as the actuarial present value of the assets of the retirement system or pension plan over the actuarial present value of the system or plan's total benefit liabilities.

General Partner means the one responsible for making investment decisions, issuing Capital Call Notices and managing portfolio investments in a private equity Fund structured as a limited partnership. The General Partner (sometimes referred to as the sponsor) owes various legal duties to the Fund and is typically compensated for its services through receipt of a Management Fee and a percentage of the Fund's profits. The General Partner may also have an equity commitment to the Fund.

Guarantor is one that promises performance or payment of the obligations of another. One who provides a guaranty.

High-Net-Worth Investor means an Investor that is a natural person with a high net worth. There is no definitive dollar threshold or methodology for determining high net worth, though an individual with at least $1 million of investable assets (excluding the value of any homes and illiquid assets) is often considered to be a High-Net-Worth Investor.

Initial (Fund) Closing Date means the date on which a Fund first accepts Capital Commitments from Investors, typically after the Fund manager has raised the minimum amount of capital needed to execute the Fund's investment program. A Fund may hold multiple Investor closings in order to reach the manager's desired aggregate commitment amount. The fundraising period is usually limited to a period of six months to one year from the date of the initial closing in a Closed-End Fund.

Investment Limitations are provisions in a Fund's governing documents that place restrictions on the types of investments the Fund may undertake, which may include limitations on the size, geography, industry, concentration or return characteristics of investments or restrictions arising out of applicable regulations or law.

Investment Period is the time frame, typically a fundraising period of 12 months, during which a private equity Fund is permitted to accept new Investors or subscriptions.

Investor means one that makes a commitment to contribute capital to a Fund in exchange for an equity interest in the Fund. Also referred to as a Limited Partner.

Investor Letter is an undertaking agreement or acknowledgement made by an Investor in favor of a Subscription-backed Credit Facility lender whereby the Investor makes representations, acknowledgments and covenants in favor of the lender as a condition to the Investor being included in the Borrowing Base. Typically, an Investor Letter will include an acknowledgement of the existence of the Subscription-backed Credit Facility and the pledge of the right to receive and enforce the Subscription-backed Credit Facility collateral, and the Investor will agree to make Capital Contributions upon notice by the lender during an event of default.

Investor Opinion is a letter issued by legal counsel to an Investor stating various legal conclusions with respect to the Investor, delivery of which is often a condition to the Investor being included in the Borrowing Base of a Subscription-backed Credit Facility. Under certain circumstances, an authority certificate can be delivered in lieu of an Investor Opinion.

Key Person Event means the departure of a certain number of specified investment professionals from a Fund sponsor that triggers certain rights granted to the Investors under the Fund's governing documents, such as the right to terminate the Commitment Period or replace the Fund manager. Key Person Events may also

encompass minimum requirements for devotion of time to the Fund by specified investment professionals or the occurrence of bad acts by a key person (e.g., fraud).

Limited Partner is an Investor in a private equity Fund that takes the form of a limited partnership. Limited Partners of a limited partnership are generally not personally liable for the obligations of the limited partnership. As such, a Limited Partner's liability to make payments or contribute capital to a limited partnership is limited to its Capital Commitment and its portion of the assets of the Fund (subject to applicable law and certain exceptions).

Limited Partner Excuse means the right by which an Investor is permitted to opt-out from an investment on a case-by-case basis, often as a result of regulatory issues or due to a policy of the Investor that would prohibit the Investor from participating in a particular investment. Also used to describe the right a General Partner has to exclude an Investor from participating in investments on a case-by-case basis for regulatory or other legal reasons.

Limited Partner Transfer is the legal sale, assignment, pledge or disposition of all or an undivided portion of an Investor's interest in a Fund, including its obligation to make Capital Contributions and its right to receive distributions of Fund assets. The constituent documents of a private equity Fund will place limitations on an Investor's ability to transfer or encumber its interest, except in accordance with the terms and conditions set forth therein and with the General Partner's consent.

Limited Partner Withdrawal is the termination of an Investor's participation in a private equity Fund. Rights of withdrawal (either mandatory or voluntary) are typically limited to situations where the Investor's continued participation in the Fund would result in the Investor or the Fund violating applicable regulations or law.

Lock-Up Period is the period of time during which an Investor in an Open-End Fund is not permitted to redeem or sell its equity interest.

Management Fee is the compensation paid to a Fund's manager for providing management and investment advisory services. The Management Fee varies based on a number of factors but has historically equaled approximately 2 percent per annum of the total amount of capital committed to the Fund (it may be higher or lower or based on other metrics).

Most Favored Nations Clause is a contract provision by which a Fund sponsor promises to provide an Investor with terms no less favorable than the terms provided to any other Investor in the Fund. Most Favored Nations Clauses entitle an Investor to elect to have any more-favorable right or privilege granted to another Investor by the Fund apply to it. There are often numerous exceptions, qualifications and exclusions to rights granted under a Most Favored Nations Clause.

Open-End Fund is a collective investment vehicle in which interests are continuously offered and Investors are generally permitted to redeem their equity interests subject to limited timing and notice requirements.

Parallel Fund is a Fund investment vehicle generally established to make the same investments and dispositions of assets at the same time as the main Fund to which it is related. Parallel Funds have substantially the same terms as the main Fund, and are formed to accommodate the tax, regulatory or other requirements of the Investors that are investing through the Parallel Fund.

Parent (of Investor) Comfort Letter (also known as a Parent Keepwell or Parent Guaranty) is an agreement in favor of a lender by which a credit-worthy parent agrees to provide credit support to, or guarantee the obligations of, an affiliate that is investing in a Fund. Delivery of a Comfort Letter from a credit-worthy parent will often enable a lender

to include a less credit-worthy Investor or special purpose vehicle in the Borrowing Base.

Placement Agent is the person or entity hired by a Fund manager to assist in raising capital for the Fund.

Promote is the compensation paid to a Fund General Partner in the form of an allocation of the profits of the Fund, typically calculated as a set percentage of the profits of the Fund (often 20 percent) after returning the Investors' Capital Contributions and a preferred rate of return. The Promote will be set forth in a distribution Waterfall in the Fund's constituent documents, and it is often subject to significant negotiation between the General Partner and the Investors. Also known as "carried interest," "carry" and "performance allocation."

Qualified Borrower is a Fund vehicle (often a holding company for an investment or a portfolio company) that is a borrower under a Subscription-backed Credit Facility whose obligations are guaranteed by the Fund vehicle itself. Qualified Borrowers do not typically provide collateral.

Redemption Period is the time frame after an initial Lock-Up Period during which an Investor may withdraw its capital (in whole or in part) from a Fund, usually on a quarterly basis. Typically applies to hedge Funds, core real-estate Funds and other Open-End Fund investment vehicle structures.

REIT or "real estate investment trust" is a company that owns and often operates real-estate assets, and that must annually distribute at least 90 percent of its taxable income to its shareholders.

Separate Account is an investment vehicle with only one Investor (commonly an institutional Investor) that is willing to commit significant capital to an investment manager subject to the terms of a two-party agreement (commonly referred to as an investment management agreement). It is not atypical for a Separate Account to be non-discretionary in terms of investment decisions made by the manager (with Investor approval being required on a deal-by-deal basis).

Side Letter means any letter or other agreement of any type that amends or supplements an Investor's Subscription Agreement and/or the partnership agreement or other applicable constituent document of a Fund.

Sidecar Fund is an investment vehicle used in a private equity Fund structure to provide for co-investment opportunities by one or more Investors in the Fund, which investments are generally made alongside investments by the main Fund.

Special Limited Partner is an Investor in a private equity Fund that is an affiliate of the Fund's sponsor. The Special Limited Partner is generally used to receive Promote or other carried interest distributions and typically has no Capital Commitment to the private equity Fund and limited obligations under the Fund's constituent documents.

Subscription Agreement is the document pursuant to which an Investor makes a Capital Commitment to a private equity Fund in exchange for an interest in the Fund. The Subscription Agreement sets forth the amount of an Investor's proposed Capital Commitment that is accepted by the General Partner on behalf of the Fund. The Subscription Agreement includes various representations made by the Investor that enable the Fund to comply with applicable securities laws.

Subscription-backed Credit Facility means a loan or line of credit made by a bank or other credit institution to a private equity Fund that is secured by (i) the unfunded commitments of the Investors to make Capital Contributions to the Fund when called from time to time by the Fund or the Fund's General Partner, (ii) the rights of the Fund or its General Partner to make Capital Calls upon the commitments of the Investors and the right to enforce payment of the same and (iii) the account into which Investors fund Capital Contributions in response to a Capital Call.

Tax-Exempt Investors means an Investor, or any Investor that is a flow-through entity for US federal income tax purposes that has a partner or member, that is exempt from US federal income taxation under Section 501(c) of the Internal Revenue Code of 1986, as amended. Tax-Exempt Investors are generally not subject to US taxation, but they may be required to pay taxes on UBTI. Examples of Tax-Exempt Investors are pension plans, universities, private foundations and charitable endowments.

UBTI or "unrelated business taxable income" is generally defined under the Internal Revenue Code of 1986, as amended, as income earned or derived from a trade or business that is unrelated to an Investor's tax-exempt purpose, which income is subject to US taxation as UBTI. Money earned from dividends, capital gains and interest income is not treated as UBTI, however, income derived from assets that are subject to certain types of indebtedness will be included in UBTI. Investors will often require a Fund to covenant in its partnership agreement that the Fund will not incur, or will minimize, UBTI, which may impact the overall Fund structure and the use of indebtedness by the Fund.

Uncalled Capital Commitment of an Investor, is the portion of such Investor's Capital Commitment that is unfunded and may be subject to a Capital Call, excluding any amounts subject to a pending Capital Call that have not yet been funded as a Capital Contribution. The Borrowing Base in a Subscription-Backed Credit Facility is determined by reference to the Uncalled Capital Commitments of the included Investors.

VCOC or "venture capital operating company" is a term used in the context of a private equity Fund that is relying on the operating company exception to holding "plan assets" under ERISA. A VCOC is a private equity Fund that is primarily invested in operating companies with respect to which the entity has the right to participate substantially in management decisions. To maintain such exception, a private equity Fund must qualify as a VCOC as of the date of its first investment and each year thereafter by satisfying annual tests that measure its ownership and management with respect to qualifying assets.

Waterfall means, when used with reference to a loan agreement, the priority of payment of amounts received from or on account of the borrower among creditors to the borrower; when used with reference to a Fund, it means the economic agreement between the Investors and the General Partner as to the priority of payment of distributions of Fund assets as between the Investors and the General Partner (often called a "distributions waterfall"). ◆

Leveraged Loan Regulatory Uncertainty Presents Opportunities for Direct Loan Funds

The appetite of institutional investors for yield continues in the current low interest rate environment and has created renewed interest in increasing allocations to fixed income portfolios, including additional allocations to private debt.[1] As a result of the heightened regulatory focus on banks and emphasis on enhanced underwriting standards for leveraged loans, investor interest has created an opportunity for non-bank institutions to provide investment opportunities to such institutional investors. Similarly, the gradual disintermediation of banking and exit from higher risk areas of lending has created opportunities for various non-bank institutions to increase their market share in respect of highly leveraged loans.

Non-bank financial institutions such as Jefferies have increased their focus on leveraged loans.[2] Fund sponsors have sought to capitalize upon this opportunity through investments in private loans (either themselves making direct loans or acquiring existing loans of private companies). As of July 2015, $46 billion has been raised by funds investing in private debt, which is on track to surpass the 2014 total of $69 billion,[3] and senior loan structures have raised more than $32 billion in 2014 and $16 billion through August 2015.[4]

Background—Leveraged Lending Guidelines

As part of an ongoing effort to regulate financial institutions, the Office of Comptroller of the Currency (the “OCC”), the Federal Deposit Insurance Corporation (the FDIC) and the Board of Governors of the Federal Reserve (the “Fed”) have issued guidance to such financial institutions in respect of underwriting and risk management standards. The guidance has evolved since 2013[5] and has been aimed at achieving of a number of goals relating to systemic risk. These goals include: (i) requiring institutions to create an internal definition of “leveraged lending” that is consistent across business lines; (ii) more uniform credit and concentration policies with limits consistent with risks; (iii) well-defined underwriting standards that include a review of the capacity to de-lever; (iv) appropriately sound methodologies for determining “enterprise value;” (v) sound practices for monitoring of exposures across business lines and pipeline management policies; (vi) setting guidelines for periodic stress testing; (vii) reliance on internal risk-ratings; and (viii) criteria for evaluating financial sponsors (including willingness/ability to repay). However, the guidance has not completely alleviated

the need for additional clarity related to the lending practices of financial institutions.

In particular, the initial 2013 guidance, while applying to leveraged loans, did not itself define the criteria of what constitutes a "leveraged loan." In theory, each institution would adopt an appropriate definition and criteria to define such loans consistently across its portfolio; however, the lack of specific criteria in the guidance led to significant uncertainty by institutions as to what types of loans would be subject to scrutiny. The guidance did specify certain "common characteristics" that the regulators regard as indicia of leveraged loans, which included : (i) purpose or use for buyouts, acquisitions or capital distributions; (ii) total debt to EBITDA ratios of greater than 4:1 (the Total Debt Test) or senior debt to EBITDA ratios of greater than 3:1 (the Senior Debt Test); (iii) a high debt to net worth ratio; and (iv) leverage permitted to exceed industry norms or historical levels.

In an effort to shed additional light on what would be considered leveraged loans subject to regulator scrutiny, the regulators issued supplemental guidance in November 2014 in the form of frequently asked questions (the "FAQ's"). The FAQ's noted that loans that are "identified as leveraged in the debt markets have all or many [such] characteristics" and that these common characteristics should only be used as a "starting point" by regulated institutions. The FAQ's also clarified that having, or failing to have, some of the characteristics would not necessarily preclude a loan from being considered to be a leveraged loan.

For example, the regulators noted that a pure use of proceeds or purpose test would be inconsistent with developing a "comprehensive risk management framework" for leveraged loans. Moreover, loans secured by tangible collateral or real estate that do not rely upon enterprise valuations for repayment would not be considered leveraged loans. This would be true even if such loans would otherwise fail to meet the Senior Debt or Total Debt criteria on the basis that the lender may have additional sources of repayment other than cash flow.

One thing that was made clear by the supplemental guidance is that the regulators will levy particular scrutiny upon leveraged loans where the Total Debt Test are in excess of 6:1. While the regulators acknowledged that this limit is not a "bright line," it was made clear in a 2015 call hosted by the regulators[6] that ratios above that amount could be a "red flag." Nonetheless, many leveraged buyout transactions have historically exceeded such levels and even as late as the fall of 2014, almost 50 percent of US private equity deals had breached this threshold.[7] As the demand for such loans continued, the market was slow to react to the guidance. This changed in the fall of last year when Credit Suisse received a letter from the Federal Reserve requiring it to address its underwriting and sale of leveraged loans, raising concerns that the banks' adherence to the guidance had been too lax. This highly publicized letter captured the attention of the market, and banks have been increasingly concerned about the seriousness of regulators with respect to such guidelines.

Additionally, a number of banks were summoned to an in-person meeting in New York during November 2014 where the Fed and the OCC emphasized their stance on compliance with guidelines and the ability to criticize loans on such basis. The regulators raised the possibility that they could use cease and desist orders to force discontinuation of leveraged lending activities, which captured the market's attention.[8] This has naturally had a chilling effect, causing regulated lenders to become increasingly reluctant to participate in leveraged buy out and other similarly leveraged debt transactions. Moreover, there are a number of reports that banks have passed on financings for public buyouts due to the guidelines. In one highly publicized transaction, a leveraged buyout of Pet Smart it was reported that a number of well-known

banks decided not to pursue the opportunity to arrange the financing of the transaction as the basis that the Total Debt Test was in excess of 6:1.[9]

Loan Funds and Fundraising Activity

As a result of these regulatory concerns, opportunities have opened up for unregulated institutions to act as lead arranger for highly leveraged transactions that may also lack financial covenants or otherwise receive regulator criticism. As previously noted, institutions such as Jefferies have stepped in to fill the gap and have been noted in the press as aggressively pursuing highly levered loans, thereby replacing lenders such as Credit Suisse and Bank of America for add-on or refinancings of debt previously issued by such institutions that exceed the guideline ratios.[10]

While investment banks that are not subject to regulation by the Fed or the OCC have increased their participation in leveraged loans, private equity funds and their investors have also been staking out their claim on desirable returns from such products. Private equity fund investors, generally comprised of pension funds, insurance companies, foundations and endowments, have become concerned about the impact of potential rate increases on their fixed income portfolios and, as a result, have sought to increase their interest in private debt just as lenders have become more cautious due to the regulatory requirements.[11] In particular, these private equity fund investors are attracted to the relatively high yields ranging from 10 to 12 percent,[12] and floating rates in reviewing their asset allocations, with such direct lending providing the benefit of a hedge against interest rate increases without the a diminution in investment value (as opposed to bond allocations).

Some pension funds have been so eager to enter this market that they have sought to purchase businesses that are already doing direct lending. For example, in June, it was announced that General Electric had agreed to sell its sponsor finance business as well as a $3 billion bank loan portfolio to the Canadian Pension Plan Investment Board.[13] The decision was viewed as part of GE's selloff of non-core businesses. Others argue, however, that this decision reflected the exit of another regulated lender from the commercial lending business due to regulatory concerns.[14]

As a response to these trends and investor desire, a number of fund sponsors, including Goldman Sachs, Ares Management, Morgan Stanley and KKR, have successfully closed large direct lending funds so far in 2015. The opportunities presented from bank exits from the market have meant that current fundraising for private debt funds has been concentrated on direct lending fund strategies (39 percent), rather than more traditional special situations (11 percent) or mezzanine fund (29 percent) strategies.[15] Moreover, it is expected that investor interest in private debt funds will continue, as 57 percent of investors in private debt funds intend to commit more capital to the sector in 2015 than they had in 2014.[16]

While private debt funds have been focused primarily on the market in North America, another trend to look out for is penetration of European and Asian markets, which seems to have increased in activity with 66 funds currently fundraising in Europe and 21 focused on Asia.[17] The impact of direct lending in European markets has taken place even in the face of renewed interest by banks and a bifurcation of transactions whereby banks have taken on more "plain vanilla" transactions and direct lending funds have made inroads with borrowers attempting to execute more complicated transactions or those that require more favorable amortization terms.[18] While the retrenchment of banks, due to regulatory concerns, has been a greater trend within US markets, it would not be surprising to see this bifurcation in the US market as well, as comfort with non-bank sources of leverage continues and funds remain a flexible and unregulated source of capital.

Conclusion

Increasing regulatory pressures on banks have created the opportunity for non-banks to stake a claim to loans that would otherwise face regulator criticism. Moreover, investor interest in chasing yield, while under the Damocles sword of interest rate hikes, has caused funds to become more interested in the market. We see this as a trend that will continue in the near future as borrowers become more comfortable with other sources of capital to suit their needs. Further, it would not be surprising to see the direct loan strategy of private funds to expand to include different types of direct loans that due to structure or complexity would require more flexibility from lenders. ◆

Endnotes

[1] "The Search For Yield Leads to Private Debt," Barrons April 25, 2015 and Arleen Jacobius, "Private Debt Ready for Takeoff," Pensions and Investments Apr. 20, 2015, available at http://www.pionline.com/article/20150420/PRINT/304209981/private-debt-market-ready-for-takeoff.

[2] Lella Parker Deo, "LPC- Jefferies profiting from highly leveraged loans" Reuters, May 29, 2015 available at http://www.reuters.com/article/2015/05/29/jefferies-loans-idUSL5N0YK4OV20150529.

[3] *Preqin Special Report: Private Debt Fund Manager Outlook*, August 2014 (the "*Preqin Report*") p. 1.

[4] See *Preqin Report*.

[5] What is generally referred to herein as "guidance" is comprised of a number of bulletins jointly issued by the OCC, the FDIC and the Fed including the following: "Leveraged Lending: Guidance on Leveraged Lending" OCC 2013-9 issued on March 22, 2013, available at http://www.occ.gov/news-issuances/bulletins/2013/bulletin-2013-9.html; OCC 2014 "Leveraged Lending: Frequently Asked Questions for implementing March 2013 Interagency Guidance on Leveraged Lending" issued November 7, 2014 OCC 2014-55, available at http://www.occ.gov/news-issuances/bulletins/2014/bulletin-2014-55.html.

[6] "Regulators on Leveraged Lending: A Cheat Sheet" Wall Street Journal Online February 26, 2015. See http://blogs.wsj.com/moneybeat/2015/02/26/regulators-on-leveraged-lending-a-cheat-sheet/.

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[10] Leela Parker Deo, "TRLPC: Companies Turn to Non-Banks to Increase Leverage," Reuters, Feb 20, 2015, available at http://www.reuters.com/article/2015/02/20/nonbanks-leverage-idUSL1N0VU14W20150220.

[11] Jacobius.

[12] Claire Ruckin, "Direct Lending Plays Bigger Role in European Loan Market," Reuters, Dec. 1, 2014, available at http://www.reuters.com/article/2014/12/01/us-direct-lending-loans-idUSKCN0JF26K20141201.

[13] "GE to Sell Buyout Unit to Canada Pension Fund for $12 Billion," Ted Mann, Ben Dummett and Chelsey Dulaney June 9, 2015, available at http://www.wsj.com/articles/ge-to-sell-buyout-unit-to-canada-pension-fund-for-12-billion-1433846821.

[14] Jacobius.

[15] *Preqin Report* p, 2, Fig 2.

[16] *Preqin Report* p. 6.

[17] *Preqin Report* p. 4, Fig 3.

[18] *Ruckin*.

Enforceability of (Debt) Capital Commitments

A subscription credit facility (a "Facility") is an extension of credit by a bank, financing company, or other credit institution (each, a "Lender") to a closed end real estate or private equity fund (the "Fund"). The defining characteristic of such a Facility is the collateral package securing the Fund's repayment of the Lender's extension of credit, which is composed of the unfunded commitments (equity or debt "Capital Commitments") of the limited partners to the Fund (the "Investors") to make capital contributions ("Capital Contributions") when called upon by the Fund's general partner, not the underlying investment assets of the Fund itself. The loan documents for the Facility contain provisions securing the rights of the Creditor, including a pledge of (i) the Capital Commitments of the Investors, (ii) the right of the Fund to make a call (each, a "Capital Call") upon the Capital Commitments of the Investors after an event of default and to enforce the payment thereof, and (iii) the account into which the Investors fund Capital Contributions in response to a Capital Call.

While there is no definitive United States Supreme Court or federal circuit court of appeals case law addressing this issue, parties to Facilities are generally comfortable that Investors' equity Capital Commitments are enforceable obligations. We are not aware of any case law in contravention of the decisions discussed in our prior article on the enforceability of equity Capital Commitments in a Facility.[1] Nor are we aware of any institutional Investor payment defaults under a Facility, which would have brought this issue to a head. However, the case law is less certain with respect to the enforceability of debt Capital Commitments within the Fund structure.

Tax Rationale

Some Funds are comprised entirely of debt Capital Commitments. In addition, even when a particular Investor's commitment consists of the obligation to make an equity Capital Contribution, that equity Capital Commitment may switch in whole or in part to a debt Capital Commitment as the obligation flows from a feeder fund through blocker entities down to the Fund borrower. Including debt Capital Commitments within the Fund structure is driven largely by tax reasons.

Non-U.S. Investors can receive more favorable tax treatment of their investments when the investment is structured, in part, as a debt Capital Commitment within the Fund structure. By switching a portion of the equity Capital Commitment to debt, the Investor can effectively block connected income, which would cause the foreign Investor to be treated as a U.S. taxpayer. In addition, a blocker entity within the Fund structure can take an interest deduction on account of a debt Capital Commitment that is unavailable with respect to an equity Capital Commitment, and this deduction will minimize the tax cost of the blocker. Tax exempt entities employ debt investments in blockers to reduce their unrelated business taxable income ("UBTI"). Finally, Investors' withholding rates on interest are lower than the withholding rates on equity.

Enforceability of Debt Capital Commitments

Despite the numerous tax reasons for employing debt Capital Commitments within a Fund structure, the lack of certainty around the enforceability of such debt Capital Commitments in a Fund bankruptcy scenario should cause parties to consider whether to require only equity commitments to mitigate the risk that debt Capital Commitments within the Fund may render an Investor's commitment unenforceable.

Section 365(c)(2) of the Bankruptcy Code governs the enforceability of contracts between a debtor and non-debtor third parties where "such contract is a contract to make a loan, or extend other debt financing or financial accommodations, to or for the benefit of the debtor." 11 U.S.C. § 365(c)(2). In the event of a Facility default, a debt Capital Commitment owed directly to a Fund borrower would likely be deemed unenforceable as a "financial accommodations contract" under § 365(c)(2) of the Bankruptcy Code. The practical effect of § 365(c)(2) is to permit a Lender to decline to advance post-petition funds to a trustee or chapter 11 debtor-in-possession, even if the Lender had a pre-bankruptcy contractual obligation to do so. In the hypothetical Fund bankruptcy scenario, the feeder vehicle owing a debt Capital Commitment to a blocker below it in the Fund structure could argue that it does not need to honor its debt Capital Commitment to the blocker because the subsidiary Fund was in bankruptcy.

It is generally accepted that § 365(c)(2) permits an entity to decline to comply with a financial accommodations contract for the benefit of a debtor in bankruptcy, and prevents the debtor from enforcing that obligation following the bankruptcy filing. *See, e.g., In re Marcus Lee Assocs., L.P.*, 422 B.R. 21, 35 (Bankr. E.D. Pa. 2009) (finding that § 365(c)(2) absolved Lender from the obligation to fund under a construction loan to the debtor borrower post-petition). What is not clear is whether § 365(c)(2) similarly permits an entity that is a party to a financial accommodations contract with a non-debtor parent of a bankruptcy entity to decline to honor its debt Capital Commitments under that contract. In other words, when an equity Capital Commitment flips to a debt Capital Commitment and then reverts to an equity Capital Commitment when made directly to the Fund, it is unclear whether a bankruptcy court would deem the obligation an enforceable equity Capital Commitment or an unenforceable financial accommodations contract.

We are not aware of any definitive case law addressing the enforceability of debt Capital Commitments within a Fund structure. In the absence of guidance from the courts on this issue, Lenders relying on such obligations to secure their loan commitments can make several arguments in support of the enforceability of debt Capital Commitments within a Fund structure:

First, Lenders could argue that § 365(c)(2) should not apply in the context of a Fund bankruptcy because the debt Capital Commitment is not an obligation to the Fund borrower itself (the bankrupt entity) but rather to another entity upstream within the Fund structure. When courts have examined whether a contract to loan funds to a third party is a financial accommodation "to or for the benefit of" the debtor, they have focused on factors such as whether the proceeds of the loan are disbursed directly to the debtor and whether the debtor incurs any secondary liability for repayment of the loans. *See, e.g., In re Sun Runner Marine, Inc.*, 945 F.2d 1089, 1092 (9th Cir. 1991) (holding that retail boat dealer floor plan financing agreement was a financial accommodation to the debtor boat manufacturer because the proceeds were disbursed directly to the debtor and the debtor incurred secondary liability for the repayment of the dealer loans). In the Fund context, the Fund proceeds of the debt Capital Commitment would be paid indirectly to the Fund in the form of equity Capital Commitments from a parent entity and the Fund would have no secondary liability to repay the debt, distinguishing the Fund structure from circumstances in which court have found § 365(c)(2) to apply.

In addition, bankruptcy courts are courts of equity that may look beyond the form (e.g., the tax structure) of a transaction to its substance (e.g., an equity commitment from the Investor). *See, e.g., In re: Dornier Aviation (N. Am.), Inc.*, 453 F.3d 225, 233 (4th Cir. 2006) ("[a] bankruptcy court's equitable powers have long included the ability to look beyond form to substance") (citing *Pepper v. Litton*, 308 U.S. 295, 305, 60 S. Ct. 238, 84 L. Ed. 281 (1939)).

In our scenario, the initial and fundamental transaction is not a debt Capital Commitment from the Investor to the Fund; it is an equity Capital Commitment. The Investor makes its equity Capital Commitment to a feeder vehicle, the feeder vehicle or an intermediary entity then makes a debt Capital Commitment down to a blocker, which, in turn, makes a debt Capital Commitment to the Fund. Notwithstanding the fact that a portion of the Investor's Capital Commitment is treated as a debt Capital Commitment for tax purposes within the Fund structure, a bankruptcy court very well could use its equitable powers to recognize that the Investor's commitment, on which a lender relies, is a Capital Commitment.

Finally, in situations where an Investor's commitment splits into both debt and equity components at a particular level within the Fund structure, even if the court were to find that the debt portion was not enforceable, the portion of the Investor's commitment that remained as equity should continue to be enforceable under generally accepted theories of the enforceability of Capital Commitments. The federal district court decision in *Chase Manhattan Bank v. Iridium Africa Corp.*, 307 F. Supp. 2d 608 (D. Del. 2004), remains good law and parties can take comfort that there has been no subsequent case law calling into question the enforceability of equity Capital Commitments in similar circumstances.

However, in order to avoid the argument that a contractual obligation to provide both debt and equity should be treated as a single financial accommodations contract (and thus be unenforceable under §365(c)(2)), parties should consider documenting the debt and equity commitments in the subscription agreement rather than solely within the applicable limited partnership agreement. Parties should also consider including in their Facility documentation a representation and warranty that the debt Capital Commitment is not a financial accommodations contract and that the applicable Investors and Fund entities waive any defenses under §365(c) of the Bankruptcy Code. We note, however, that it is unclear whether such provisions would be enforceable in a bankruptcy context.

Conclusion

While we are not aware of any definitive case law addressing whether § 365(c)(2) would render an Investor's Capital Commitment unenforceable when that Capital Commitment is initially made as equity but is treated as debt within the Fund structure, the arguments discussed herein could be employed to defend the enforceability of the initial equity Capital Commitment. Nevertheless, parties should consider whether the tax benefits of incorporating debt Capital Commitments into a Fund structure outweigh the risks that such debt Capital Commitments could render the Investors' Capital Commitments unenforceable in a bankruptcy scenario. ◆

Endnotes

[1] See Mayer Brown Legal Update, *Enforceability of Capital Commitments in a Subscription Credit Facility*, July 7, 2011, on page 1.

FALL 2016

In this Fall 2016 edition of our *Fund Finance Market Review*, we discuss some of the more noteworthy developments in the subscription credit facility and fund finance markets, including our views of BREXIT's impact on our sector and its forthcoming implementation.

We also analyze some of the trends in financing the underlying assets of secondary funds, how the facility market may be able to adjust thereto, as well as the convergence of the US and UK markets with respect to facility documentation.

Fall 2016 Market Review

Fund Financings continued positive growth and strong credit performance as an asset class through Q2 2016. Capital call subscription credit facilities (each, a "Facility") continued their steady growth and followed the uptick of closed funds and capital raised through Q2 2016. Investor capital call (each, a "Capital Call") funding performance continued its near-zero delinquency status, and we were not aware of any Facility events of default in 2016 that resulted in losses. Below we set forth our views on the state of the Facility market and current trends likely to be relevant in the latter half of 2016. In addition to such trends, this Market Review touches on Brexit and its impact on the Fund Finance markets, developments in Irish regulated funds, developments relating to the introduction of Cayman limited liability companies, and hedging constraints and Facility attractiveness.

Fundraising and Facility Growth

Fundraising in 2016

So far, 2016 has continued a positive trend for private equity funds (each, a "Fund"). Globally, through Q2 2016, Funds raised over $182 billion in investor (each, an "Investor") capital commitments ("Capital Commitments"), markedly higher than the same period in 2015 where $137 billion of commitments were raised.[1] Larger sponsors continued to attract a large share of commitments—notably the five largest Funds raised almost half of the commitments in Q2, four of which were focused in buyout, with the fifth and largest Fund being a secondary fund. In addition to buyout, venture capital funds were also popular with investors, and a larger number of venture capital funds closed in Q2 than any other type of fund. Going forward into the latter half of 2016, one could make the case that investor interest appears to be shifting away from private equity and venture capital, towards other areas including growth funds, funds of funds and secondary funds, which are being targeted by larger proportions of investors.[2]

Even with the unexpected Brexit vote and the ensuing political uncertainty, investor interest has been fairly steady through Q2. While the North American market continues to dominate, with 45 percent of the capital raising targeted there in Q2, European-focused Funds continue to be second with approximately 25 percent of the capital of Investors in the market being focused on investments there.[3] About the same number of Investors are seeking global allocations as compared to the same period in 2015. That said, it appears that going forward, Investors may be doubling down on Europe. More than a majority of Investors (56 percent) are looking to make new commitments in Europe in the next 12 months, which is a notable increase in European interest from this time last year and tops current Investor interest in any other region, including North America (at only 48 percent).[4] Such reports seem to bode well for Facility growth, including in the European market.

Facility Growth

Although the Fund Finance market lacks league tables or an overall data reporting and tracking service, our experience is that so far in 2016 the subscription facility market is continuing its steady trajectory, and we are seeing continued diversification in product offerings in the Facility market (including hybrid, umbrella and unsecured or "second lien" facilities). In particular, Alternative Fund Financings such as fund of hedge fund financings, management fee lines and facilities based on the net asset value of a Fund's underlying assets have garnered more interest, with Mayer Brown representing Lenders and Funds in approximately $7 billion of such transactions closed so far in 2016 versus $5 billion for all of 2015. These Alternative Fund Financings have been a key driver of growth in the Fund Finance market to date in 2016 and this category of fund financings is emerging as a permanent fixture of the market. Anecdotally, we are seeing a number of new entrants into this space both on the Lender side and Fund side, and the focus on levering up investment portfolios has increased volume among secondary funds and funds of funds as well as by non-traditional market participants such as family offices and insurance companies.

Trends and Developments

Monitoring and Technical Defaults

We are only aware of a couple of technical defaults over the course of 2016, which is in sharp contrast to 2015 where many of these defaults were caused by reporting failures in respect of borrowing base calculations and components thereof (including failures to timely report the issuance of capital calls). Facility covenants providing for monitoring of collateral (including prompt delivery of capital call notices, notices of transfers, Investor downgrades and similar requirements) have tightened, and a number of lenders have provided their customers with monitoring guidelines or templates to assist with their back office processes.

Also, there have been recent reports in the news capturing the attention of those in the fund world surrounding allegations raised with respect to funds, placement agents and fund sponsors. In one instance, it has been reported that a prominent hedge fund manager with more than $1.3 billion in assets under management, is considering unwinding its main hedge fund and buying out a $20 million investment by a New York City correction officers' union after allegations surfaced, and an FBI-related raid, about possible bribery relating to this investment.[5] Additionally, Andrew a former employee of a prominent private equity advisory group and placement agent, pleaded guilty in July to charges of defrauding Investors and creating a Ponzi-like investment scheme involving many familiar names in the fund world, including various nonprofit foundations.[6] Such reports have increased lender attention upon the issues of pay to play and other common side letter provisions which often have withdrawal or other consequences for Investors in Funds, and ultimately with respect to Facilities as well. Therefore the importance of due diligence on subscription agreements, side letters and Investors continues as a timely lender focus.

Brexit Impact on Facilities

The recent referendum in the United Kingdom to exit the European Union took place on June 23, 2016 (the exit, commonly known as "Brexit"). The vote did not in and of itself trigger Brexit, which will require the formal activation by the European Union under Article 50 of the Treaty on European Union, and given that the process, once triggered will last a minimum of two years, the aftermath has created speculation on the impact on the loan market and the fund market during this time.

While this impact on fundraising and deal volume continues to materialize, as far as documentation is concerned, we understand that the Loan Market Association (the "LMA"),

the leading industry group for the UK syndicated loan markets, is setting up a working group which will consider and advise on changes to its documentation on an ongoing basis as the situation matures. The below outlines some general thoughts on documentation changes that may transpire, but we note that as an initial matter, while various aspects of the UK and European economy will be affected, the structure and documentation relating to many lending deals should be relatively unaffected by Brexit, although cross-border secured deals would be affected more than most.

In particular, the loss of the passport if the United Kingdom triggers Article 50 and begins the procedures to exit the European Union would be the largest area of impact, but would not affect UK domestic lending – and much cross-border lending work would not require a passport. Therefore, the lending market may continue much as it did before, recognizing that the details may change. Also, one particular area of difficulty post Brexit (if the United Kingdom no longer has a passport) may occur in lending to jurisdictions such as Italy and France and where there is security held by a UK security trustee if that security needs to be held by EU passported entities.

CHOICE OF GOVERNING LAW/JURISDICTION

No change is anticipated to decisions made by lenders and borrowers regarding the choice to use English law, as the United Kingdom is well established as a commercial jurisdiction of choice due to its recognition of freedom of contract, and it is expected that English law will still be upheld by other EU member states through the EU regulation commonly referred to as Rome 1 which would be applicable regardless of Brexit.[7] This regulation requires EU courts to recognize and uphold the parties' choice of governing law, and would cover, by way of example, the choice of a French borrower to agree to be bound by a US law credit agreement. This is expected to apply regardless of where the counterparties are located, and would, subject to only a few exceptions, require an EU court to uphold the parties' right to choose to be bound by a particular legal regime. While UK courts would not be bound after Brexit to Rome 1, it is expected that UK courts would introduce similar laws due to the commercial need for the same, and it is also thought that old UK laws had similar effect in any case.

Submission to jurisdiction is less clear, as the United Kingdom will no longer benefit from the rules commonly referred to as the Brussels Regulation[8] that are part of a network of EU regulations and international treaties on the recognition and enforcement of foreign judgments. Post Brexit, the United Kingdom would not benefit from mutual recognition under the Brussels regulation, but there is however, good reason to believe that reciprocal recognition of judgments would continue after Brexit, including alternatives to arrive at the same (or similar) position through treaties such as the Lugano Convention and the Hague Convention that similarly provide for recognition and enforcement of foreign judgments (although the latter relates to exclusive jurisdiction clauses only) and also common law. We are of the view that significant changes to current practice or drafting are unlikely in this regard, other than more thought being given to using exclusive jurisdiction clauses, rather than non-exclusive or one-sided jurisdiction clauses. We also note that these treaties and Brexit would not affect the recognition of US judgments so the position vis–à–vis US credit agreements would be unlikely to change.

REFERENCES TO THE EU/EU LAWS

For contracts entered into before the referendum and still in force after Brexit, the assumption is that the English courts will take a pragmatic approach to interpreting pre-Brexit contracts when it comes to references to the EU/EU legislation and perhaps introduce English legislation to provide continuity. Also, for transactions that are currently being

documented, terms ought to be checked to see if there are any sensible changes that could be made at this time to also include references to applicable UK laws and regulations as an option, including review of VAT concepts and restrictions currently in place requiring a borrower to use the audit services of a particular auditor or group of auditors[9] (which would require compliance at least until Brexit has been completed and possibly beyond if the United Kingdom itself were to introduce such concepts), as well as generic references to the European Union as either a body or a location which may be used in the documentation, including setting the scope of where account debtors could be located or the places in which Cash Equivalent Investments could be made.

BRRD ARTICLE 55 (BAIL-IN)

The addition of the Bail-in requirements was the subject of our prior Market Review and while such language would still need to be inserted until Brexit has occurred, it should be considered that the United Kingdom could become subject to the BRRD after Brexit (whether via becoming part of the EEA or otherwise) and/or that the United Kingdom may impose its own form of bail-in requirements, which would also need to be included.

ILLEGALITY

Standard in many LMA-based documents, continued use of clauses in loan agreements providing for the repayment of loans if they are illegal to maintain will be helpful to the extent that cross-border loans to France/Italy will require a passport and loss of that passport would require the lender to terminate the loan (or its participation in the loan). Equally, other remedies to this issue could be considered, such as an enhanced right to transfer commitments to affiliates or the ability to simply designate affiliates of the lenders to make loans in certain of the affected jurisdictions.

MATERIAL ADVERSE CHANGE

There has been much discussion as to whether the standard material adverse change or material adverse effect clauses would be triggered by any of the vote to Brexit, the economic impact of such vote and/or Brexit itself. Lending institutions in general are loathe to use such a clause where a Facility is otherwise in good standing, so it is generally viewed as unlikely to be used, and if the vote or Brexit itself were to cause an economic downturn it would appear that lenders could likely rely on other, more specific triggers.

In the situation of a market MAE such as what is seen in mandate documents or syndication documents, it would be more likely that if Brexit leads, for example, to an inability to syndicate deals, a market MAE could be triggered; however it remains to be seen if this will come to pass. We note that prior to the Brexit vote, a number of sponsors requested a carveout from the MAE clause for Brexit in anticipation of such possibility.

Hedging Mechanics

As discussed in our prior Market Reviews, the inclusion of hedging and swap collateralization mechanics in Facilities was a significant trend in 2015, providing the means for borrowers to secure hedging and swap obligations under existing Facilities, rather than posting cash or other collateral. We note that margin regulations for uncleared derivatives adopted by regulators around the globe ("Margin Regulations"), including the US, European, Japanese, Swiss and Canadian regulators, coming into effect in March 2017 may impact this trend and will certainly need to be considered when structuring Facilities. Once the Margin Regulations come into effect, swaps between most market participants will be required to collateralize their obligations under uncleared derivatives with cash or highly rated securities meeting prescribed parameters set out by regulators ("Eligible Collateral").[10] Capital commitments and letters of credit supported by capital commitments will not

constitute Eligible Collateral. Generally, the Margin Regulations do not apply to transactions entered into prior to the date on which the regulations come into effect.

A notable exception to these requirements involves foreign exchange forwards and foreign exchange swaps, so depending on the Fund's intended use of hedging mechanics, such regulations may or may not be impactful[11]

To the extent the effect of these regulations curtails a popular use of a subscription facility, it is still likely to be good news for the subscription facility market as a whole, as many Funds may need to secure their swap obligations and require liquidity to do so. Therefore, Funds that did not previously use Facilities may find them more attractive as a source of liquidity in order to post cash collateral, and funds that already have Facilities may be more inclined to utilize them to secure such obligations.

Introduction of Cayman Limited Liability Companies[12]

We understand that the Cayman Islands government and private sector have reacted to significant market demand with the introduction of the Cayman Islands limited liability company (the "LLC") pursuant to the Limited Liability Companies Law, 2016 (the "LLC Law"). The LLC Law was implemented on 13 July 2016 and it is anticipated that the LLC will be a very helpful additional structuring product, including in investment fund structures, corporate reorganizations and other finance transactions. Similar to a company, the LLC is a body corporate with separate legal personality. It has capacity, in its own name, to sue and be sued, to incur debts and obligations and to acquire and dispose of assets. However, the LLC Law provides a framework and a number of fall-back provisions which make the LLC primarily a creature of contract and enable its members to agree as to what the LLC will do, how it will be administered and managed, how members' investments and contributions to the LLC will be tracked and how distributions will be allocated. In this respect, the LLC benefits from many features typically associated with a limited partnership and, as with Delaware LLCs, the members of a Cayman LLC will in most instances agree and adopt an LLC agreement which regulates the conduct of business and the affairs of the LLC.

Assuming the LLC agreement does not stipulate otherwise, any capital call rights hardwired into the LLC agreement (or any subscription agreement entered into by the LLC and its members) will fall to the LLC itself in the same way as with a company. This should simplify any security package in a fund finance transaction such that security should only need to be granted by the LLC and not its manager. There is no prescribed form of LLC agreement under the LLC Law so a careful review of the contractually agreed terms should be undertaken on a case-by-case basis. However, the expectation is that this new, flexible vehicle will be utilized in the fund finance space in largely the same way as companies and exempted limited partnerships. As such, Cayman Islands law will recognize and hold enforceable such arrangements in much the same way as current market practice.

Use of Irish Regulated Funds[13]

We are aware of increased interest and use of Irish regulated funds across a spectrum of fund managers and financing transactions, including UCITS, ICAVs and other AIF vehicles ("Irish Regulated Funds"). Specifically, we have seen the use of Irish Regulated Funds in hedge funds, hedge funds of funds, real estate funds and private equity funds. Interest in such Irish funds is often motivated by the access they grant to EU market Investors. While Irish Regulated Funds are generally free to borrow and provide collateral like other common investment vehicles (including security over investments or unfunded capital commitments), there are limitations on the ability of such Irish Regulated Funds to provide guarantees. As of late, the most popular vehicle could be the relatively new ICAV; the majority of

ICAVs have been utilized for new funds but we have seen an uptick in conversions from Irish plcs as well as migrations from other offshore jurisdictions. All anecdotal evidence points to more conversions throughout 2016 and we are forecasting that most new fund launches are likely to use the ICAV.

Conclusion

As noted above, 2016 continues the generally steady growth in the Facility market. We, like Investors that are currently in the market, remain optimistic that such trends will continue through the remainder of 2016 and that the recent market changes in the United Kingdom and Europe will also provide opportunities for Investors as well as funds seeking financing and institutions providing such financing. ◆

Endnotes

1 *Preqin Quarterly Update Private Equity* Q2, 2016, p.6.

2 Preqin at p.9

3 Preqin at p.8

4 Preqin at p. 9

5 *Hedge Fund Tied to Kickback Probe to Liquidate 2d Fund, New York Post, July 20, 2016.*

6 *Andrew Caspersen Pleads Guilty to Federal Charges in $40 Million Fraud, New York Times, July 6, 2016.*

7 This refers to Regulation (EC) No. 593/2008 of the European Parliament and of the Council of 17 June 2008 on the law applicable to contractual obligations.

8 This refers to the Recast Brussels Regulation or the Brussels 1 Regulation, Regulation (EC) No 1215/2012).

9 This refers to the EU Audit Directive 2014/5/6/EU and Regulation (EU) (537/2014).

10 *For example, please see Margin and Capital Requirements for Covered Swap Entities, 80 Fed. Reg. 74,840, 74,910 (codified at Appendix B to the final rule).*

11 The term 'foreign exchange forward' means a transaction that solely involves the exchange of two different currencies on a specific future date at a fixed rate agreed upon on the inception of the contract covering the exchange. The term 'foreign exchange swap' means a transaction that solely involves: (a) an exchange of two different currencies on a specific date at a fixed rate that is agreed upon on the inception of the contract covering the exchange; and (b) a reverse exchange of the two currencies described in subparagraph (a) at a later date and at a fixed rate that is agreed upon on the inception of the contract covering the exchange. *See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 § 721(a), 124 Stat. 1376, 1661 (2010) (codified at Commodity Exch. Act § 1a(24)-(25); 7 U.S.C. § 1a(24)-(25)).*

12 Our special thanks go to Tina Meigh, Partner at Maples and Calder, for her insights and contributions to this section on Cayman limited liability companies.

13 Our special thanks go to Kathleen Garrett, Partner at Arthur Cox, for her insights and contributions to this section with respect to Irish regulated funds.

Fund of Funds Financing: Secondary Facilities for PE Funds and Hedge Funds

Real estate, buyout, infrastructure, debt, secondary, energy and other closed-end funds (each, a "Fund") frequently seek to obtain the benefits of a subscription credit facility (a "Subscription Facility"). However, to the extent that uncalled capital commitments may not be available to support a Subscription Facility (for example, following expiration of the applicable investment or commitment period, a Fund's organizational documentation does not contemplate a Subscription Facility) or a Subscription Facility already exists, alternative fund-level financing solutions may be available to Funds based on the inherent value of their investment portfolios (each, an "Investment"). As Fund finance continues to grow in popularity, banks (each a "Lender") have been working with their private equity and hedge fund clients in particular to assist them with unlocking the value of their Investments. The appetite for liquidity among these Funds dictates facilities that share similar characteristics, although hedge fund financing includes unique issues to address in this expanding market.

One solution for providing liquidity to a Fund is to structure borrowing availability based on the net asset value ("NAV") of a Fund's Investments. Although lending against a Fund's Investments is a far different credit underwrite than a traditional Subscription Facility, we have seen a steady increase in NAV-based credit facilities (a "NAV Facility"), particularly in the context of Funds which invest in other Funds ("PE Secondary Funds"). In a typical structure, the PE Secondary Fund arranges for a credit facility to be provided to a subsidiary of the Fund (the "Vehicle") as the borrower that is established for purposes of holding/ acquiring Investments on behalf of the PE Secondary Fund, and such Vehicle is restricted from having any indebtedness other than the NAV Facility. As security for this type of NAV Facility, 100 percent of such Vehicle's equity is pledged in favor of the Lender (along with its bank accounts receiving both capital contributions from the parent Fund(s) and distributions from the Investments). Additionally, in many transactions, guarantees from the PE Secondary Fund are provided in support of such Vehicle's obligations under the NAV Facility and/or support the payment of any unfunded commitments relating to the Investments. Certain contractual rights may also be provided to permit the Lender to require or direct the

disposition of Investments held by the Vehicle after a default of the NAV Facility. This general structure is often used to secure a NAV Facility, such that a PE Secondary Fund is able to pledge the equity of the entity holding the Investments as collateral. We note that as with any NAV-based credit facility, due diligence with respect to the Investments may be required to confirm that transfer restrictions[1] in the underlying subscription documents and partnership agreements relating to such private equity Investments would not be violated by the pledge of such equity, and if necessary, appropriate consents to such pledges can be obtained. Hedge funds investing in other hedge funds (each, a "Hedge Fund of Funds" or "Master Funds") are increasingly seeking to utilize a similar structure to obtain the benefit of Fund-level financing for purposes of portfolio management (access to liquidity without the necessity of exiting illiquid positions in an untimely manner), facilitating redemptions and/or to enhance returns through leverage. Recently we have noted an uptick in Lenders providing financings for Hedge Funds of Funds based primarily on the NAV of its Investment portfolio, i.e., the limited partnership interests in other funds (hereinafter, a "Secondary Facility"). In this article, we set out the basic structure and likely issues that may be presented in the context of a Secondary Facility for Hedge Fund of Funds.

Basic Structure

Secondary Facilities for Hedge Funds of Funds are a highly specialized type of NAV facility and can take multiple formats, including that of a straightforward credit facility, a note purchase agreement or a pre-paid forward sale under an ISDA master agreement used in over-the-counter derivatives transactions. Regardless of form, these facilities contain common components. Traditionally, availability under a Secondary Facility is limited to an amount equal to the "Eligible NAV" of the "Eligible Investments," multiplied by an advance rate. The "Eligible NAV" typically equals the NAV of the Eligible Investments, less any concentration limit excesses deemed appropriate by the Lender under the circumstances. "Eligible Investments" will typically be a subset of Investments that are not subject to certain exclusion events or other limitations as described in further detail below.

While a common approach to collateralizing NAV Facilities for PE Secondary Funds is for a Lender to obtain an equity pledge of the Vehicle in order to address potential transfer restrictions applicable to the Investments, in the context of Secondary Facilities for a Hedge Fund of Funds, the applicable Master Fund segregates the Investments serving as collateral into a "securities account" under Article 8 of the UCC which is subject to a control agreement executed by a securities intermediary ("Securities Intermediary") in favor of the Lender. By segregating these assets into a separate securities account, the Securities Intermediary becomes the legal owner of each hedge fund Investment in which the Master Fund invests by executing the applicable subscription documents of the underlying hedge fund Investment (while the beneficial ownership of such Investment remains with the Master Fund). This structure thereby enables the Master Fund borrower to pledge its "security entitlement" (described below) in the underlying hedge fund assets in the securities account to the Lender while the direct owner of such Investment remains unchanged without violating certain transfer restrictions which may otherwise be applicable (similar to the PE Secondary Fund structure described above). However, the right to foreclose on any applicable Investments will remain subject to any applicable transfer restrictions, so the Lender's primary remedy is redemption (where the Lender instructs the Securities Intermediary to redeem the hedge fund interests credited to the securities account pursuant to the terms of the control agreement). And although such redemption also remains subject to any timing constraints set forth in the hedge fund subscription documents, transfer restrictions should not preclude a practical realization on the underlying collateral.

It should also be noted that feeder funds (each, a "Feeder Fund") can obtain similar financing by establishing a securities account with respect to its Investment in the Master Fund (thereby enabling the Investment in the Master Fund to serve as the "Eligible Investment" for the Secondary Facility). In this scenario, the portfolio requirements established by the Lender in order to determine the suitability of the collateral supporting the Secondary Facility (described below) are typically tied to the Master Fund's portfolio of underlying investments.

Portfolio Requirements

In many cases Borrowers that enter into Secondary Facilities will have a mature portfolio of Investments, so a Lender may assess at the outset which Investments should be included as "Eligible Investments" for the NAV of the Secondary Facility (otherwise Lenders may look to the investment guidelines provided for in the Master Fund Private Placement Memorandum to establish eligibility criteria for the proposed Secondary Facility). Regardless, Lenders will ordinarily be sensitive to the composition of such portfolio of Eligible Investments, and as a result, will set forth requirements with respect to diversification of the portfolio, investment strategy and minimum liquidity. Common diversification requirements include the following: limitations on the NAV of the largest Investments, sponsor diversification, minimum number of Investments, limitations on the particular types of Investments involved (infrastructure vs. buyout, growth, venture and special situation funds, etc.), geographical limitations and strategy diversification (long vs. short equity Investments, arbitrage and global macro, etc.) and particular investments underlying the limited partnership interests. Nonetheless, it is a typical requirement that there be no change in the investment policy of the Hedge Fund of Funds, sponsor or other creditworthy entity guaranteeing the Secondary Facility without Lender consent.

Exclusion events related to Eligible Investments are also established at the outset of a Secondary Facility and can include: the existence of liens, bankruptcy or insolvency events of the Investment issuer or sponsor, failure by the Master Fund to pay capital contribution obligations as they become due, a write-off or a material write-down by the Master Fund of an Investment, redemption gates or other matters impacting the general partner of an underlying Fund (such as general partner "bad boy" acts or replacement of the general partner). Appropriate exclusion events and diversification requirements are key elements for any Lender providing a NAV-based credit facility as Investments failing to satisfy these criteria will not be included in the borrowing base (while these requirements must also be balanced with the need of the Master Fund to retain appropriate flexibility for purposes of maximizing portfolio value). In any event, ongoing portfolio monitoring and reporting requirements will be imposed on the applicable borrower throughout the term of the Secondary Facility as further described below.

Advance Rate and Financial Covenants

In connection with Secondary Facilities for Hedge Funds of Funds, Lenders establish an "Advance Rate" with respect to the NAV of the Eligible Investments to be acquired and/or refinanced with the proceeds of the Secondary Facility, as may be adjusted to reflect a "haircut" specified by the applicable Lender. Such a "haircut" (or discount) methodology is Lender specific and will often be set forth on an appendix to the initial term sheet for the Secondary Facility and is concerned with addressing risks and exposure the applicable Lender has with respect to the Investment portfolio (including specific Eligible Investments) securing the Secondary Facility (incorporating above-mentioned factors such as the diversification of the Eligible Investments and the Investment style/strategy of the particular borrower and/or Fund of Funds). Considering these "haircuts" are Lender specific, it is not uncommon for a Secondary Facility for Hedge Fund of Funds to be structured as a bilateral lending arrangement (and not syndicated due to difficulties associated with attempting to synchronize these proprietary formulas in the context of a multi-lender credit facility as discussed below).

In order to give Lenders assurance of the continued performance of a borrower and/or related guarantor on its obligations under a Secondary Facility, such facilities are often structured by setting forth a maximum "Loan-to-Value" ratio of the outstanding facility amount to the NAV of the Eligible Investments included in the securities account. Loan-to-Value calculations are commonly determined by taking the lowest of (a) the aggregate NAV of Eligible Investments as calculated by the sponsor of the underlying Investment in the most recently provided valuation; (b) the borrower and/or related Hedge Fund of Funds' valuation in good faith and in accordance with its investment policy or applicable governing documents; and (c) acquisition costs minus NAV adjustments attributable to (i) distributions with respect to such Investments, (ii) other customary to exclusion events or write-downs and/or (iii) any portion of NAV of eligible investments in excess of concentration limits. Such Loan-to-Value calculations may also take into consideration cash distributions maintained in the collateral account.

Another common and important financial covenant to ensure performance of the Secondary Facility focuses on share drop percentage thresholds on a monthly, quarterly and yearly basis. For each such calculation it is important to specify at the outset whether NAV will be pegged on the closing date of the Secondary Facility (or whether the NAV value can increase over the life of the borrower and/or Hedge Fund of Funds), and whether impacts to NAV resulting from third-party redemptions will be included in such calculations. Other financial covenants include limitations on debt or liens incurred by the applicable borrower and that all Investments are made through the account held by a securities intermediary and pledged to the Lender as security, as described in further detail below. A change of the securities intermediary or a change of control of the Investment manager can also lead to a default of the Secondary Facility. Finally, Lenders may require prohibitions on Investments other than the Investments in the initial portfolio and investments relating to the initial portfolio Investments.

Custody Matters

Lenders should also be aware of the prominent role a Securities Intermediary plays with respect to the custody of, and reporting requirements associated with, the Investments serving as collateral for the Secondary Facility. As previously mentioned, assets such as limited partnership interests, limited liability company interests, shares of closely-held corporations and life insurance policies are commonly subject to broad transfer restrictions which impact grants of security interests over such collateral. To secure the obligations to a creditor under a Secondary Facility, a Hedge Fund of Funds commonly pledges an investment account, managed by a Securities Intermediary as collateral.[2] A security interest in such account is typically perfected through a control agreement executed by the Securities Intermediary, and in contrast to a direct pledge of a Fund of Fund's rights in the underlying Funds (which may be viewed as breaching such transfer restrictions), the rights at issue under the control agreement are directly traceable to a Securities Intermediary and are viewed under the Uniform Commercial Code as a "security entitlement" (which is both a package of personal rights against a securities intermediary and a property interest in the assets held by the Securities Intermediary). And in addition to other remedies available under the loan documentation, the creditor's avenue of enforcement of its security interest in the Investments pledged as collateral may be through redemption, whereby the creditor instructs the Securities Intermediary to redeem the Hedge Fund of Funds' interests from the underlying Funds which have been credited to the securities account, which the Securities Intermediary will be obligated to request pursuant to the relevant control agreement.

Lenders typically require reporting with respect to the Investments pledged as collateral, including monthly reporting of the Investments maintained by the Securities Intermediary and redemption information. Lenders may also seek from the applicable borrower month-to-date estimated NAV, monthly estimated NAV and monthly official NAV reporting with respect to each Investment pledged as collateral. Furthermore, periodic reporting relating to a Hedge Fund of Funds' balance sheet showing aggregate assets, liabilities and net assets, as well as ongoing reporting requirements such as a management letter, audited financial statements, schedules of Investments (detailing all of the Hedge Fund of Funds' Investments) and other financial assets may be requested by the applicable Lender. Other reporting requirements may involve disclosure of any changes to liquidity, currency or other significant terms of the Hedge Fund of Funds' Investments, or even relate to the Securities Intermediary and involve weekly reporting of aggregate assets and detailed positions at the Securities Intermediary, as well as access to the positions electronically or via email reports with required consent for any movements of cash or securities into and out of the account. And to the extent the information provided by the Securities Intermediary to the Master Fund (which may include weekly reporting of aggregate assets and monthly fair market value information (net of liabilities) and similar information) is consistent with the reporting requirements of the applicable Lender, this may simplify implementation of a Secondary Facility.

Other Issues

One of the primary challenges in a Secondary Facility is the Lender's comfort around the calculation of the NAV of Investments, as Hedge Funds of Funds are often invested in illiquid positions with no readily available mark. To further complicate such issue, in a multi-Lender facility, each Lender will have different ways of calculating the advance rate applicable to a given portfolio of Investments and thus issues might arise as to which Lender decides what the value of the collateral is and/or what NAV of the Investments shall be for purposes of covenant compliance under the Secondary Facility. Additionally, in the context of Secondary Facilities provided to a Feeder Fund, issues may arise as to whether the Feeder Fund can have more beneficial rights than other limited partners invested in the Master Fund. For instance, a Lender may request that the Feeder Fund acting as borrower be able to redeem its interest in the Master Fund notwithstanding any other gates imposed on redemption (and applicable to the remaining limited partners), and despite the fact that such Master Fund will always be subject to the redemption provisions of the underlying Investments. Nevertheless, the Lender will argue that it should be entitled to more favorable provisions on the basis that it is a debt provider, instead of equity. And while a detailed examination of these issues is beyond the scope of this article, we note that Lenders and Master Funds alike have successfully navigated around these issues in connection with establishing Secondary Facilities.

Conclusion

While the underwriting process of Secondary Facilities is materially different from that of Subscription Facilities and other Fund financing alternatives, when structured properly, Secondary Facilities can offer an attractive risk-adjusted return for a Lender while providing Funds and Hedge Funds of Funds needed liquidity and flexibility. As more Funds and particularly Hedge Funds of Funds seek to maximize the value of their underlying Investments, we expect additional growth in the market for Secondary Facilities. ◆

Endnotes

[1] In many circumstances, General Partner consent may be required to address indirect transfer limitations contained in the underlying Investment documentation. We note that General Partners will generally provide consents to such pledges, and the foregoing are more easily obtained than a lien on the Investment itself.

[2] The Master Fund also typically provides a security interest in the financial assets pledged as collateral, and a Uniform Commercial Code financing statement is filed in connection therewith.

Converging Trends in US and UK Subscription Credit Facility Markets[1]

Introduction

As of the start of the second quarter of 2016, 1,684 private equity funds were in the market fundraising, with nearly 20 percent of those funds (representing approximately 26 percent of aggregate target capital levels) focused on investing primarily in the European subcontinent.[2] In addition, as of March, 2016, Europe was the most targeted geographic region for private equity investment, with 57 percent of active investors seeking exposure to Europe.[3] Given this backdrop, it is not surprising that there continues to exist a robust market for lending to European private investment funds. While historically there have been key differences between how credit providers ("Lenders") approach advancing a capital call subscription credit facility (a "Facility") to a private investment fund (a "Fund") domiciled in the United States as compared to Europe, there are increasing similarities in the US and UK Facility markets.[4]

In both the United States and Europe, the defining characteristic of a Facility is the collateral package securing the Fund's repayment of the Lender's extension of credit. Such collateral is typically comprised of the unfunded commitments ("Capital Commitments") of the limited partners to the Fund (the "Investors") to make capital contributions ("Capital Contributions") when called upon by the Fund's general partner, not the underlying investment assets of the Fund itself. The loan documents for the Facility contain provisions securing the rights of the Lender, including a pledge of (i) the Capital Commitments of the Investors, (ii) the right of the Fund to make a call (each, a "Capital Call") upon the Capital Commitments of the Investors after an event of default and to enforce the payment thereof and (iii) the account into which the Investors fund Capital Contributions in response to a Capital Call. While both US and UK Facilities share these basic characteristics, as more fully described below, the markets differ in respect of both how availability under such a facility is determined and the methods and mechanisms used to perfect a Lender's security interest depending on the jurisdiction in question.

Converging Markets

There are many factors contributing to the increasing similarities between Facilities in the United States and Europe. In recent years, growing numbers of US-based financial institutions have entered the European Facility market, both in search of banking new Funds with European managers and following US Fund managers that have launched Europe focused Funds or are operating in Europe. As these US Lenders look to offer Facilities to European Funds, they bring with them the Facility structures and documentation with which they're familiar, driving a convergence of Facility terms and documentation between these markets. With this expansion, Lenders frequently employ cross-border teams that cover both US and European Funds, which contributes to this trend. In addition, as Fund sizes increase and there is a corresponding need for more debt capital, an increasing number of deals out of London are being transacted on a club basis resulting in a movement towards a more unified documentary approach. Furthermore, with the exponential growth of the private investment fund industry since its inception, the Investor pool in Funds has become more globalized and diversified with a number of Investors investing across a range of asset classes and jurisdictions.

Key Credit Documentation Provisions (US vs. UK Perspective)

GOVERNING LAW AND FORMS OF FACILITY DOCUMENTATION

Similar to the frequent use of New York law as the preferred governing law for US Facilities, the governing law used for the primary credit document for many European Facilities is that of England and Wales ("English law"). As such, this article will focus on certain typical features of a Facility from a US and English perspective. There are many reasons for the selection of English law and inclusion of English jurisdiction clauses in continental transactions. English common law is based on the fundamental principle of freedom of contract, which provides more flexibility for the parties than the law of many civil law jurisdictions, which would apply a more prescriptive civil code. In addition, England's highly regarded legal and court system and the various international reciprocal arrangements allow for mutual recognition and enforcement of English judgments. The current assumption is that the United Kingdom's recent decision on 23 June 2016 to leave the European Union will not have a significant impact on this although thought may need to be developed around certain documentary considerations as the terms of the United Kingdom's exit from the European Union emerge. Mayer Brown is reviewing and advising clients on the position on an ongoing basis.

In the United States, most Lenders have their own institutional form of credit agreement that has been specifically tailored for the Facility product (as opposed to other types of leveraged lending transactions such as a corporate line). Unlike in the United Kingdom, there is no industry-accepted full model form of credit agreement equivalent to the LMA described below in the United States.[6] While there are many key Facility features and terms that are common across the US Facility market, each Lender's form of credit agreement is distinct from those of its competitors and reflects the particular credit, procedural and documentary preferences of the individual institution.

In contrast, UK Facilities are often documented using the Loan Market Association ("LMA") model facility agreement as a starting point, with Facility-specific provisions layered on. This is the case even in circumstances where there is no present intention or expectation for the administrative agent to syndicate the Facilities. This results in a degree of familiarity and uniformity across the boilerplate or framework provisions, subject to structural variations. Such structural variations may include those driven by the Fund's

organizational structure and the type of Facility—for example, if a multi-borrower umbrella-style Facility is required.

COVERAGE RATIOS AND THE BORROWING BASE

In a Facility, the collateral package consists of the unfunded Capital Commitments of the Fund's Investors and the associated Capital Call rights. In the past, the UK Facility market has tended to take a coverage ratio-style approach to determining availability under a Facility, while in the US market, Lenders have traditionally determined availability by assigning different percentages ("Advance Rates") to the Investors on an Investor-by-Investor basis ("Borrowing Base Methodology"). For reasons outlined earlier, the Borrowing Base Methodology is increasingly being adopted in the UK Facility market and, similar to the US Facility market, Lenders apply their own credit models in determining any individual Investor advance rates or concentration limits, depending on the financial wherewithal of the Investor(s) and the Investor pool and the track-record and identity of the Fund sponsor. This individual credit analysis also impacts whether additional financial covenants are included in a Facility.[7]

INVESTOR EXCLUSION EVENTS

A key feature for a Lender in a Facility is the ability to evaluate the credit quality of the Investors in the borrowing base from time to time. Both US and UK Facilities will contain "Investor Exclusion Events," which are triggering events that will immediately result in an otherwise included Investor's uncalled Capital Commitment being removed from the Fund's borrowing base. Typical Investor Exclusion Events include (i) failure to timely fund Capital Contributions, (ii) insolvency of the Investor, (iii) default by the Investor of its material obligations as a limited partner in the Fund, (iv) termination or cancellation of the Investor's Capital Commitment and/or (v) a material adverse event with respect to the Investor. In general, where the Borrowing Base Methodology is adopted, the Facility tends to include a longer list of narrowly-drafted Investor Exclusion Events. This is in comparison to Facilities adopting a coverage ratio-style approach, where Investor Exclusion Events are typically fewer in number but broader in scope.

TENOR

In both the US and UK markets, it is not uncommon for the tenor of Facilities to be in excess of 364 days and often up to three years (sometimes with extension options, not always at the sole discretion of the Lenders). The tenor and presence of any mandatory prepayment features and/or clean downs in Facilities are driven in principle by a number of possible factors, including (i) the terms of the Fund's partnership agreement and other organizational documents which may permit longer-term borrowings, (ii) market practice, in certain circumstances driven by a response to the European Union's Alternative Investment Fund Managers Directive (commonly know as AIFMD), where shorter-term borrowings are more typical and/or (iii) the requirements of the Lenders, which can vary from institution to institution with some Lenders requiring at least an annual clean down while many others are comfortable without one, subject to other factors described above. In addition, some Lenders will look to the termination of the Fund's commitment period as a deciding factor in determining the tenor of a Facility, on the basis that a Fund presents a different credit risk pre- vs. post-commitment period, notwithstanding the ability of a given Fund borrower to call for Capital Contributions to repay debt after the Fund's commitment period has terminated.

KEY COMMON COVENANTS

A great deal of similarity exists among the key covenants in US and UK Facilities. Facility documentation typically includes prohibitions on competing liens over the Lender's collateral (a negative pledge); restrictions on changes to the Fund's constituent documents; limitations on the ability of the Fund or its general partner to permit an Investor to withdraw or transfer

its limited partnership interest if a mandatory-prepayment would result; and limitations on when the Fund can make distributions, dividends or other "restricted" payments to its Investors and investment manager.

CUSTOMARY EVENTS OF DEFAULT

Similarly, in US and UK Facility documentation, most of the common events of default are similar. Standard events of default include non-payment, breach of the representations and warranties made by the Fund parties to the Lenders, breach of the covenants under the Facility, insolvency of the Fund, material adverse effect, and a cross-default to other indebtedness of the Fund.

INVESTOR LETTERS AND INVESTOR OPINIONS/CERTIFICATIONS

As part of their diligence process, Lenders to a US Fund may request that the Fund provide letter agreements ("Investor Letters") signed by Investors in favor of the Lender in which the Investor makes various confirmations for the benefit of the Lender. For historical reasons, Investor Letters have been more prevalent in the real estate Fund Facility market in the United States where the subscription line product has its start, but may also be used when the Fund's limited partnership agreement or other relevant constituent document lacks basic terms the Lender deems necessary in order to extend credit. In such circumstances, Lenders will often require receipt of such an Investor Letter as a condition to giving an Investor borrowing base credit. While increasing comfort by Lenders with the Facility product in general has resulted in fewer deals being completed with Investor Letters, they continue to be an effective tool, particularly where a Fund's limited partnership agreement contains less robust Facility-specific provisions or where a single Investor is included in the borrowing base.

In addition to Investor Letters, Lenders sometimes require that an Investor deliver an opinion of counsel (an "Investor Opinion") opining that the Investor's obligations under its subscription documents are valid and binding.[8] Some Lenders will accept a certification of the Investor to that effect instead of an Investor Opinion or other evidence of authority. As with the Investor Letters, Lenders use the Investor Opinions and certifications in determining whether to grant borrowing base credit to the uncalled Capital Commitment of a particular Investor if the Facility is one for which such documents are required by the Lender. For the historical reasons outlined above, and jurisdiction-specific legal reasons beyond the scope of this article, Investor Letters and Investor Opinions are more commonly seen in the US market, and more likely to be required where the LPA contains a deficiency or where a single investor is in the borrowing base.

US-SPECIFIC PROVISIONS IN UK FACILITY DOCUMENTS

The expanding presence of US Lenders, Investors and Fund entities in UK Facilities, as well as US Dollar denominated / optional UK Sterling Facilities, has led to the inclusion of US-specific provisions in otherwise UK-centered transactions. These provisions may include representations, warranties and covenants addressing ERISA, the Investment Company Act of 1940, US federal margin regulations and money-laundering, anti-terrorism and sanctions laws such as the Patriot Act and the Foreign Corrupt Practices Act. These regulations are highly technical in nature and parties would be best served by consulting with specialist counsel familiar with their interpretation and application in the Funds context.[9]

Security Interest Creation/Perfection Considerations

As noted above, the defining characteristic of a Facility is its collateral, which generally consists of two key components: (i) the uncalled Capital Commitments of the Fund's Investors and the Fund general partner's rights to make Capital Calls thereon and (ii) the collateral account into

which Investors' Capital Contributions are funded. In more complex Fund structures, which may be subject to certain regulatory or tax considerations, the uncalled Capital Commitments and associated Capital Call rights may be pledged in back-to-back fashion through several Fund entities and ultimately to the Lender in what is known as a "cascading pledge" structure. In addition, where several Fund entities are involved in a Facility, the parties may agree to pledge multiple collateral accounts to the Lender or they may pledge only a single master collateral account held in the name of a borrower entity. Where a single master collateral account is pledged, the Facility documents often require that the feeder entities transfer Capital Contributions into the pledged account within a limited period of time after receipt by the applicable Fund entity. In both the US and UK markets, a pragmatic approach is sought once the relevant risks, and potential mitigants, have been identified and appropriately managed.

Creation and perfection of a Lender's security interest in collateral is generally governed by the laws of the jurisdiction(s) in which the debtor or the collateral is located. Given the numerous jurisdictions where Fund entities and assets are located, parties must often consider local law requirements of several different jurisdictions within a single transaction.

Depending upon the type of collateral and the applicable governing law, perfection of a security interest may be accomplished by various methods. Perfection mechanisms may include control (via possession or contract), filing of a financing statement, delivery of a notice and/or registration of the security interest in public or company records.

In the United States, security interests in general intangibles such as uncalled Capital Commitments and the Capital Call rights in respect thereof are perfected by filing a UCC-1 financing statement naming the Fund as debtor, and the Lender as secured party, in the state of the jurisdiction of formation of the Fund if the Fund is a limited partnership or limited liability company organized in a state of the United States. In contrast, a security interest in a deposit account is perfected by control, typically through the execution of a control agreement among the Fund, the Lender and the depository bank, where the depository bank's jurisdiction as determined under the applicable US uniform commercial code rules is a state of the United States. In such circumstances, delivery of notification to the Investors of the creation of a security interest in the Facility collateral is not required to perfect the Lender's security interest.

In the United Kingdom, security interests in uncalled Capital Commitments are perfected by the delivery of a notice of the pledge of such Capital Commitments to the Investors. Similarly, a security interest in deposit accounts is perfected by delivery of a notice to the depositary bank. In such cases, since notice is not required for the creation of such security interests, content, timing and mode of delivery of such notice may be subject to negotiation between the parties.

In all cases, consulting knowledgeable local counsel is critical to ensuring that a Lender's security interest in the collateral is properly created and perfected.

Conclusion

While many key provisions of US and UK Facility documentation are similar or converging, jurisdiction-specific nuances and customs, particularly with regards to Investor deliverables and collateral perfection mechanics, remain. With the ever-increasing complexity of Fund structures and the cross-border nature of many Funds and Facilities, Lenders and Funds are well advised to consult with knowledgeable counsel to ensure that their Facility documents reflect the latest technology and comply with the relevant jurisdiction-specific security interest creation and perfection requirements. ◆

Endnotes

[1] Reference to US Facilities denotes Facilities governed by New York law and reference to UK Facilities denotes Facilities governed by English law.

[2] *The Preqin Quarterly Update: Private Equity*, Q1 2016, at p.6.

[3] *Id.* at p. 7.

[4] For an introduction to the key terms used in the subscription finance space, see Mayer Brown's *Fund Finance Market Review*, *Beginner's Glossary to Fund Finance*, February 2, 2016, on page 178.

[5] For up-to-date information on the impact of Brexit and related analysis, please visit Mayer Brown's dedicated webpage, *Brexit - The UK and the EU*, available at https://www.mayerbrown.com/experience/Brexit-The-UK-and-the-EU/.

[6] In the United States, while the Loan Syndications and Trading Association (the "LSTA") publishes select Model Credit Agreement Provisions, such model provisions generally focus on syndicate and agent-related terms. The LSTA does not publish a full model credit agreement, and the LSTA's Model Credit Agreement Provisions do not include form provisions related to borrowing mechanics, closing conditions, operational covenants or events of default.

[7] For additional analysis regarding certain borrowing base considerations, see Mayer Brown's *Fund Finance Market Review*, *Governmental Plan Investors and the Borrowing Base*, August 6, 2014, on page 106.

[8] For analysis on the enforceability of Capital Commitments under US law, please see Mayer Brown's *Fund Finance Market Review*, *Enforceability of Capital Commitments in a Subscription Credit Facility*, on page 1, and E*nforceability of (Debt) Capital Commitments*, on page 189.

[9] See also Mayer Brown's *Fund Finance Market Review*, *Subscription Credit Facilities and the Volcker Rule*, August 6, 2014, on page 103 and *Subscription Credit Facilities: Certain ERISA Considerations*, July 29, 2013, on page 38.

[10] For further detail, see Mayer Brown's *Fund Finance Market Review*, *Feeder Funds*, February 17, on page 172.

Management Fee Subordination: Potential Issues with Subscription Credit Facilities and Management Fee Lines of Credit

A management fee credit facility (a "Management Fee Facility") is a loan made by a bank or other financial institution (a "Lender") to the management company or investment advisor (collectively, a "Management Company") that is typically the sponsor (or affiliated therewith) (a "Sponsor") of a private equity fund (a "Fund"). The Lender under a Management Fee Facility is typically secured by, among other things, a pledge from the general partner (the "General Partner") or Management Company of its rights to receive management fees under the Fund's limited partnership agreement (a "Partnership Agreement") or other applicable management or investment advisory agreement. The Fund itself may have a subscription credit facility (a "Subscription Facility"), also known as a "capital call facility," for which the collateral package is the commitments of the limited partners in the Fund (the "Investors") to make capital contributions when called by the General Partner.[1] A Lender under a Subscription Facility typically requires a covenant that restricts payments by a Fund in respect of other debt or obligations owed to affiliates of the Fund (including, without limitation, to its General Partner or the related Management Company in respect of fees) following the occurrence and during the continuance of an event of default, any potential event of default and/or other mandatory prepayment events thereunder, essentially subordinating such payments to the obligations owing to the Lender under the Subscription Facility (a "Subordination Provision"). A Subordination Provision may be problematic for the General Partner or Management Company because the Lender under a Management Fee Facility will be reluctant to permit the subordination of the payment streams needed to make payments owed to such Lender to payments owed to a Lender under a Subscription Facility. This article will discuss the potential tension between a Management Fee Facility and a Subscription Facility in the context of a Subordination Provision and suggest a few possible solutions that would allow the Fund, General Partner/Management Company and Lender(s) to permit the two different facilities to coexist and benefit each party in interest.

Management Fees Generally

The ability of any Fund to invest and provide returns to its Investors is necessarily dependent on the guidance of the General Partner or Management Company regarding how the capital of the Fund will be invested. The General Partner and/or Management Company will receive a fee as compensation for discovering and evaluating investment opportunities and conducting other management responsibilities along with providing general back-office support to a Fund (such fees collectively, the "Management Fee"). The Management Fee may be applied by the General Partner or Management Company to pay its operating expenses and the salaries of the employees and investment professionals employed thereby. Payment of the Management Fee is typically either made directly to the General Partner and/or Management Company by an Investor or it may be paid through the Fund in the form of a capital call pursuant to the subscription agreement that each Investor has with the Fund. The General Partner or Management Company will typically receive payment of the Management Fee from the Investors in the Fund on either a quarterly or semiannual basis.

The Management Fee is usually charged on a per-Investor basis and is often calculated by multiplying a percentage (historically between 1.5 percent and 2 percent per annum) by such Investor's capital commitment. The Management Fee is appropriately calculated to cover the cost of operating the General Partner or Management Company.

Note that not all payments to the General Partner or Management Company constitute Management Fees. A General Partner or Management Company may also receive a performance payment (often referred to as the "promote" or "carried interest") as compensation for achieving returns above a certain benchmark (a "Performance Fee"). Once a Fund is able to return the capital of an Investor and a certain percentage of profit on such capital, the General Partner or Management Company may participate in any returns above this preferred or hurdle return. The Performance Fee is generally separate and distinct from the Management Fee and is not typically included as collateral or a payment stream in a Management Fee Facility.

Subscription Facilities and the Subordination Provision

A Subscription Facility is beneficial to a Fund (and thus the General Partner and Management Company) for many different reasons, including its ability to provide bridge financing that allows the Fund to quickly capitalize on an investment opportunity by providing access to capital on a faster basis (sometimes as early as the next day) than would normally be available from Investors under the terms of the Fund's Partnership Agreement. Typically, each Investor will have up to ten business days to fund its capital commitment following a capital call by the Fund. The mechanics related to calling capital from Investors necessarily require a Fund to delay (or have sufficient advance notice of) any investment and may limit the investment opportunities of a Fund simply due to this timing restriction. A Subscription Facility will eliminate or significantly reduce this delay. The Lender under a Subscription Facility will advance capital to the Fund and rely on the ability of the Fund to call capital from Investors as the source of repayment. The collateral package given to a Lender under a Subscription Facility by the Fund will include the collateral assignment of the right to make capital calls upon Investors to repay the amounts advanced to the Fund under the Subscription Facility.

The loan documentation for the Subscription Facility will often include a Subordination Provision, which will typically extend to the Management Fee. If the Fund were to make a payment of the Management Fee following the occurrence and during the continuance of an

event of default, potential default or other mandatory prepayment event under a Subscription Facility, such payment will likely violate the Subordination Provision. Lenders, however, are increasingly willing to include a carve-out to the Subordination Provision that allows for payment of the Management Fee by the Fund despite the existence of an event that triggers the Subordination Provision under the Subscription Facility. The inclusion of this carve-out by Lenders for payment of the Management Fee (but typically not permitting payment of any Performance Fee) while the Subordination Provision is effective has become a market trend because payment of the Management Fee is viewed by Lenders as critical to the Fund's ability to continue to operate. In contrast, Lenders generally view the Performance Fee as excess compensation that constitutes a share of the profit of the Fund and not as a payment that is necessary for the General Partner or Management Company to continue to function.

Permitting the payment of the Management Fee, even during an event of default, can be viewed as an alignment of interests for all parties that goes beyond keeping the Fund operational. The Lender has a vested interest in permitting the Fund to manage its investments and continue to operate the Fund so as to maximize the potential source of repayment of obligations owed to the Lender under the Subscription Facility. Achieving this result to maximum effect can realistically only be achieved if the General Partner and/or Management Company can continue to pay its employees and keep the Fund functioning. If the General Partner or Management Company is not paid for its services during this critical period, the ability to receive payment on the Fund's obligations to the Lender under the Subscription Facility or capture potential profits for Investors (and a potential Performance Fee for the General Partner/ Management Company), in each case, could be severely impaired. While recognizing the mutually beneficial aspect of permitting the payment of the Management Fee, a Lender may be hesitant to allow unrestricted payments in respect thereof. In such instances, the Lender may place a cap on the dollar amount the Fund is permitted to pay in respect of the Management Fee on either a quarterly or annual basis or the cap may only be effective during the occurrence and continuance of an event of default under the Subscription Facility.

While the market trend recognizes the benefits of exempting the payment of the Management Fee from the Subordination Provision of a Subscription Facility during times of stress, the Partnership Agreement of the Fund increasingly includes restrictions on paying Management Fees. These so-called "overcall" restrictions prohibit capital calls with respect to Management Fees on non-defaulting Investors to offset the shortfall created when another Investor defaults in its capital commitment to the Fund.[2] An overcall restriction becomes problematic for a Lender under a Subscription Facility because the terms of a Subscription Facility will often permit the payment of Management Fees with the proceeds of any borrowing under the Subscription Facility. If the Partnership Agreement of the Fund, however, includes an overcall restriction, the Lender can only rely on the non-defaulting Investors for purposes of repaying the obligations under the Subscription Facility attributable to the payment of the Management Fee.[3] Due to this risk, Lenders may consider limiting the payment of Management Fees with the proceeds of any borrowing under the Subscription Facility. Another approach to mitigating a Lender's exposure to the overcall restriction risk is to require an accelerated repayment period (a "clean-up call") in respect of any borrowings under a Subscription Facility that are earmarked for payment of the Management Fee.[4]

Placing caps on Management Fee payments, prohibiting borrowings under a Subscription Facility to pay Management Fees or implementing a clean-up call feature are all solutions that can be successfully used under a

Subscription Facility to permit payment of the Management Fee while mitigating the risk exposure of a Lender.

Management Fee Facilities and the Restrictive Agreement Covenant

The Management Fee is typically paid by Investors in the Fund on either a quarterly or semiannual basis, however the General Partner's or Management Company's ongoing expenses related to managing the Fund (from managing and evaluating investments to paying employee salaries) must be paid on a more frequent basis. The General Partner or Management Company may use the proceeds of the Management Fee to pay a variety of different costs associated with its business, such as providing general working capital, funding its own capital contribution to a Fund, and facilitating the buy-out of partners and/or mergers and acquisitions. A Management Fee Facility allows the Management Company or Sponsor to receive consistent cash flow that would otherwise be unavailable if relying on the standard Management Fee payment schedule and is typically structured as a revolving loan commitment from the Lender, secured by a pledge by the General Partner or Management Company of its right to receive payment of the Management Fee from one or several Funds.[5] Generally, a Lender will only provide a Management Fee Facility to a Management Company or Sponsor that can demonstrate a proven history of receiving Management Fees; it is unlikely that a first-time Sponsor will find a Lender willing to provide financing based on the anticipated and as-of-yet undocumented receipt of Management Fees.

A Management Fee Facility will often include covenants that are designed to give the Lender comfort that the payment stream of each Management Fee securing the facility will continue to be paid to the General Partner or Management Company for the duration of the Management Fee Facility. These covenants may take the form of a requirement that (i) the General Partner or Management Company receive a minimum amount of income from the Management Fees, (ii) a certain ratio of the Management Fees received to the aggregate commitments of the Investors in each Fund that are paying the Management Fee is maintained or (iii) the Fund maintain a minimum net asset level. A negative covenant with respect to entering into "restrictive agreements" is another common restriction found in a Management Fee Facility. This type of covenant, which is analogous to a negative pledge, restricts the General Partner or Management Company from entering into, or permitting to exist, any agreement or other arrangement that prohibits, restricts or imposes any condition upon the ability of any Fund to pay Management Fees to the General Partner or Management Company (a "Restrictive Agreement Covenant"). If the General Partner and/or Management Company agree to include a Subordination Provision under a Subscription Facility for a Fund from which the Management Fees are part of the collateral package granted to the Lender under a Management Fee Facility, the General Partner/Management Company would most likely breach the Restrictive Agreement Covenant in such instance.

Addressing the Subordination Provision/ Restrictive Agreement Covenant Conflict

The conflict between the Subordination Provision that is often included in a Subscription Facility and the Restrictive Agreement Covenant included in a Management Fee Facility presents challenges to both Management Companies/Sponsors and Lenders in attempting to accommodate both facilities. A Lender may be willing to provide a blanket carve-out to the Restrictive Agreement Covenant for any Subscription Facility that may include a Subordination Provision, recognizing that the ability of the Fund to secure financing under a Subscription Facility contributes to the success (and the continued payment of Management Fees) of a Fund. A Lender may also be willing to

grandfather on a case-by-case basis existing Subscription Facilities that include a Subordination Provision for any Fund that will contribute Management Fees to the borrowing base for a Management Fee Facility following diligence related to such Subscription Facility and similarly evaluate any new Subscription Facilities for eligibility under a Management Fee Facility. In the instance where the Lender under a Fund's Subscription Facility is also the Lender under the Management Fee Facility for such Fund's General Partner/Management Company, the Lender may include a blanket carve-out from the Restrictive Agreement Covenant with respect to the Management Fees that are subject to a Subordination Provision in the Subscription Facility for such Fund due to the Lender's familiarity with the overall structure of the Subscription Facility and its Investors.

A Management Fee Facility can also be structured in a manner that will (i) reduce the Lender's exposure to Management Fees that may be subject to a Subordination Provision or (ii) otherwise reduce the Lender's reliance on Management Fees to secure repayment from the General Partner or Management Company. The former may be accomplished by simply providing a reduced advance rate for any Management Fees subject to a Subordination Provision under a Subscription Facility. The latter may be achieved by diversifying the payment streams that secure a Management Fee Facility. In this diversification scenario, the Lender may elect to expand the collateral package under the Management Fee Facility by receiving a pledge from the General Partner/Management Company that also includes the Performance Fee discussed above, payments with respect to co-investments or other payment streams in addition to the Management Fee. In some cases, the Lender may actually receive a guaranty by one or more of the principals in the General Partner/Management Company or even the Sponsor as another form of support. Each of these approaches provides the General Partner/Management Company and the Lender flexibility to structure a Management Fee Facility that both acknowledges and accommodates Subordination Provisions.

Conclusion

The tension between a Subordination Provision and a Restrictive Agreement Covenant, if properly addressed, should not prevent a Management Company/Sponsor from obtaining financing for a Fund under a Subscription Facility while also permitting it to receive regular cash flow by leveraging Management Fees paid by Investors in such Fund or other income streams. Experienced legal counsel can help both the Management Company/Sponsor and the Lender navigate these issues and suggest structures and proposals that will support borrowing capacity for the Management Company/Sponsor under a Management Fee Facility while ensuring the Lender will also be properly secured. ◆

Endnotes

[1] For a detailed update on current trends and developments in the subscription credit facility market and fund finance market, please see Mayer Brown's *Fund Finance Market Review* Spring 2016, beginning on page 167.

[2] The non-defaulting Investor will likely object to paying the management fees owed by a defaulting Investor, and overcall limitations are increasingly included in the Fund's Partnership Agreement. Further discussion of overcall limitations in respect of management fees can be found in the *"Spring 2016 Market Review"* in Mayer Brown's *Fund Finance Market Review* Spring 2016, on page 167.

[3] Note that, typically, the Partnership Agreement of a Fund will make each Investor obligated to repay any amounts owing under a Subscription Facility by the Fund up to the total capital commitment of such Investor; an overcall restriction may negate this if the amounts owing under the Subscription Facility are in respect of the payment of the Management Fee that is attributable to a defaulting investor.

[4] Borrowings under a Subscription Facility are not generally required to be repaid (barring the occurrence of an event of default or other triggering event) prior to maturity of the loan. A clean-up call feature may require that any borrowings that are made in order to pay the Management Fee be repaid within 90 days.

[5] For a detailed description and examination of management fee credit facilities, please see "Management Fee Credit Facilities" in Mayer Brown's *Fund Finance Market Review Winter 2013*, on page 64.

Lending to Single Investor Funds: Issues in Connection with Subscription Credit Facilities

As the subscription credit facility market continues to experience steady growth, lenders seek to expand their lending capabilities beyond traditional subscription credit facilities to commingled private equity investment vehicles ("Funds"). One way lenders have accomplished this is by lending to Funds that have a single dedicated investor in the Fund (each, a "Fund of One"). By way of background, a subscription credit facility (a "Facility") is a loan or line of credit made by a bank or other credit institution (a "Creditor") to a Fund that is secured by (i) the unfunded commitments (the "Capital Commitments") of the investors to fund capital contributions ("Capital Contributions") to the Fund when called from time to time by the Fund (or its general partner, managing member or manager (a "Manager")), (ii) the rights of the Fund or its Manager to make a call (each, a "Capital Call") upon the Capital Commitments of the investors and the right to enforce payment of the same and (iii) the account into which investors fund Capital Contributions in response to a Capital Call.[1]

A Fund of One has one investor (which is typically a well-established institutional investor) (the "Investor"). The respective rights and obligations of the Investor and the Manager are primarily contained in the limited liability company agreement, the limited partnership agreement or an investment management agreement of the Fund of One (the "Governing Agreement"). A Fund of One may also have an equity interest from an additional party (typically an affiliate of the sponsor and Manager of the Fund of One), but the additional party's equity interest is often small compared to the equity investment of the Investor. A number of institutional Investors have shifted towards investing in Funds of Ones for a number of reasons, including: (i) a Fund of One offers greater control of all aspects of the investment process (such as investment decisions and reporting), (ii) Funds of One usually have reduced management fees, (iii) the investment mandate can be custom-tailored for the Investor and (iv) the Investor is protected from co-investor default risk.[2] Many institutional investors, including state pension plans, foreign pension plans and sovereign wealth funds,

have been known to use a Fund of One as an investment vehicle. Although a Manager will control the Fund of One and have primary responsibility for conducting the operations and making investment decisions for the Fund of One, the level of involvement and control by an Investor in a Fund of One can vary. The level of involvement of the Investor is generally shaped by the specific investment policies and experience of the Investor's personnel in the type of investments intended to be made by the Fund of One, the relative negotiating power of the Investor and the Manager and, in some cases with respect to certain foreign investors, the desire to avoid having effective practical control over the Fund of One in order to be eligible to achieve desirable US federal income tax treatment on the investment.

This article addresses issues and documentation considerations for Facilities to a Fund of One.

Governing Agreement Issues

Not all potential Fund of One borrowers have a Governing Agreement that is able to support a Facility. To be suitable for a Facility, the Governing Agreement should, among other things, expressly authorize the Manager to obtain a Facility on behalf of the Fund of One and provide as collateral the right to call upon the unfunded Capital Commitments of the Investor. For purposes of this article, we assume that the Capital Commitment of the Investor is an equity commitment and the Investor is fully obligated to fund upon a validly issued Capital Call from the Manager or the Creditor pursuant to a pledge of the Manager's rights. Three common concerns regarding the Governing Agreement of a Fund of One in particular are: (1) the consent rights of the Investor with respect to borrowings and the operating budget, (2) limitations on the right to pledge the Capital Commitment of the Investor and (3) enforcement rights against the Investor if the Investor fails to fund its Capital Commitment.

Consent rights afforded to an Investor under the Governing Agreement for a Fund of One may be quite broad. For example, the Investor may have consent rights for each investment with respect to each borrowing and/or the budget. This is unlike a commingled Fund with a large number of Investors, in which the mandate to the Manager with respect to investments is often broad in nature, and consent is not generally required prior to each investment. Furthermore, the Investor in a Fund of One may have a consent right regarding all borrowings of the Fund of One (or a consent right for all borrowings above a particular threshold amount) and/or the right to approve the Fund of One's operating budget. In a commingled Fund, by contrast, there is typically a provision in the Governing Agreement permitting borrowings and giving authorization to the Manager to set the Fund's operating budget. If the Investor has a consent right with respect to individual borrowings and the operating budget, the Creditor may consider making it explicit in an Investor Letter (as described in "Facility Documentation Considerations" below) that the Investor consents to the Facility and agrees to fund Capital Contributions to the Creditor during an event of default under the Facility.

There may also be limitations in the Governing Agreement regarding the amount of the Investor's Capital Commitment that can be pledged to the Creditor as collateral for the Facility. For example, if an Investor has a Capital Commitment of $100 million, the Governing Agreement for the Fund of One may provide that only 80 percent ($80 million) of the Investor's Capital Commitment may be pledged to the Creditor. In this case, the Creditor would only consider $80 million as part of the borrowing base for the Facility, not the total $100 million Capital Commitment. In addition, there may be issues with tracking (whether or not capital that has been called is part of the Capital Commitment that may be pledged to the Creditor). One solution is to provide in the Governing Agreement or subscription documents, as

applicable, that the Investor has two Capital Commitments: one Capital Commitment that may be pledged to a Creditor and one that may not be pledged. In addition, the Creditor may require that the reporting of Capital Calls clearly sets forth the Capital Contributions that have been called and what portion is part of the Capital Commitment that has been pledged to the Creditor.

Finally, Funds of One differ from commingled Funds in their treatment of defaulting Investors. In a typical Governing Agreement for a commingled Fund, there are often draconian enforcement rights with respect to Investors that fail to fund Capital Contributions when due, including a forced sale of the defaulting Investor's interest in the Fund at a discount of up to 50 percent as well as loss of distribution rights and other rights such as participating in future investments of the Fund and voting. In a Fund of One, however, there are typically narrower enforcement rights under the Governing Agreement (often limited to default interest and the right of the Manager to pursue ligation against the Investor), and the Manager does not have the ability to call on other Investors to make up the defaulting Investor's shortfall. In addition, it is unlikely that the Manager's Capital Commitment would be sufficient to make up the shortfall caused by the defaulting Investor. The Creditor may consider seeking additional credit support from the Manager, a sponsor of the Manager or a parent entity of the Investor to address the limited enforcement rights in the Governing Agreement.

Facility Documentation Considerations

While a Facility for a Fund of One is generally similar to a Facility for a commingled Fund in terms of closing documentation, a Facility for a Fund of One may require a few specific changes in order to give the Creditor comfort from an underwriting perspective.

First, the Creditor may require an investor letter (the "Investor Letter") from the Investor in a Fund of One in connection with the Facility. An Investor Letter is an acknowledgement made by an Investor in favor of a Creditor in which the Investor makes representations, acknowledgements and covenants relating to the pledge to the Creditor of the right to receive and enforce the Facility collateral. It is also not uncommon for the Creditor to require an investor opinion (an "Investor Opinion") from legal counsel of the Investor stating various legal conclusions with respect to the Investor, such as the valid existence and good standing of the Investor and the corporate power and authority to execute the Investor Letter. Although there is a market trend away from requiring an Investor Letter and an Investor Opinion for Facilities generally, it is still common for a Creditor to require this additional documentation in a Facility for a Fund of One where the Creditor is relying on the Capital Commitment of a single Investor for repayment.

A second issue for a Creditor to consider is the proper advance rate against the Capital Commitment of the Investor. In a Facility in which there are numerous Investors, the Creditor will often advance against different percentages of each Investor's Capital Commitment depending on the creditworthiness of each Investor based on the Creditor's underwriting of each Investor (for example, the Creditor may advance 90 percent against well-established institutional Investors and 70 percent against other designated Investors). For a Fund of One, the analysis may be similar and the advance rate for that single Investor may depend on what the Creditor would normally advance against that particular Investor in the case of a Facility to a commingled Fund. However, an important consideration for the Creditor is how much overall exposure the Creditor has to that particular Investor across the Creditor's other Facilities, such as exposure to that Investor in Facilities to commingled Funds in which that Investor has also invested.

Alternatively, the Creditor may decide to advance a lower percentage against the Investor's Capital Commitment than it would

otherwise in case of a Facility to a commingled Fund because the Creditor does not have certain benefits related to a Facility for a commingled Fund. Most notably, the Creditor is relying on the Capital Commitment of a single Investor in a Fund of One and does not benefit from the reduced risk that comes with diversification from relying on the Capital Commitments of numerous Investors in a commingled Fund. In a commingled Fund, a Creditor typically advances loans against the Capital Commitments of only well-established institutional Investors and certain other Investors in the Fund, although the Creditor takes as collateral the Capital Commitments of all Investors in the Fund. In a Fund of One, the Creditor does not have such additional collateral from other Investors aside from the sponsor Capital Commitment, which is often just a fraction of the Investor Capital Commitment, and that is likely insufficient to cover any shortfall.

Events that would remove an Investor from the borrowing base (“Exclusion Events”) in a Facility to a Fund of One will often be similar to what would be found in a typical Facility. Such Exclusion Events generally include the Investor filing for bankruptcy, judgments against the Investor over a certain threshold amount, failure to make a Capital Contribution within a certain time period, transfer of the Investor’s interest in the Fund of One and default under the Governing Agreement or other subscription documents. However, the Exclusion Events in a Facility to a Fund of One may be more stringent in a few respects, including with respect to a cure or grace period. If any credit support is provided by a parent of the Investor (as discussed more fully below), the Exclusion Events typically extend to the parent of the Investor as well. Also, if the Investor executes additional documentation supporting its obligations to fund Capital Commitments in the form of an Investor Letter (as discussed above) and the Investor violates the term of that Investor Letter, there may be an Exclusion Event relating to that breach. If there is an Exclusion Event and there are amounts outstanding under the Facility, then the Investor’s removal from the borrowing base is likely to result in a mandatory prepayment event under the Facility.

Another difference between a Facility to a commingled Fund and a Facility to a Fund of One involves Creditor consent for an Investor to transfer its interest in the commingled Fund or the Fund of One, as applicable. In a Facility to a commingled Fund, the Creditor may be more comfortable permitting an Investor to transfer its interest (subject to any necessary prepayment under the Facility) because the Creditor’s collateral includes the Capital Commitments of many other Investors. However, for a Fund of One, because the Creditor’s underwriting of the Facility is strongly tied to its underwriting of the single Investor, a transfer by that Investor may likely require additional credit approval. Therefore, it is typical that a Facility to a Fund of One prohibits the Investor from transferring its interest in the Fund of One without the prior consent of the Creditor. In addition, even if the Creditor ultimately permits the Investor to transfer its interest (for example, to an affiliate of the Investor), the Creditor may require the original Investor to provide credit support for the new Investor.

For a Facility to a Fund of One, the Creditor may also require some form of credit support or other credit enhancement from the Investor, a parent of the Investor and/or the sponsor of the Fund of One. When the credit support is from a parent of the Investor, it is typically in the form of a comfort letter, guaranty or keepwell agreement. Delivery of one of these documents will often enable a Creditor to include a less creditworthy Investor or special-purpose vehicle in the borrowing base. If the credit support is from the Manager or a sponsor of the Fund of One (or principals of the sponsor) or

from the Investor itself, such credit support will often be negotiated and a cap may be placed on the guarantor's obligations with respect to the Facility.

Conclusion

Given the utility of these Facilities for Funds in terms of providing liquidity and facilitating investments, the number of Funds seeking a Facility continues to rise as does the demand for Facilities for a Fund of One. With attention to the nuances in the Governing Agreement and related subscription documentation, loans to Funds of One can be made with closing documentation similar to what is required in a Facility to a commingled Fund together with an Investor Letter, Investor Opinion and perhaps a comfort letter or other form of credit support or credit enhancement. Please contact the authors with questions regarding these transactions and the various methods for establishing a Facility in connection with a Fund of One. ◆

Endnotes

1. For more background on these terms and related terms used in this article, see *"Beginner's Glossary to Fund Finance"* in the *Fund Finance Market Review*, Spring 2016, on page 178.
2. See *"Separate Accounts vs. Commingled Funds: Similarities and Differences in the Context of Credit Facilities"* in the *Fund Finance Market Review*, Summer 2013, on page 35.

SPRING 2017

In this Spring 2017 edition of our *Fund Finance Market Review,* we discuss some of the more noteworthy developments in the subscription credit facility and fund finance markets, including Basel III's impact on facility structures and the proliferation of partner loan programs.

We also analyze some of the trends in financing business development companies and certain tax efficient Irish vehicles. Additionally, updates on certain investor classes such as pension funds and endowments are provided herein.

Fundraising and Subscription Facility Growth

Fund financings experienced positive growth and strong credit performance as an asset class through the end of 2016. Capital call subscription credit facilities (each, a "Subscription Facility") sustained their steady growth as the product continues to diversify into various fund industries and follows the performance of capital raising in 2016. Investor capital call (each, a "Capital Call") funding performance continued its near-zero delinquency status, and we remain unaware of any Subscription Facility lender suffering any losses on any particular transaction. Below we set forth our views on the state of the Subscription Facility market and current trends likely to be relevant in 2017, as well as the market for secondary facilities and other fund financings ("Alternative Financings"). In addition to such trends, this Market Review touches on recent updates with respect to public pension funds as well as the latest legal issues affecting fund financings.

Fundraising and Subscription Facility Growth

Fundraising in 2016 and view to 2017

In our last Market Update, published in the Fall of 2016, we predicted a positive fundraising trend for private equity funds through 2016 (each, a "Fund"). Despite the volatility and uncertainty seen in each of the US and UK political spheres, our optimism proved to be correct for the balance of 2016. Globally, Funds raised over $347 billion in investor (each, an "Investor") capital commitments ("Capital Commitments"), which surpassed 2015 when $329 billion of commitments were raised.[1] Flight to quality (or at least familiarity) continued in that larger sponsors continued to attract a more-concentrated share of commitments. Notably, the 10 largest Funds accounted for 26% of all fundraising and 12% fewer Funds closed in 2016 than in 2015, resulting in an average fund size of $471mm—an all-time high.[2]

As the low interest rate environment persists, the interest in Funds appears to be high, and it seems that such activity will continue into 2017. Returns for Funds in 2016 continue to average in the mid-teen range[3] for all asset classes—which makes such investments popular for institutional investors. In particular, public pension funds generally experienced lackluster returns in 2016 (a gross 1.7% on assets)[4] as did endowments (as described below). With options for higher returns limited, we believe that Investors seeking higher yields will continue the trend of increasing their exposure and allocations to private equity asset class.

Secondary Funds

A significant area of growth in the Fund Finance area continues to be the financing of Secondary Funds (Funds that primarily purchase private equity LP interests on the secondary market). These Secondary Funds provide liquidity and other benefits for both Investors and sponsors, especially at the end of a Fund's life cycle. Sponsors find the use of Secondary Funds attractive as it can allow them to restructure or recapitalize their Funds. Secondary Funds can also be attractive to Investors looking to realize investments at a price

certain or rebalance or reallocate their asset class exposure and investment priorities.

In 2016, there was continued and significant demand for assets to be purchased by Secondary Funds, given large fundraises by such Funds closing last year.[5] The competition resulting from such demand has also resulted in higher than expected asset value.[6] One private equity secondary advisor, Greenhill, has estimated that pricing increased for such transactions as a result, with pricing at 89% of net asset value on average.[7] Notwithstanding the robust demand, secondary purchases were reportedly down in 2016 by about 10% (as measured by net asset value).[8]

The financing of Secondary Funds follows both fundraising in respect of traditional Facilities as well as Alternative Financings focused on both the acquisition of a portfolio of investments and potentially dividend recapitalizations for the end stage of fund life. Given the significant amount of dry powder that remains, we are optimistic with respect to additional volume and performance for both acquisition activity and Alternative Financings in 2017.

Subscription Facility Growth

Although the Fund Finance market lacks league tables or an overall data reporting and tracking service, our experience is that, in 2016 and so far in 2017, the Subscription Facility market is continuing its steady upward trajectory as Funds seek to take advantage of the numerous benefits Subscription Facilities provide.[9] Following this trend, Mayer Brown saw an increase in both the number of fund finance transactions and the aggregate new-money lender commitments in 2016, with new-money commitments across the Firm's Fund Finance platform exceeding $36 billion – a new record for the Firm. Moreover, diversification with respect to such financings continue, in both product offerings (such as hybrid, umbrella and unsecured or "second lien" facilities) as well as geographic scope. We have also seen that the Subscription Facility market is rapidly gaining traction outside of the US and the UK with Asian, Canadian and Latin American lenders heavily investing in strengthening their own Fund Finance platforms.

Additionally, Alternative Fund Financings, such as fund of hedge fund financings, management fee lines and facilities based on the net asset value of a Fund's underlying assets, have garnered more interest, with Mayer Brown representing Lenders and Funds in approximately $8 billion of such transactions that closed in 2016.

These Alternative Fund Financings have been a driver of growth in the Fund Finance market and are emerging as a permanent fixture of the market with such additional opportunities for leverage being increasingly appealing to general partners. One recent poll of general partners in Funds found that Alternative Financings of interest include general partner facilities, hybrid facilities and asset recourse facilities with 45%, 29% and 26% respectively, of general partners polled saying they would consider using them in the future.[10]

Trends and Developments

Monitoring and Technical Defaults

We are not aware of any technical defaults over the course of 2016, which seems to follow more rigorous monitoring of collateral by lending institutions (including prompt delivery of capital call notices, notices of transfers, Investor downgrades and similar requirements). As reported in our prior issue, a number of lenders have provided their customers with monitoring guidelines or templates to assist with their back-office processes, which have likely contributed to this result.

Complexity of Fund Structures

We have seen Funds be more willing to adjust their Fund structures to admit Investors with specific needs, including those related to tax, jurisdictional and similar concerns. This has resulted in a proliferation of parallel funds, funds-of-one, sidecar vehicles, and rather complex Fund structures over the last year.

For example, while so-called "cascading pledge" structures have been somewhat common for years in Subscription Financings, we are now seeing structures where capital contributions must "cascade" through five or six layers of fund entities before hitting the borrower's collateral account. Lenders have adjusted accordingly and are actively developing solutions to streamline documentation and overcome a multitude of new obstacles presented by these structures.

Pension Fund Update

Much has been made with respect to the funded status of public pensions, due to recent reports regarding investment losses and underfunding of various plans. In particular, recent reports relating to both the State of Connecticut and the Dallas Police and Fire Pension Fund have highlighted funding level declines. In the case of Dallas Police and Fire, this decline has occurred due to mounting real estate and other investment losses over the past few years, leaving the fund with only 45% of the assets necessary to meet future benefits, requiring substantial additional contributions to be requested from the city of Dallas[11] and additional withdrawals as retirees opted to accelerate retirement. With respect to the Connecticut State Employee Retirement System, recent valuations coupled with state budget proposals would provide that it has only enough assets to cover 35% of its long-term liabilities,[12] and new proposals for taxation have been raised to close state budget shortfalls associated with payment of pension costs.[13]

However, for the most part, good news prevailed in 2016, which marked the third year where the average funded status of public pensions made gains, with the average status of public pension funds being 76.2% at the end of 2016.[14] Additionally, such gains were made while 40% of the funds lowered their assumed rate of return and many reduced their investment return assumptions[15] to be more realistic in light of the overall investment environment. Regardless, in a typical Subscription Facility, public pensions are only included in the borrowing base to the extent that they have an investment grade rating and/or 90%+ funding status, so a significant drop in a pension's funding status versus its liabilities would likely cause a mandatory prepayment of a Subscription Facility (to the extent such an investor were to be necessary to support outstanding borrowings).

Additionally, continued lender attention has been seen with respect to the issues of pay-to-play and other common side letter provisions which often have withdrawal or other consequences for Investors in Funds, and ultimately with respect to Facilities as well. In particular, federal prosecutors have recently targeted a former pension executive of the New York Common Retirement Fund in a probe of possible misconduct.[16] The allegations stem from possible bribery including trips and other possible compensation by contacts at an outside brokerage providing services to the pension fund. While such allegations remain unproven, they continue to show the importance of obtaining assurances to the extent possible in side letters containing cease funding or other requirements, in order to require funding by a pension fund to a lender who has relied on commitments.

Endowment Updates

Another traditional investor in Funds, endowments, struggled in 2016. The largest US endowments, in particular, have seen below-average and in some cases negative investment results in 2016, with the worst average annual return (-2.6%) since the financial crisis.[17] Most of these returns have followed the capital markets and, therefore, reflect asset allocations for such endowments that were more heavily weighted on exposure to such markets rather than private equity.[18]

In fact, disappointing overall returns have caused many endowments to shift strategy. In a public move, the largest US endowment,

Harvard University, with $34.5 billion of assets under management, has recently announced that it is revisiting its traditional approach of relying on a large internal team.[19] Instead, it seeks to eliminate a large number of its in-house investment staff, and the remaining investment staff would become more "generalist" covering multiple aspects of the portfolio rather than specialists on a particular asset class or strategy. [20]

We think that such shifts in strategy may also lead to growth of endowment interest in Funds managed by outside managers and perhaps increase allocations by endowments in private equity in 2017.

Hague Convention and Impact on Alternative Financings

One development of particular note for Alternative Financings is the upcoming effectiveness of the *Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary*, commonly known as the "HSC," which was promulgated by the Hague Convention on International Private Law. This conflicts of laws regime is important in respect of multi-jurisdictional transactions and applies to securities held through an "intermediary" and generally relates to perfection and priority of a security interest in a security entitlement of securities accounts.

Given securities accounts can often serve as the primary collateral account for Financings, and in respect of Alternative Financings such as hedge fund of fund financings, the primary collateral is a securities entitlement with respect to a hedge fund of fund's accounts; the HCS and its applicability to indirect holdings systems can cause issues of concern for Lenders relating to perfection of security interests.[21] Such issues should be carefully navigated by Lenders using experienced counsel with respect to both the intersection of the HSC, the Uniform Commercial Code and Alternative Financings.

2017 Outlook

As noted above, 2017 continues the generally steady growth in the Subscription Facility market. We, like Investors that are currently in the market, remain optimistic that such trends will continue through the remainder of 2017 and that the recent market changes in the United States, United Kingdom and Europe will continue to provide opportunities for Investors as well as Funds seeking financing and institutions providing such financing. ◆

Endnotes

1. *Preqin Private Equity & Venture Capital Spotlight*, January 2017, p.11.
2. *Id.*
3. *Preqin* at p.10.
4. *Public Pension Funds Lower Fees, Improve Funding Ratios in 2016*, Meghan Kilroy, Pensions and Investments Online, January 17, 2017.
5. *Greenhill Secondary Market Trends & Outlook*, January 2017.
6. *Id.*
7. *Id.*
8. *Id.*
9. For more information on the benefits of Subscription Facilities, please see our article *The Advantages of Subscription Credit Facilities*, page 240.
10. *Investec Fund Finance GP Trends 2016*.
11. *Dallas Mayor Sues to Stop Police, Fire Pension Exits*, Heather Gillers, November 21, 2016, Wall Street Journal.
12. *Future Payment Scheme Takes a Heavy Present Toll on State Pension Fund*, Keith M. Phaneuf, January 5, 2017, Connecticut Mirror.
13. *Connecticut Governor Seeks to Shift Teacher Pension Costs to Towns, Cities,* Joseph De Avila, February 3, 2017, Wall Street Journal.
14. *Kilroy* at p.1.
15. *Kilroy* at p.1.
16. *New York Pension Scandal Prompts Firing of Second Employee*, Justin Baer, February 1, 2017, Wall Street Journal.
17. *Large Endowments Struggled with Returns in Fiscal 2016*, Christine Williamson, February 6, 2017, Pension and Investments Online.
18. *Id.*

[19] *Harvard Decides to go Different Way on Investing,* James Comtois, February 6, 2017, Pension and Investments Online.

[20] *Id.*

[21] For more information on this topic and assistance navigating these changes, please see the recent article by Mayer Brown partner Barbara M. Goodstein, *Hague Securities Convention Comes Into Effect*, New York Law Journal, February 1, 2017. http://www.newyorklawjournal.com/id=1202778150394/Hague-Securities-Convention-Comes-Into-Effect?mcode=1202614952687&curindex=0&curpage=1

Basel III Regulations and the Move Toward Uncommitted Lines of Credit

Background/Key Issues

Basel III, a regulatory capital framework for financial institutions, was developed by the Basel Committee on Banking Supervision (the "Basel Committee") in response to the financial crisis that began in 2008. During the crisis, banks were unable to dig themselves out of financial trouble due to their relative inability to convert assets into cash. In hopes of preventing a reoccurrence of this problem, the Basel Committee created Basel III to better regulate and supervise the financial sector and manage its risk. In so doing, Basel III's reforms target the financial sector on both micro and macro levels.

The Basel III regulations have been gradually phased in by participating jurisdictions[1] and, among myriad effects on the capital markets, have impacted the types of subscription credit facilities lenders are putting in place. A subscription credit facility is an extension of credit by a lender to a private equity fund (the "Fund") wherein the lender is granted a security interest in the uncalled commitments of the Fund's limited partners to make capital contributions when called from time to time by the Fund's general partner (a "Subscription Facility"). This article will briefly summarize the Basel III regulations as they have been implemented in the United States, examine a resulting increase in the use of uncommitted lines of credit, and consider certain issues in the context of uncommitted lines of credit.

Basel III Regulations

While a full analysis and description of the U.S. implementation of Basel III (as thereby implemented, "U.S. Basel III") is beyond the scope of this article, it is worth understanding the general structure of this regulatory framework, which in the United States applies to banks, bank holding companies (except small bank holding companies with less than $500 million in assets), certain savings associations and savings and loan holding companies (each, a "Bank"). The overall purposes of the U.S. Basel III regulations are to: (i) improve the financial sector's ability to absorb losses during periods of financial and economic stress; (ii) strengthen risk management and governance; and (iii) build greater transparency and disclosures in the financial sector.[2] There are a few key components of the U.S. Basel III

framework that can be linked to the recent increase in the use of uncommitted lines of credit: a liquidity coverage ratio, a capital conservation buffer, and a leverage ratio.

LIQUIDITY COVERAGE RATIO

The first key feature is the liquidity coverage ratio (the "LCR"):[3] to ensure that Banks have sufficient capital reserves to withstand any severe short-term disruption to liquidity, U.S. Basel III requires Banks to maintain "an adequate stock of unencumbered high-quality liquid assets ("HQLA")" that can be easily converted to cash to meet liquidity needs for a 30-day stress scenario. The goal is for a Bank to be able to meet 100% of its total net cash outflows during the 30-day stress period. Implementing a global minimum standard for bank liquidity and "reaffirming that a bank's stock of liquid assets are usable in times of stress" should strengthen the financial sector's ability to finance a recovery in the event of another financial and economic crisis.[4]

U.S. agencies jointly issued a final rule in September 2014 that mandates 100% compliance with the minimum LCR standards set out by the final rule, which are more stringent than those under the international Basel III framework, by January 2017.[5] The final rule applies to large internationally active U.S. banking organizations and any consolidated bank or saving association subsidiary of one of those companies that, at the bank level, has total consolidated assets of $10 billion or more.[6]

CAPITAL CONSERVATION BUFFER

Another key component of the U.S. Basel III framework is the requirement of a capital conservation buffer: in addition to the requirement that Banks maintain a minimum of 4.5% of common equity tier 1 capital, Banks must retain an additional buffer of 2.5% of common equity.[7] Together, the two requirements entail that Banks retain a total of 7% of common equity tier 1 capital. Should a Bank fall below the 7% level, additional constraints will be imposed on the Bank's discretionary distributions. Banks therefore have an incentive to keep more capital on hand, rather than lend it out, to ensure they meet this requirement.

If supervising authorities determine that the credit risk exposure of a Bank is approaching a level of systematic risk (i.e., when judging whether credit growth in relation to measures such as GDP is excessive and could lead to increased system-wide risk), then in order to combat any risk of failure of such credit exposure, a countercyclical buffer requirement ranging in size from 0% to 2.5% of risk-weighted assets may also be imposed. This is treated as an extension of the capital conservation buffer and would remain in effect until the system-wide risk lessens.[8]

LEVERAGE RATIO

U.S. Basel III also implements a "non-risk-based" leverage ratio (which includes off-balance sheet exposure) for large internationally active U.S. banking organizations that serves as a backstop to the risk-based capital requirements mentioned above.[9] This capital reserve is extra insurance in the event that, despite the new risk-based capital adequacy requirements, the Bank's exposures turn south and the Bank must rely on its own reserves to avoid systemic collapse. A leverage ratio requirement will prevent the financial sector from building up too much leverage; the leverage ratio is meant to prevent excessive leverage and therefore avoid deleveraging processes that can weaken the financial sector.[10]

Impact on Credit Facility Markets

The key features of the U.S. Basel III regulations discussed above serve to require Banks to keep more cash on hand in the aggregate. Accordingly, it is expected to be more expensive and/or less profitable for Banks to lend money under the U.S. Basel III regulatory regime. In the context of Subscription Facilities, this expense or loss of profit may be (i) retained by the Bank as a loss of profit, (ii)

passed along to the Fund in the form of a higher interest rate margin/spread or, in connection with any existing Subscription Facility, increased costs, or (iii) as discussed further below, mitigated through the use of uncommitted credit facilities.

Subscription Facilities have traditionally been structured as committed lines of credit, in which a Bank commits (subject to satisfaction of certain defined conditions precedent) to lend up to a certain amount to a Fund over the life of the facility. For balance-sheet purposes, this effectively involves setting aside capital reserves for the benefit of the Fund; such capital reserves cannot be used for any other purpose before repayment in full of all principal and interest thereon by the Fund or termination of the Bank's commitment per the terms of the credit agreement. Committed facilities thereby limit the amount of capital available to a Bank to satisfy the U.S. Basel III liquidity and capital adequacy requirements.[11]

Due to this increased cost, Banks have increasingly considered offering uncommitted lines of credit in an effort to satisfy borrower credit demand, including reducing the passed-along costs associated with committed facilities, while mitigating the impact of these facilities under the liquidity and capital adequacy requirements of U.S. Basel III.

In general, an "Uncommitted Line" is a line of credit offered by a Bank to a Fund that does not obligate a Bank to advance loans. Rather, the Bank agrees to make loans available to the Fund in the Bank's sole discretion. Accordingly, under an Uncommitted Line, a Bank may always refuse to advance a loan, notwithstanding the timely submittal by the Fund of a notice of borrowing, the satisfaction of any conditions precedent or the Fund's continued compliance with all obligations under the credit documentation. While all Uncommitted Lines maintain the ability of the Bank to make or withhold loans in its sole discretion, Uncommitted Lines can vary in how they address certain issues, including maturity or termination dates and events of default.

Differences between Committed Facilities and Uncommitted Lines

Since a Bank under an Uncommitted Line does not have an ongoing obligation to lend, such a facility may not have a fixed date and may instead be open-ended. Given the Bank's discretion to refuse a request for a loan under an Uncommitted Line, the Bank has sole control over the tenor of new loans under such a facility. With respect to repayment tenor, some Uncommitted Lines are demandable, allowing a Bank to require repayment at any time upon demand of the Fund (a "Fully Demandable Uncommitted Line"). We have also seen Uncommitted Lines contain maturity dates or termination dates that function to end a Fund's ability to request additional loans and to fix a date for repayment. Similar to committed facilities, the termination of Uncommitted Lines may be linked not just to a specific date, but also to the occurrence of certain events (e.g., the termination of the Fund's commitment period). Some Uncommitted Lines are both fully demandable and also have a fixed maturity or termination date.

While the representations, warranties, covenants and obligations of a Fund are generally similar between a committed facility and an Uncommitted Line, there is often divergence with respect to how each handles defaults and other termination events. For instance, in Fully Demandable Uncommitted Lines, Banks may be willing to do away with fixed events of default such as those typically found in a committed facility, instead relying on reporting requirements to learn of any non-compliance and making a real-time decision on when to demand repayment of the Uncommitted Line at such time. Other Uncommitted Lines take an alternative approach and retain events of default typical in a committed facility. Such Uncommitted Lines may tie termination and repayment to both such events of default and demand. Of course, some Uncommitted Lines are

structured similarly to committed facilities, and once loans are made thereunder, they are subject to a maturity date or acceleration only upon the occurrence of an event of default.

Other Considerations of an Uncommitted Line

There are a number of other potential considerations that Funds and Banks may weigh when deciding whether to implement an Uncommitted Line.

First, Uncommitted Lines may not offer the same assurances to capital that committed facilities offer. A Fund that has a binding commitment to make an investment may suffer negative economic consequences if it does not have capital available when required for purposes of such investment. Banks offering Uncommitted Lines may therefore have to reassure Funds that, despite the uncommitted nature of an Uncommitted Line, they nonetheless will provide capital as and when the Fund needs it. As Uncommitted Lines have become more prevalent, more and more Funds have grown comfortable that such Uncommitted Lines can provide reliable access to capital.

A second consideration relates to fees a Fund may have to pay a Bank in connection with a facility. Funds understandably may have concerns about paying a large upfront fee. Unlike in a committed facility, where a Fund may pay an upfront fee to secure a Bank's commitment to fund, a Bank under an Uncommitted Line could refuse to make loans, even after receiving an upfront fee. Banks and Funds have found a number of fee structures under Uncommitted Lines to mitigate this risk, including spreading such fees across the term of the facility or providing for funding fees, payable in connection with each funded loan, rather than upfront or facility fees.

Third, an Uncommitted Line can be difficult for a Bank to syndicate. Having multiple Banks, each with sole discretion as to funding its share of any requested loan, provides another potential source of uncertainty for Funds. Additionally, in connection with Fully Demandable Uncommitted Lines predicated on the Bank having sole discretion over whether to demand repayment of the line, the presence of two or more Banks, even when acting through an agent, could result in inter-lender issues where one Bank demands repayment and the other Bank chooses not to. There are also concerns if each Bank has discretion with respect to which limited partners to include in the borrowing base.

Conclusion

Based on our experience in documenting Uncommitted Lines and our view of the market, we expect there to be continued appetite in the market for Uncommitted Lines. While we expect that there will always be demand for committed facilities, particularly for larger Funds seeking larger multi-lender facilities, U.S. Basel III's requirements may encourage Banks, especially banks with less access to liquid capital, to offer additional Uncommitted Lines. Given that an Uncommitted Line, in practice, will provide reliable access to capital, and that the pricing may be favorable to Funds, Fund appetite, particularly for those Funds that share a strong relationship with the Bank, should remain consistent for Uncommitted Lines. ◆

Endnotes

[1] For an overview of the phase-in timelines for the various Basel III requirements, *see* Bank for International Settlements, "Basel III Phase-In Arrangements," available at http://www.bis.org/bcbs/basel3/basel3_phase_in_arrangements.pdf. As discussed further in this article, the United States has set its own timetable for the implementation of these requirements.

[2] *See* Bank for International Settlements, "Basel III: International Regulatory Framework for Banks," available at http://www.bis.org/bcbs/basel3.htm.

[3] For more detail on the Basel III framework, *see "Leverage and Liquidity Requirements under Basel III,"* the *Mayer Brown Fund Finance Market Review* Summer 2014, on page 111.

[4] Mervyn King, Chairman of the Group of Central Bank Governors and Heads of Supervision, quoted at http://www.bis.org/publ/bcbs238.htm.

[5] *See* OCC, "Description: Final Rule," available at https://www.occ.gov/news-issuances/bulletins/2014/bulletin-2014-51.html.

[6] *See* U.S. Department of the Treasury, "Description: Final Rule" (October 2014), available at https://www.occ.gov/news-issuances/bulletins/2014/bulletin-2014-51.html; Law360, "Basel III Is Not the End of Regulatory Overhaul", available at https://www.law360.com/articles/460903/basel-iii-is-not-the-end-of-regulatory-overhaul.

[7] The capital conservation buffer was first put into place at 0.625% in January 2016 and will reach 2.5% effective as of January 2019.

[8] *See* Federal Reserve System, "Regulatory Capital Rules: The Federal Reserve Board's Framework for Implementing the U.S. Basel III Countercyclical Capital Buffer," available at https://www.federalreserve.gov/newsevents/press/bcreg/bcreg20160908b1.pdf.

[9] The U.S. agencies' final rule required certain public disclosures by banks to regulators connected to the leverage ratio to be made beginning in the first fiscal quarter of 2015. Full implementation of the minimum leverage ratio requirement is not due until January 1, 2018. *See* Federal Reserve System, FDIC, OCC, "Joint Press Release: Agencies Adopt Supplementary Leverage Ratio Final Rule," available at https://www.federalreserve.gov/newsevents/press/bcreg/20140903b.htm.

[10] *See* Department of the Treasury, Federal Reserve System, FDIC, "Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action," available at https://www.occ.gov/news-issuances/news-releases/2012/nr-ia-2012-88a.pdf.

[11] *See "Capital Commitment Subscription Facilities and the Proposed Liquidity Coverage Ratio,"* the *Mayer Brown Fund Finance Market Review Winter 2013*, on page 75.

Partner and Employee Co-Investment Loan Programs for Private Investment Funds

I. Introduction

As the fund finance market continues to mature, fund-related product offerings are expanding both in number and in customization, attracting a broader array of private equity and real estate funds ("Funds") and credit providers, and increasing the range of the financing products available to Funds and their Sponsors ("Sponsors") beyond the traditional subscription credit facility product.[1] We have seen growing interest among participants in the Fund finance market in partner or employee loan programs, often also commonly referred to as a shareholder or Sponsor loan program or a co-investment line of credit, depending on the nature and structure of the facility (a "Co-Investment Facility"). At the most fundamental level, a Co-Investment Facility is a line of credit extended by a bank or other financial institution (a "Lender") to an individual member, principal or key employee of a Fund's General Partner ("General Partner"), affiliated Management Company ("Management Company") or Sponsor (collectively, a "Participant"), the proceeds of which are used by the borrower to make direct or indirect investments in Funds managed by their firms or the General Partner or Management Company affiliated with such Funds. Co-Investment Facilities are frequently established on a platform basis, permitting multiple Participants to partake in the benefits of a credit line while streamlining the documentation process. In some cases, a Co-Investment Facility is structured with the Fund's General Partner, Sponsor-affiliated "special limited partner" or Management Company (collectively, a "Sponsor Vehicle") as the borrower, with individual employees and principals acting as guarantors of the facility based upon a pre-determined maximum allocation of the overall facility amount. While there are a number of similarities between a Co-Investment Facility extended to a General Partner or Management Company and what is commonly known as a management fee credit facility[2], this article will focus primarily on facilities extended to or for the benefit of individuals affiliated with a Fund as part of a broader loan program.

When security is taken, the basic collateral package for a Co-Investment Facility typically consists of a pledge by the Participant of its limited partnership

interest in the Fund or the relevant Sponsor Vehicle, including the right to receive distributions from the underlying Fund or Sponsor Vehicle, as applicable. In the case of a Sponsor Vehicle borrower, the collateral, when required, is often comprised of a pledge of any limited partnership interest the Sponsor Vehicle holds in the Fund, the Sponsor Vehicle's right to receive distributions from the Fund, any management or other fees payable to such Sponsor Vehicle under the Fund's limited partnership agreement (the "Partnership Agreement"), and potentially any right to receive carried interest payments, as applicable. In either structure, the security package usually also includes a pledge over the deposit account into which Fund distributions and other relevant payments are made (a "Collateral Account"). A control agreement among the borrower, the Lender and the depository bank would be needed to perfect the Lender's security over the Collateral Account. In some cases, a Co-Investment Facility is secured only by the Collateral Account into which Fund partnership interest distributions or other payments are required to be made, without a security interest being granted in any partnership interest or other contractual rights held by the borrower. We have also seen Co-Investment Facilities completed on an unsecured basis. In such a situation, additional credit support in the form of guarantees from the Sponsor Vehicle or individual principal or employee Participants, as applicable, may be delivered. A negative pledge over each Participant's or Sponsor Vehicle's partnership interest in the Fund or other relevant assets is frequently required in unsecured facilities to give the Lender comfort that other creditors will not have a competing secured priority interest over such assets.

In addition, the Lender may also require a pledge of a common restricted cash account into which Co-Investment Facility loan proceeds are funded with respect to all individual Participant borrowers participating in a loan program (a "Common Restricted Account"). It is customary for such a restricted account to be established nominally in the name of the Fund or relevant Sponsor Vehicle, and gives the Lender additional comfort that loan proceeds will be deployed directly by the Participant or Fund to make investments. Use of a Common Restricted Account also may aid in the administration of a loan program by the Sponsor and Fund; the Fund may withdraw loan proceeds from a single account instead of having to aggregate individual wires from the borrowers to make an investment (similarly, this minimizes the number of wires and advances the Lender must send out for a borrowing, which are usually coordinated across Participants in the program).

II. Background and Context

The utility of Co-Investment Facilities in a number of areas makes them increasingly popular. First, a Co-Investment Facility may enhance the ability of Participants to invest alongside other Investors in a Fund, either directly or through a Sponsor Vehicle, by potentially increasing the amount of capital a Participant may commit to a Fund (or Sponsor Vehicle). While for any given employee of a Fund or affiliated vehicle the decision to invest in an employer's Fund may be discretionary and viewed as an employment benefit, after the economic downturn, Sponsors have faced growing pressure by their outside Investors to make larger investments in the Funds they manage. By leveraging the expected distributions from equity interests held in a Fund or other Sponsor Vehicle, a Co-Investment Facility may permit a Sponsor and its affiliated professionals to increase the total amount of capital committed to the Fund, thereby helping to satisfy calls from Investors that a Sponsor have more "skin in the game." This in turn further strengthens the alignment of the interests between the third-party Investors and the Fund's principals. Given the positive effect a Co-Investment Facility can have on aligning the interests of the Investors and Fund management and the recent traction this product has gained in the

Fund finance market, we suspect that most Fund managers would find a Co-Investment Facility beneficial on one or more levels.

Second, a Co-Investment Facility may facilitate the funding by Participants of their capital contributions upon a capital demand notice by the General Partner of the Fund (or the relevant Sponsor Vehicle) by minimizing or eliminating the need and time for such Investors to gather personal funds to honor such a capital call. As mentioned above, the cash proceeds of the loan(s) under a Co-Investment Facility are typically deposited into a segregated Common Restricted Account held by the relevant Sponsor Vehicle or Fund, thus avoiding the need for individual Participant borrowers to transfer loan proceeds from their own account to the Fund or Sponsor Vehicle. This permits the Fund or applicable Sponsor Vehicle to more expeditiously deploy capital and avoid having to monitor separate wires from individual affiliated Investors, while also providing additional certainty that a capital call will be satisfied.

Finally, from the perspective of a Lender, advancing an Co-Investment Facility may allow a Lender to deepen its relationship with a Sponsor and better position itself to meet other financing needs of the Fund and its affiliated entities. A better understanding of the Sponsor's structure and business may in turn lead to opportunities for a Co-Investment Facility Lender to provide other financing services, such as portfolio-company level financings, after-care facilities as the Fund approaches and surpasses its investment period, and potentially private wealth management services for the Sponsor's principals and employees. A Lender willing to provide a Co-Investment Facility to a Sponsor may have a competitive advantage in winning subscription facility business over other Lenders that are not able to provide liquidity at the top of the Fund's capital structure. These ancillary benefits are, of course, in addition to the fees and interest income a Lender would earn in providing a Co-Investment Facility.

III. Structure and Loan Documentation

Co-Investment Facilities can be structured as term loans or revolving lines of credit and, consistently in our experience, carry an interest rate higher than prevailing rates for a traditional subscription facility. Such facilities may be extended to the Participants themselves or to a Management Company or other Sponsor-affiliated vehicle through which the Participants will invest. The maximum available amount of a Co-Investment Facility is principally based on a credit assessment of each Participant and the quality of the collateral, if required.

The basic loan documentation for a secured Co-Investment Facility will often include the following: (a) a loan agreement that contains all of the terms of the loan, borrowing mechanics, conditions precedent, representations, warranties and covenants, events of default and miscellaneous provisions typically found in a commercial loan agreement; (b) a promissory note; (c) a pledge or security agreement pursuant to which an individual Participant borrower assigns its rights with respect to its limited partnership interest in the Fund or relevant Sponsor Vehicle (or in the case of a Sponsor Vehicle borrower, any limited partnership interest the Sponsor Vehicle holds in the Fund and potential rights to receive management fees and carried interest payments); (d) a pledge over the Collateral Account into which distributions and other payments on account of the assets described in clause (c) are to be paid; (e) a pledge over the Common Restricted Account, if relevant to the particular borrowing structure being employed; (f) guarantees from individual employees or principals if the borrower is a Sponsor Vehicle (or in the case of Participant borrower(s), a guarantee from the relevant Sponsor Vehicle); (g) account control agreement(s) over the Collateral Account and any Common Restricted Account to perfect the Lender's security interest therein and permit the Lender to block withdrawals from such

account(s); (h) Uniform Commercial Code financing statements filed in respect of Article 9 collateral against the applicable debtors; and (i) other customary deliverables such as an officer's certificate certifying as to the relevant organizational documents, resolutions and incumbency signatures, opinion letters and other diligence deliverables, as appropriate.

In underwriting and advancing a Co-Investment Facility, a Lender may also require a more robust document package including one or more of the following: (i) personal financial statements from the Participants detailing such individual's financial condition, copies of bank and brokerage statements and tax returns (which materials may be required to be delivered on an ongoing periodic basis); (ii) a letter agreement executed by the Participant and the Fund or Management Company certifying as to the individual borrower's employment data; and (iii) if required under the Partnership Agreement of the Fund or other relevant formation documentation of the Sponsor Vehicle, a consent to the pledge by the Participant (or Sponsor Vehicle) of its rights with respect to its partnership interest in the Fund or other Sponsor Vehicle from the General Partner or other relevant entity, and potentially a consent from other Investors in the Fund if required by the Partnership Agreement.

In addition to the loan and other documentation described above, as additional credit support, Lenders may require one or more guarantees in connection with a Co-Investment Facility. Where individual Participants are the borrowers, the Lender may require a guarantee by the Management Company or other Sponsor-affiliated entity of all outstanding amounts under the Co-Investment Facility. Where a Sponsor Vehicle is the borrower, the Lender will often require the individual principals to guarantee up to a pre-determined specified percentage of the obligations of the Sponsor Vehicle under the Co-Investment Facility. In addition, a Co-Investment Facility Lender may require that a minimum balance (typically determined as a percentage of the outstanding loans) be maintained in the Collateral Account or Common Restricted Account to cover a portion of the outstanding loan balance. Some Lenders require that draws on the Co-Investment Facility be used to fund only a specified percentage of the Participant's or Sponsor Vehicle's capital contributions as a way of promoting the borrower's "skin in the game" and ensuring that the borrower's investment is not fully leveraged.

Other key terms that may be included in Co-Investment Facilities are minimum net asset value tests with respect to the relevant Fund or Sponsor Vehicle or financial covenants specifying that the net asset value not decrease by a specified percentage year-over-year. In situations where the Lender is primarily looking to distributions from the Fund or Sponsor Vehicle as a source of repayment, the Co-Investment Facility may include a mandatory prepayment provision, whereby a specified percentage (often between 50% and 100%) of the proceeds of all distributions, payments and fees paid to the borrower (net of any applicable taxes) must be applied to repay the loan. Co-Investment Facilities usually include cross-defaults to other material debt of the individual borrowers and often to any subscription credit facility to which any related Fund may be a party. Ultimately, the structure and terms of a Co-Investment Facility will be bespoke, and contingent upon the Fund's structure, underlying formation documentation, financing needs and the credit quality of the relevant debtors.

IV. Diligence Matters

As with most Fund finance products, a Lender must carefully review the Partnership Agreement and other constituent documents to understand how and when payments or distributions with respect to any proposed collateral or loan repayment sources are made, and to assess any attendant risks related to such collateral or sources of payment. The Fund's constituent documents should also be reviewed for any limitations on the right of the Participant or

Sponsor Vehicle, as applicable, to pledge its limited partnership interest in a Fund or right to receive management fees or other payments if such assets are intended collateral. For example, it is not unusual for a Partnership Agreement to prohibit a limited partner from pledging its interest in the Fund to a Lender without first obtaining consent from a specified percentage of Investors and/or the General Partner. Such a restriction would be relevant if the Lender expects to take a security interest in such assets. As noted above, however, we have seen Co-Investment Facilities completed without limited partnership interests as collateral, with credit support instead being provided in the form of any of a guarantee, pledge of Collateral Account and/or Common Restricted Account, negative pledge over partnership interest rights or minimum balance requirements, for example. In addition, to the extent the Fund has entered into a subscription credit facility or other debt obligations, consideration should be given to whether any pledge or other restriction contemplated by the Co-Investment Facility could run afoul of covenants in such other debt instruments. Finally, as with most credit products, a Lender will want to assess the general economic and investment environment relevant to the Fund's business to stress-test the basic underwriting assumptions used in structuring and pricing a Co-Investment Facility.

V. Conclusion

As the traditional subscription facility market becomes ever more competitive, Lenders that can offer a Sponsor additional value-add financing products at different levels of the capital structure may be better able to differentiate themselves in an increasingly crowded market. Co-Investment Facilities may provide an opportunity for a Lender to expand its lending relationship with a Sponsor while enabling a Sponsor and its principals to have more "skin in the game." With ample legal and credit due diligence and careful structuring, Lenders may be able to arrange a Co-Investment Facility to provide additional liquidity at the top of the Fund's capital structure in a way benefiting both the Lender and the Fund.

Please feel free to contact the authors with questions regarding Co-Investment Facilities or the various structuring alternatives and considerations attendant to such facilities. ◆

Endnotes

1 A subscription credit facility, also known as a capital call facility, is a loan made by a bank or other credit institution to a private equity fund, for which the collateral package is the unfunded commitments of the limited partners in the fund (the "*Investors*") to make capital contributions when called by the fund's general partner (as opposed to the underlying investment assets of the fund). For an in-depth analysis of certain alternative Fund financing products, please see Mayer Brown's *Fund Finance Market Legal Updates "Structuring a Subscription Credit Facility for Open-Ended Funds,"* on page 31, *"Separate Accounts vs. Commingled Funds: Similarities and Differences in the Context of Credit Facilities"* on page 35, and *"Net Asset Value Credit Facilities"* on page 44.

2 Please see Mayer Brown LLP's article *Management Fee Credit Facilities* on page 64, for further discussion and analysis of the management fee facility product and key issues when lending against management fee payment streams.

The Advantages of Subscription Credit Facilities

The market for subscription-backed credit facilities, also known as "capital call" or "capital commitment" facilities ("Subscription Facilities"), continues to grow rapidly, expanding into a broader range of Funds,[1] with constantly evolving features and mechanics. As the Subscription Facility market continues to grow, the functionality of Subscription Facilities has also grown beyond its roots of bridging capital calls. Funds are now realizing a variety of benefits beyond bridging capital calls, several of which are briefly discussed below.

Bridging Capital Calls and Other Financings

Traditionally, the primary function of Subscription Facilities has been to bridge capital calls and other types of permanent financing, creating a number of benefits including the following.

First, Subscription Facilities offer Funds fast access to capital, allowing Funds to move quickly with respect to time-sensitive investments. In the governing documentation of typical Funds, investors must be given at least 10-15 business days notice prior to funding a capital call. In contrast, the terms of most Subscription Facilities permit Funds to receive borrowings with as little as one business day notice, avoiding the long lead time required in calling capital from investors. The faster access to capital afforded by a Subscription Facility may give Funds a competitive advantage over rivals, especially with respect to quickly developing opportunities. Additionally, by having a Subscription Facility available, Funds may be able to avoid making anticipatory capital calls for investments that are ultimately not consummated resulting in an administrative burden of returning the capital to the investors.

Second, Subscription Facilities provide a means for Funds to "smooth" capital calls made to investors in terms of size and frequency. Without a Subscription Facility in place, Funds may need to make frequent capital calls in small amounts in order to provide for working capital and similar expenses, including payment of management fees. With a Subscription Facility in place, Funds are able to borrow for these smaller capital needs and subsequently call larger amounts of capital at more regular intervals to repay such borrowed amounts. By utilizing the

Subscription Facility to "smooth out" capital calls, Funds and investors are relieved of the administrative burden caused by small and frequent capital calls, meaning cost savings for both Funds and investors.

Finally, Subscription Facilities offer a means for Funds to bridge permanent asset-level financing. In a scenario where a Fund is unable to secure asset-level financing prior to the consummation of an investment, the Fund may be able to rely on the Subscription Facility to bridge the gap. Proof of access to capital via the Subscription Facility may be a means for the Fund (as a bidder) to show the seller of an asset that it has access to funds for purposes of finalizing the transaction prior to the Fund being able to secure commitments from asset-level lenders. This bridging function gives Funds a stronger bargaining position when negotiating asset-level financing with lenders, since the Fund's hand is not forced by the ticking clock of the impending investment closing. Additionally, incurring debt under the Subscription Facility may be a cheaper alternative to the asset-level financing available, with less burdensome reporting requirements, in which case the Fund may be incentivized to leave Subscription Facility debt outstanding for a longer period of time.

Access to Letters of Credit and Alternative Currencies

Another benefit of Subscription Facilities is providing Funds access to letters of credit and alternative currencies. Access to letters of credit can provide a valuable financial instrument to Funds, particularly in the development phase of projects. Additionally, as Funds expand globally, the ready access to alternative currencies often provided in Subscription Facilities can be an advantage for Funds. Such ready access to alternative currencies eliminates the need for Funds to call capital in one currency and convert it to another, improving the speed of capital access, lessening the impact of exchange rate exposure and reducing administrative burden. In the event a Fund needs access to new alternative currencies, typical Subscription Facility mechanics generally permit Funds and lenders to readily add new alternative currencies to the Subscription Facility.

Facilitates "True Up" of Capital

Typical governing documents of Funds require investors "true-up" capital contributions when new investors are admitted to the Fund. These true-up mechanics ensure that capital contributions made by prior investors are rebalanced so that new investors have their pro rata interest in the Fund. Such mechanics typically require contributions from new investors and return of contributions to prior investors, which is burdensome and adds back-office costs for both the Fund and the investors. By utilizing a Subscription Facility for the Fund's capital needs prior to the Fund's final investor closing, the Fund may be able to eliminate or lessen the need for this true-up requirement. Rather than calling for additional contributions or returning prior contributions each time new investors enter the Fund, the Fund may be able to front the purchase of investments with proceeds of the Subscription Facility until the final investor closing.

Hedging and Swaps

The inclusion of hedging and swap collateralization mechanics into Subscription Facilities offers a means for Funds to secure "foreign exchange forwards" and "foreign exchange swaps" (collectively, "Eligible Swaps") [2] under the Subscription Facility, rather than posting cash or other collateral with hedge and swap counterparties. These mechanics, in short, permit the Fund to request that Eligible Swaps be allocated a portion of the borrowing base on a pari passu basis for purposes of collateralizing such agreements. In the event the applicable Eligible Swap moves against the Fund, the Fund can typically request that additional collateral be allocated to the

borrowing base. These mechanics are extremely valuable to Funds as they avoid either the borrowing expense of posting cash or the drag on return caused by the Fund keeping cash or other liquid collateral on hand.

So too, in light of certain margin regulations scheduled to take effect in many jurisdictions around the globe, most other types of swaps and hedges (hereinafter, "Ineligible Swaps") will now be required to be collateralized by cash or highly rated securities. For these Ineligible Swaps, Subscription Facilities offer crucial and quick liquidity for Funds needing to post cash to secure such swaps at relatively inexpensive borrowing and carrying costs.

Qualified Borrowers

Subscription Facilities often include an option for Funds to add Qualified Borrowers to the Subscription Facility. Typically, "Qualified Borrowers" are portfolio companies or their holding companies that are controlled by the Fund, do not provide any security or credit support with respect to the Subscription Facility, are only liable for their own borrowings (and not the borrowings of the Fund or any other Qualified Borrower), and are included in the Subscription Facility without the lenders conducting an in-depth review of their financial health. Qualified Borrowers provide Funds the flexibility to incur indebtedness at different levels of their organizational structure, primarily for tax and accounting purposes. This function may be particularly valuable when a Fund wishes to incur debt at the holding company level but is unable or delayed in obtaining its own financing or the Subscription Facility provides a cheaper alternative.

Distributions and Redemptions

Subscription Facilities may enhance the ability of Funds to pay distributions to investors and honor redemptions on behalf of Investors. The liquidity provided by Subscription Facilities allows Funds to make distribution payments to investors prior to the liquidation of such Funds' investments. This function can smooth distributions for investors and prove particularly valuable in a scenario where a Fund owns appreciating assets that do not generate large cash flows. With respect to open-end Funds, Subscription Facilities can likewise provide liquidity to Funds in honoring redemptions by investors, allowing Funds to avoid liquidation of investments at inopportune times. Effective use of a Subscription Facility for the foregoing distribution and redemption functions may make Subscription Facilities more attractive to investors.

The foregoing provides only a brief overview of some of the advantages of Subscription Facilities. As the features and mechanics of Subscription Facilities continue to grow, the utility of Subscription Facilities to Funds continues to grow. As more Funds realize the benefits associated with Subscription Facilities, we expect greater market penetration and higher utilization of Subscription Facilities. ◆

Endnotes

1 "Fund" is used herein to describe any real estate, private equity, infrastructure, debt and similarly focused investment funds.

2 The term "foreign exchange forward" means a transaction that solely involves the exchange of two different currencies on a specific future date at a fixed rate agreed upon on the inception of the contract covering the exchange. The term "foreign exchange swap" means a transaction that solely involves: (a) an exchange of two different currencies on a specific date at a fixed rate that is agreed upon on the inception of the contract covering the exchange; and (b) a reverse exchange of the two currencies described in subparagraph (a) at a later date and at a fixed rate that is agreed upon on the inception of the contract covering the exchange. See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 § 721(a), 124 Stat. 1376, 1661 (2010) (codified at Commodity Exch. Act § 1a(24)-(25); 7 U.S.C. § 1a(24)-(25)).

Business Development Company Financing

Business development companies ("BDCs")[1] have become popular with various groups of investors in the period following the global financial crisis due to the access a BDC provides to an investment class with potential for higher returns than other types of investments. Such popularity has correspondingly increased the interest of BDCs in leverage, in order to provide liquidity, leverage their portfolios and satisfy the growing appetite of their investors. Accordingly, BDCs have become higher profile borrowers, and this article will provide a brief introduction to BDCs while exploring common collateral structures used in connection with credit facilities for BDCs.

Business Development Companies

In an effort to facilitate access to capital by developing or financially strained companies, Congress created BDCs in the hope of stimulating lending to and investment in companies that often had difficulty securing capital from traditional lending sources such as banks. BDCs were created in 1980 through the Small Business Incentive Act to be investment companies regulated under the Investment Company Act of 1940, as amended ("ICA"), with limited purposes, operating limitations and parameters dictated by statute, as further described below.[2]

In order for an investment vehicle to qualify as a BDC under the ICA and under the Internal Revenue Code, as amended ("IRC"), an entity must satisfy the following requirements:[3]

First, under the ICA, a BDC, by definition, must be operated for the purpose of making investments in certain securities specified in the ICA, and, with some exceptions, must make available "significant managerial assistance" with respect to the issuers of those securities (*e.g.*, providing significant guidance and counsel concerning the management, operations or business objectives of the company). Second, under the ICA, a BDC may not acquire certain types of assets unless, at the time of acquisition, at least 70% of the value of its total assets are comprised of certain eligible assets. Third, the IRC places caps on the amount that any one investment may comprise of the overall BDC portfolio (*e.g.*, the securities of any

one issuer may constitute no more than 25% of the total portfolio value) in order to achieve asset diversification.[4] Fourth, under the ICA, a BDC must have an asset coverage ratio of at least 200%, which is equivalent to a maximum leverage ratio (total debt to total equity) of 1:1.[5] Fifth, under the ICA, BDCs are subject to certain prohibitions and restrictions on transactions with "affiliated persons" (a term that the ICA defines broadly) and various other requirements governing the management and operation of the BDC. Finally, a BDC must distribute at least 90% of its investment company taxable income to investors in order to maintain pass-through tax status under the IRC.[6]

One appeal of BDCs to investors is that BDCs may provide exposure, through a liquid investment, to private, often illiquid, investments that are normally only accessible to high net worth or otherwise sophisticated investors. Typically, private equity investments are attractive to investors because they have potential to result in higher returns than other closed-end funds such as a high-yield bond fund. Because there are fewer lenders and investors in the market that BDCs target, higher returns are frequently possible.

The indebtedness that a BDC may incur pursuant to a BDC credit facility will most likely be used to expand its investment portfolio in the form of loans or additional equity investments in assets. Such indebtedness must be structured and secured in a manner that will achieve appropriate leverage for such BDC while ensuring that such BDC will be able to comply with the various BDC regulatory requirements and the stated investment objectives, policies and restrictions of such BDC.

Lending to Business Development Companies

While a BDC is a unique entity that is distinguishable from other types of borrowers in both form and function, loans to BDCs from a commercial perspective are largely comparable to fund financings to private equity funds. The most easily recognizable characteristic that a BDC credit facility may have with other fund financings is found in the collateral package that is used to secure the indebtedness and the methods used for calculating the borrowing base.

SUBSCRIPTION-BACKED CREDIT FACILITY SIMILARITIES

The vintage of the BDC may be a determining factor in the type of collateral structure that is used to secure the credit facility. When a BDC initially begins to attract investors and acquire its investment portfolio, it may be a private entity (a model successfully employed by many REITs). Such an entity is typically marketed to an existing investor base by large private equity firms, whereby its shares are not listed on an exchange and its shares are sold through a private placement offering.[7]

In general, the capital structure of a BDC that is a private entity may closely resemble that of a private investment fund with an ongoing capital commitment (*i.e.*, equity commitment) by each of its investors. This commitment to make additional contributions of capital to the BDC at future dates, coupled with the fact that the investment portfolio is either nonexistent or too recently acquired to provide a reliable credit profile, will likely result in a lender structuring the transaction in a manner similar to a subscription-backed credit facility with a private investment fund (a "Subscription Facility"). A Subscription Facility, also known as a "capital call facility," secures the obligations owing to the lender thereunder by pledging the unfunded capital commitments of the limited partners in the private investment fund and the corresponding obligation to make capital contributions when called by the private investment fund's general partner. In the case of a BDC credit facility, the lender may similarly choose to secure the obligations owing thereunder by taking a pledge of the unfunded capital commitments of the investors and the

corresponding obligation to make capital contributions in accordance with the relevant organizational documents for such BDC and the BDC's interest therein. The borrowing base in respect of such a facility will also be determined in large part by the composition of the investor pool and an advance rate will be derived from various investor-specific factors, including the credit profile of individual investors. The diligence conducted by a lender with respect to the collateral in such a facility, therefore, will likely be focused on the obligation (or, alternatively, any defenses related thereto) of each investor to fund its respective unfunded capital commitment and on the capacity of such investor to make payments in respect thereof. If a BDC has a credit facility similar to a Subscription Facility and such BDC were to convert from a private entity into a publicly traded entity, the occurrence of such an event would require a material amendment to its constituent documents and would trigger a requirement to repay the credit facility.

For a BDC that has a more mature portfolio of assets or a different organizational structure, however, a lender may be able to structure the credit facility by relying on the portfolio of assets held by the BDC as opposed to the investors in the BDC.

NET-ASSET-VALUE CREDIT FACILITY SIMILARITIES

BDCs may initially begin with a non-traded or private structure as discussed above and then convert to an exchange listed entity or have a more traditional initial public offering. In either instance, such BDC will become a publicly traded company, and like most other publicly traded companies, investors will only be required to make a one-time up-front investment with no obligation to contribute further capital to the company. If a BDC is similarly structured (*i.e.*, with no ongoing capital commitment by its investors), lenders will be unable to secure the obligations under a BDC credit facility by taking a pledge of future capital to be contributed by the existing investors. As a result, the BDC will likely seek a credit facility that would, instead, be secured by all or a portion of its underlying investment portfolio. The collateral pledged by the BDC may consist of deposit or securities accounts, instruments such as promissory notes documenting loans made by the BDC to a portfolio company, or the equity shares held by the BDC in a portfolio company and various rights relating thereto. Using the underlying portfolio to secure the obligations under a BDC credit facility is similar to the collateral package employed by lenders in connection with a net-asset-value credit facility with a private investment fund ("NAV Facility").[8]

The underlying portfolio investments can be used not only to secure the indebtedness under a BDC credit facility but can also be used to determine the borrowing base and amount of leverage available to a BDC thereunder. Similar to the type of borrowing base calculations that may be used in a NAV Facility, lenders will be concerned with the composition of the BDC's portfolio and, as a result, will set forth requirements with respect to diversification of the portfolio, investment strategy and liquidity. Common borrowing base considerations may include limitations on the value attributable to any one portfolio investment or type of investment (*e.g.*, second-lien loans or common equity shares), minimum number of investments and nonperforming assets. Similar to a NAV Facility, the lender may also include covenants and mandatory prepayment events tied to performance of the underlying portfolio, which, unlike the borrowing base, may or may not be strictly related to the net asset value of the underlying portfolio. In a BDC credit facility structured around the portfolio of investments, the diligence conducted by a lender will likely be focused primarily on the historical performance of each portfolio asset and any issues related to the pledge and foreclosure upon any of the pledged portfolio assets.

Conclusion

When properly executed, a BDC credit facility can provide the maximum amount of leverage for such BDC while at the same time providing the lender with acceptable collateral and borrowing base protections. Experienced legal counsel can advise both BDCs and lenders on any potential obstacles in respect of the proposed collateral package, and each BDC will have special considerations that need to be analyzed when considering the appropriate type of credit facility collateral and borrowing base package. For instance, (i) an investor's obligation to make future capital contributions to a BDC and (ii) a BDC's investment in an underlying portfolio investment (structured either as a loan thereto or an equity stake therein) may be subject to restrictions on the pledge of such collateral to a lender under a BDC credit facility, and any appropriate consents or other mitigation in respect thereof should be obtained or addressed prior to such pledge. The growing popularity of BDCs and the unique characteristics of such an entity in its capacity as a borrower will present challenges that can be navigated with the assistance of legal counsel and result in growth opportunities for both BDCs and lenders. ◆

Endnotes

1. A "business development company" is defined in Section 2(a)(48) of the ICA.
2. BDCs endeavor to structure and operate as regulated investment companies under the IRC in order to qualify for pass-through tax treatment.
3. Provisions related to BDCs are set forth in ICA Sections 54-65, including related definitions in Section 2(a) and certain corresponding SEC rules.
4. IRC § 851(b)(3)(B)(ii). The IRC offers some relief from the diversification requirements for BDCs that have been identified by the SEC as principally engaged in providing funding to other corporations that are principally engaged in the development or exploitation of inventions and technological improvements that have not been previously available. IRC § 851(e)(1).
5. Note that if a BDC wants to issue debt (*e.g.*, debentures), such BDC must have an asset coverage percentage of at least 200% immediately after such debt is issued. The existence of other indebtedness, such as debentures or notes, may reduce the amount of indebtedness that may be incurred under a BDC credit facility in order to comply with this asset coverage requirement.
6. IRC § 852(a)(1)(A).
7. Some BDCs, particularly at their inception, might structure themselves to operate (i) without registration under the ICA, in reliance on relevant exceptions from the ICA's definition of investment company (*e.g.*, Section 3(c)(1) or Section 3(c)(7)); (ii) without registering their securities under the 1933 Act; and (iii) without regulation under the 1934 Act. Following registration and election under the ICA, BDCs may take various forms (*e.g.*, exchange listed, non-exchange listed but publicly offered, and privately offered).
8. For a detailed update on current trends and developments in the subscription-backed credit facility, net-asset-value credit facility and general fund finance markets, please see Mayer Brown's *Fund Finance Market Review* Fall 2016, starting on page 195.

Lending to Irish Regulated Funds

Special thanks to Kevin Lynch, partner at Arthur Cox, for contributing this article to the *2017 Spring Fund Finance Market Review.* The views expressed are the author's own and do not necessarily represent the views of Mayer Brown.

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[1] funds, Irish-domiciled AIFs 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[2] in 2013). The majority of the investments in these regulated investment funds comes from non-Irish institutional investors.

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[3] is restricted, although 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[4] and ILPs[5], 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.

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 under whose name the account is opened. 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 and 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. It is important in this regard that stakeholders understand what impact a suspension of NAV[6] [7]or a termination or suspension of the Investment Period could have. Irish regulated funds are generally very tax-efficient, but the legal and regulatory framework can be very complex, and accordingly, proper local counsel should be engaged.

The Administrator also plays an important role in processing subscriptions, and recording and registering the subscriptions; commonly, 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 insofar as they relate to subscriptions.

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, a lender may consider Irish law-governed security be taken in addition to any New York or other U.S.-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 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 in 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 in 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 in 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, how 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 granted 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 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] Undertaking for Collective Investment in Transferable Securities.

[2] Alternative Investment Fund Managers Directive.

[3] Alternative Investment Fund.

[4] Irish Collective Asset-Management Vehicle.

[5] Investment Limited Partnership.

[6] Net Asset Value.

[7] During a suspension of NAV a fund will not be able to calculate NAV and issue or redeem shares.

FALL 2017

In this Fall 2017 edition of our *Fund Finance Market Review*, we discuss some of the more noteworthy developments in the subscription credit facility and fund finance industries, including our views on the continued globalization of fund finance products, this time with a focus on Asia. We also explore the use of fund-level debt as a viable and efficient alternative to asset-level debt. Finally, we analyze the impact of margin regulations on funds' foreign currency hedging transactions and review the Institution of Limited Partners Association's recently published guidelines on subscription credit facilities.

Fall 2017 Market Review

The strong credit performance and significant growth of subscription credit facilities (each, a "Subscription Facility") and the broader Fund Finance market continued into the first half of 2017. In fact, Mayer Brown remains unaware of any Subscription Facility lender (each, a "Lender") experiencing a loss in connection with any Subscription Facility. Likewise, while we are aware of a handful of exclusion events occurring in 2017, these events were isolated and were largely based on factual issues related to the specific investor (each, an "Investor") and not the private equity fund (each, a "Fund"). Below we set forth our views on the state of the Fund Finance market as well as current trends likely to be relevant as 2017 comes to a close.

Fundraising in 2017

Investor capital commitments ("Capital Commitments") raised in Q2 exceeded $100 billion, continuing what Preqin has described as an "unprecedented sustained period of strong fundraising."[1] In fact, Q2 saw traditional buyout Funds have their best Q2 in five years, raising approximately $88 billion – accounting for 73 percent of total capital raised in the quarter.[2] Notably, the five largest Funds raised in Q2 were buyout funds, and they accounted for 71 percent of all buyout capital raised and 52 percent of total Q2 fundraising. [3]

While buyout Funds comprised the vast majority of capital raised, the trend of larger sponsors attracting the lion's share of Capital Commitments was consistent across all Fund types, as evidenced by the fact that nearly 63 percent of Capital Commitments were committed to the ten largest Funds closed in Q2.[4] Likewise, the average Fund size grew over the first half of 2017 with $543 million as the average size in Q1 and $637 million in Q2.[5] As more Investors look to limit their investments to a smaller group of preferred sponsors, sponsors are also diversifying their product offerings. For example, we have seen a number of sponsors leverage their existing Investor relationships by creating Funds focused on sectors in which they have not traditionally participated (i.e., buyout shops creating direct-lending Funds). Mayer Brown's fund formation team confirms this trend, indicating that a large portion of their work this year has been devoted to assisting sponsors in developing new platforms in the private credit and debt sectors.

Consistent with prior quarters, most of the capital raised in Q2 originated in North America.[6] Europe was again the second-largest fundraising market, and notably, the largest Fund that closed in Q2 was a €16 billion Europe-focused buyout Fund. [7] Asia continued its steady climb into private equity in Q2, including the closing of a $9 billion Asia-focused Fund. [8] As further explored below, many Investors have indicated increasing interest in Asia making that the second-most-targeted region for future investment after North America and supplanting Europe. This shift is evidenced by the fact that four out of the five largest Funds in the fundraising market are Asia focused, and three specifically target investments in China.[9]

Capitalizing on this trend, Asia-focused Funds that are in their fundraising periods are seeking $94 billion more in Capital Commitments than Europe-focused Funds.[10]

Fund Finance Growth and Product Diversification

Although the Fund Finance market lacks league tables or centralized reporting, our experience and anecdotal reports from a variety of market participants strongly suggest that the Subscription Facility market continues it steady and persistent growth and, as of Q2, is more robust than ever. In fact, both the number and size of Subscription Facilities Mayer Brown has documented this year have outpaced last year. Based on anecdotal reports, again from a variety of market participants, most of those polled expect growth and performance of Fund Finance to continue into at least mid-2018.

We also continue to see diversification in Fund Finance product offerings (including hybrid, umbrella and unsecured or "second lien" facilities). In particular, "Alternative Fund Financings" such as fund of hedge fund financings, management fee lines, 1940 Act lines (i.e., credit facilities to Funds that are required to register under the Investment Company Act), and net asset value credit facilities have garnered more interest by Funds and Lenders alike. In the first half of 2017 alone, Mayer Brown had already documented more and larger "Alternative Fund Financings" (i.e., net asset value facilities, secondary facilities, hybrid facilities and second lien facilities) than all of last year. Our mid year update will be held in New York this year, focused on such types of Alternative Fund Financings. Please join us on September 13 for our Hybrid Facilities and Other Alternative Lending Products Seminar focused on Alternative Fund Financings.[11]

Trends and Developments

TECHNICAL DEFAULTS

As expected with growth, we have seen an uptick in technical defaults over the course of 2017. A handful of such technical defaults were caused by Funds making capital calls without notifying the Lender as required in the Subscription Facility documentation. We note that Subscription Facility covenants providing for monitoring of collateral (including prompt delivery of capital call notices, notices of transfers, Investor downgrades and similar requirements) have continued to tighten, and more Lenders are preparing monitoring guidelines in order to provide a document compliance roadmap for Funds. Additionally, a number of Lenders have refined their back office processes with the goal of detecting any compliance problems more quickly and getting ahead of any potential issues.

As more Funds enter into Subscription Facilities prior to their final Investor closings, market participants have seen an increased number of defaults resulting from Funds entering into side letters without prior Lender review and consent, contrary to the requirements of the Subscription Facility loan documentation. Working through these issues and unwinding the problematic side letter provisions (including provisions that had spread through the "most favored nation" clauses) prove to be difficult and costly for Funds. Such situations highlight the importance of Funds working with both the Lender and their counsel to confirm the reporting requirements and to devote adequate resources in connection with loan document compliance prior to entering into side letters.

EVOLVING EXCLUSION EVENTS

While the market has traditionally been cognizant of jurisdictional risks such as sovereign immunity concerns, the globalization of the product and investor base have also presented new concerns in light of cross-border economic policies such as currency controls. It was widely discussed at the Asia-Pacific Symposium (discussed in further detail below) that in some instances, Chinese

Investors have been prohibited from moving cash outside of the country, in light of currency controls recently implemented by the Chinese government. To mitigate the risk that this leads to their inability to fulfill their contractual obligation to fund a capital commitment, Lenders should consider whether their current exclusion events cover off such a risk, and if not, could consider adding exclusion events tailored to currency controls and similar legal impediments to funding.

ILPA RECOMMENDATIONS

Since our last market review, there has been much discussion in the press regarding the ways Funds and sponsors can utilize Subscription Facilities, and the disclosure provided to Investors regarding Fund performance in light of the use of leverage – specifically how using Subscription Facilities can distort a Fund's internal rate of return ("IRR"), one of the key financial metrics used in the Funds industry to judge overall performance.

The resulting discussion has been robust, with a number of interested parties expressing their views as to the use of such leverage. Perhaps most importantly, the Institutional Limited Partners Association ("ILPA"), which is the industry organization for institutional Investors in private equity, issued "Subscription Lines of Credit and Alignment of Interests – Considerations and Best Practices for Limited and General Partners" in June.[12]

The ILPA guidelines focused mostly on Funds properly disclosing the key terms and conditions of any Subscription Facility to Investors. To that end, ILPA included a sample due diligence questionnaire Investors might consider having a Fund answer prior to investing.[13] The guidelines also recommended that Funds also report IRR net of any Subscription Facility indebtedness and suggested that quarterly Investor reports include outstanding Subscription Facility usage, the amount of time that Subscription Facility draws are outstanding and fees and costs relating to Subscription Facilities. While these guidelines remain a work in progress and Fund Finance market participants are currently working with ILPA to refine them, we do think a standardized approach to disclosure would be a positive development for Funds, Investors and Lenders.

Industry Conferences

MAYER BROWN CHICAGO MID-YEAR REVIEW

We hope you can join us at September's Mayer Brown Mid-Year Review to be held in Chicago on September 20.[14]

In last year's Mid-Year Review in Chicago one of the more interesting discussions revolved around a "race to the bottom" arising from Lenders and counsel new to the market, which often unknowingly take underwriting and loan documentation risks. One Lender cited an example where they were asked to join a syndicated deal for a top-tier fund where agent's counsel failed to flag unfavorable side letter provisions (including cease-funding rights) and the loan documentation did not contain numerous market-standard exclusion events. The topic garnered so much interest that we plan to address the topic again at our September review in Chicago.

FUND FINANCE ASSOCIATION ASIA-PACIFIC SYMPOSIUM

The 1st Asia-Pacific Fund Finance Symposium (the "Asia-Pacific Symposium") was held in Hong Kong in mid-June. The Symposium brought together over 350 bankers, lawyers, Lenders and Fund sponsors for the first time to discuss the Asian private equity market generally as well as the market for Subscription Facilities and Alternative Fund Finance products. A number of themes were raised during the Asia-Pacific Symposium and a brief summary is set forth below.

INCREASED APPETITE

One of the themes of the Asia-Pacific Symposium was the increased interest and appetite of Asia-sponsored Funds for Subscription Facilities. In particular, while the market in America and Europe is viewed as mature and a number of Asia-focused

Funds with U.S. or European sponsors have Subscription Facilities, most Funds with Asian sponsors do not yet take advantage of such leverage at the Fund level. Additionally, many facilities with Asian sponsors tend to be fairly bespoke given the newness of the product in the market and the complexities regarding investor bases for such Funds

Preqin provided an interesting presentation at the Asia-Pacific Symposium which expanded on this theme, noting a strong start to fund-raising in the Asian market, with 95 percent of Investors in private equity seeking to maintain or increase allocations to Asia and 86 percent wishing to invest equal or greater Capital Commitments in Asia in 2017 versus 2016.[15] Additionally, preliminary data show the IRRs for Asia-focused Funds exceeding those of European Funds for vintage years since 2010.[16] As the market for Subscription Facilities generally follows fundraising, it is not a leap to suggest that Asia is a burgeoning market.

It was also noted at the Asia-Pacific Symposium that the recent press relating to Subscription Facilities has not led to a negative impact on lending activity, but rather hasled to discussions and interest from sponsors and Investors in better understanding the product and perhaps using such leverage.

SEPARATE MARKETS

Another point that was emphasized by Preqin was the diversity of various markets within Asia. Asia-focused Funds continued to delve mainly in private equity buyout and infrastructure, with smaller concentrations of Capital Commitments being raised for venture capital, private debt, real estate and natural resources.[17] However, it was also noted that allocations among these areas varied widely depending upon country focus as the areas of focus for China-focused Funds varied from that of Australia-Asia Funds and Japanese markets.

INVESTOR MATTERS

The impact of special purpose Investor vehicles, which are often used by Asian Investors, was debated. Such vehicles, often used to make a single investment, can muddy Lenders' assessment that a credit link exists whereby parent entities with otherwise demonstrable creditworthiness are in fact backstopping the vehicle's obligations to Fund Capital Commitments. With respect to such Investors, the availability of financial information and Investor privacy were also raised as barriers to Lenders' ability to properly assess credit risk and create a diverse borrowing base. On the other hand, it was noted that the ability to assess creditworthiness of Investors in the Asian market may be a particular advantage for Asian banks that have established deep relationships with such Investors and can assess such risks more readily.

Additionally, the Asian Investor profile is changing as private wealth increases. The proliferation of high net worth Investors and family offices can be challenging to Lenders to the extent they make up a significant proportion of the borrowing base for a Subscription Facility. While this challenge is not a new one for Lenders, and is often mitigated by the use of concentration limits, this also seems to be increasingly impactful for Funds with Asian sponsors in particular (as opposed to Funds investing in Asia with U.S. or European managers, as the mix of Investors in such Funds tends to be different).

Another overarching theme was that larger economic forces may be brought to bear on Funds and Investors in the Asian market. The flight of capital from China in 2015 and 2016 drove foreign exchange reserves down by 25 percent, and China responded by slowing capital outflows and tightening controls on moving cash out of China since late 2016.[18] Recent news reports indicate that such controls have already impacted some of China's most prolific overseas Investors in making overseas Investments.

Additionally, the segregation of separate feeder or parallel Funds for Investors who could be impacted could be a solution for Lenders with respect to Subscription Facilities, such that those Investors' Capital Commitments would not be financed by a Subscription Facility. Additionally, it was noted that Chinese banks' increased role in the market for Subscription Facilities could make them uniquely suited to finance such Investor risk, in that structures to permit payment in local currency in China might be arranged, to the extent such controls would otherwise prevent funding to a Lender outside of China to repay a Subscription Facility.

Conclusion

2017 continues the generally steady growth in the Fund Finance market. Large sponsors diversifying their platforms into debt funds and credit funds will likely give rise to an uptick in the number of fund financings during the near term. The germination taking place in Asia should eventually lead to significant cultivation over the long term. So long as market participants remain vigilant with respect to underwriting, diligence and structure we project that that overall health of the market for Subscription Facilities and Alternative Fund Financings will be well sustained for several years to come. ◆

Endnotes

1. *Preqin Quarterly Update Private Equity and Venture Capital*, Q2 2017, p.2.
2. *Preqin* at p.3.
3. *Preqin* at p.3.
4. *Preqin* at p.2.
5. Please note that the fundraising related to the Soft Bank Vision Fund, which is targeting a $100 billion close, and has raised $93 billion year to date, skews these averages.
6. *Preqin* at p.4.
7. *Preqin* at p.4.
8. *Preqin* at p.4.
9. *Preqin* at p.5.
10. *Preqin* at p.5.
11. Please register for this year's Mayer Brown Hybrid Facilities and Other Alternative Lending Products Seminar at https://connect.mayerbrown.com/133/630/compose-email/internal-invitation-event-170913-nyc-seminar-fundfin-hybrid.asp?sid=blankform
12. https://ilpa.org/wp-content/uploads/2017/06/ILPA-Subscription-Lines-of-Credit-and-Alignment-of-Interests-June-2017.pdf.
13. For more proposed sample answers to these due diligence questions, see *Model Responses to ILPA's Subscription Credit Facility Due Diligence Questionnaire.*
14. Please register for this year's Mayer Brown Mid-Year Review at https://connect.mayerbrown.com/email_handler.aspx?sid=blankform&redirect=https%3a%2f%2fconnect.mayerbrown.com%2f56%2f316%2flanding-pages%2fblank-rsvp-business_draft.asp.
15. *Preqin Private Capital in Asia Pacific, Insight into this Diverse Market,* Ling Yan Teo, Manager, Asian Fund Managers, http://www.fundfinanceassociation.com/wp-content/uploads/2017/06/Asia-Pacific-Preqin-Slides.pdf.
16. *Preqin Private Capital* at p.3.
17. *Preqin Private Capital* at p.5.
18. *China Gives up its Global Role for a Stronger Yuan,* Nathaniel Taplin, Wall Street Journal, Aug. 7, 2017 https://www.wsj.com/articles/china-gives-up-global-role-for-a-stronger-yuan-1502106508.

Benefits of Fund-Level Debt in Acquisition Finance

Introduction

Private equity and other investment funds have traditionally utilized portfolio company-level financing to finance acquisitions. These types of financings have focused on the portfolio company for both the debt underwriting and collateral package. The categories of these loans include asset-based loans ("ABL"), cash flow financings and real property mortgages, among other traditional lending products.

In our practice, we are seeing increased and opportunistic use of fund-level debt as an alternative or complement to secured financing at the portfolio company level. Fund-level debt can include net asset value ("NAV") credit facilities, subscription credit facilities and facilities combining characteristics of both NAV and subscription credit facilities ("hybrid facilities"). This article focuses on the relative benefits of using fund-level credit facilities to finance acquisitions of portfolio companies and/or assets thereof as compared to traditional acquisition finance.

Overview of NAV, Subscription and Hybrid Credit Facilities

NAV credit facilities are fund-level facilities that look to investments of the fund as the primary source of repayment. Although a lender may consider the strength of a fund in its underwriting process (e.g., compare the credit evaluation for providing financing to a successful $1 billion Fund VI versus an untested $50 million Fund I), the assets of the fund are typically the primary basis for a lender's underwriting and, in the case of a secured facility, the sole collateral. In a secured NAV facility, the lender can obtain liens on, among other things, (a) the equity interests in portfolio companies (or holding companies that ultimately own the portfolio companies), (b) distributions and liquidation proceeds from the portfolio companies or other investments, (c) in the case of debt funds, loans extended by the debt fund to its borrowers and (d) fund-level collection accounts. In other cases, borrowers with creditworthy assets are able to access credit based on borrowing base formulas but without granting liens on their assets.

Loan availability under an NAV credit facility is typically limited to a sum equal to (a) an agreed advance rate for a given category of assets (potentially subject to concentration limitations for each category) *multiplied by* (b) the NAV of certain agreed "Eligible Investments." NAV credit facilities are often subject to unique covenants and other terms in financing agreements (e.g., the requirement to maintain a minimum NAV or loan-to-value ratio, or rights with respect to asset replacement).

Whereas NAV credit facilities look downward to the underlying portfolio investments or other assets of the fund and their value as collateral and/or source for repayment, subscription credit facilities look upward to the unfunded capital commitments of the investors in the fund.

Subscription (also known as "capital call" or "capital commitment") credit facilities are now well known and utilized by private equity funds of all stripes. For years, such credit facilities have offered funds with numerous benefits including: (a) quick access to capital to bridge timing gaps in and "smooth out" the timing and receipt of capital calls from investors; (b) flexibility and nimbleness to rapidly access and deploy capital to take advantage of time-sensitive and opportunistic investments; (c) the means to borrow smaller amounts as needed and later call capital in larger amounts to reduce administrative burdens, maximize efficiency and bolster positive investor relations; (d) access to letters of credit and the ability to borrow in multiple currencies; (e) the ability to secure hedges, swaps and other derivatives transactions and (f) the means to bridge capital needs in connection with an asset-level financing.[1]

Hybrid credit facilities are a blend of NAV credit facilities and subscription credit facilities. Collateral for hybrid credit facilities is negotiated on a deal-by-deal basis, but it can provide lenders with recourse to the underlying investment assets that typically support an NAV credit facility, as well as the uncalled capital commitments of investors that typically support a subscription credit facility.2 For hybrid credit facilities with a blended borrowing base, the proportion of the borrowing base made up of capital commitments versus NAV assets often changes over time; as capital commitments are called and those funds are deployed to make investments, the value of those investments builds up the borrowing base through the NAV asset prong. The blended borrowing base of the hybrid credit facility helps fulfill the financing needs of the fund at multiple stages in its life cycle and obviates the need to refinance as capital commitments are called.

Relative Benefits of Fund-Level Financing

Funds and lenders alike can enjoy benefits of fund-level financing, particularly to facilitate acquisitions, including:

- Decreased transaction costs due to having only one credit facility per fund (rather than multiple asset-level or portfolio company-level credit facilities), resulting in lower overall costs and low to no commitment or broken deal costs.
- Timing benefits due to not having to arrange, structure, coordinate and close multiple asset-level or portfolio company-level credit facilities contemporaneously with, or in order to, facilitate acquisitions.
- The ability to focus fund financial and personnel resources on acquisitions, without the need to run a simultaneous process to secure asset-level or portfolio company-level financing.
- Lower relative cost of debt and increased fund profitability, for reasons including (a) lenders' greater comfort in the fund's overall performance, as opposed to performance on an asset-level or portfolio company-level basis; (b) multiple income streams from multiple portfolio companies and assets to support repayment; (c) reputational risk of non-repayment; (d) decreased diligence costs and (e) better pricing on fund-level debt secured across a diversified

- pool of collateral, compared to stand-alone portfolio company-level debt.
- Multiple high-quality sources of repayment supporting a single-credit facility.
- Potentially increased deal flow for lenders who are positioned to provide financing for the fund through its investment cycle across various platforms.
- A single, top-level credit facility lends to high levels of cooperation between funds and their lenders, increasing transparency into a fund's ultimate business goals and strategy and promoting partnerships.
- Lenders at the fund-level facility have a larger hold percentage of the fund's overall debt, with greater diversity of assets.
- Potential pricing breaks and beneficial borrowing base adjustments depending on the assets and concentrations thereof comprising the borrowing base.

Though beyond the scope of this article, we recognize that fund-level financing is not an ideal fit for every fund and situation. Potential challenges to be addressed include: (a) accounting and tax issues, e.g., how to allocate expenses at the asset or portfolio company level or otherwise as desired, and international tax implications for funds that have diverse investments in multiple jurisdictions; (b) the risk of insolvency at the portfolio company level (although this risk is likely limited for well-diversified and properly structured funds)[3] and (c) unique portfolio goals and challenges, e.g., whether advance rates and eligibility criteria offered by lenders will permit funds to achieve preferred leverage levels and returns.

We have addressed these issues in a variety of ways for a diverse array of funds and can suggest solutions based on individual fund characteristics and transaction dynamics. In many cases, these concerns can be mitigated or resolved by consulting experienced counsel early on in the fund formation and/or financing processes, or with other creative approaches (e.g., placing what would otherwise be mezzanine or junior-level debt in a senior position at the portfolio company level, which may be obtained at a much lower all-in rate than usual given its then senior position in the capital structure).

Depending on the type, goals and characteristics of the fund, it is possible to employ each of the aforementioned types of financing and to call on uncalled capital commitments, as well as underlying assets and investments, to fulfill varying capital and liquidity needs throughout the entire life cycle of a fund.

Market Trajectory and Conclusion

Given the relative benefits of fund-level credit facilities over traditional asset-level and portfolio company-level financing, as well as the overlap in collateral and sources of repayment, we see funds enjoying numerous benefits in obtaining fund-level facilities on a stand-alone basis, and/or as a jumping-off point to financing at multiple levels of the capital structure over the life of the fund. As a fund's capital demands, needs and goals evolve, fund-level facilities can provide unique advantages in terms of flexibility. As funds continue to mature and lenders shift their underwriting focus from individual investments to the strengths of funds themselves, we expect funds will utilize (and lenders will offer) additional fund-level facilities and financing options. ◆

Endnotes

1. For more information on subscription credit facilities, see https://www.mayerbrown.com/files/Publication/96e93616-8f87-407c-ac3c-c0d151b512b3/Presentation/PublicationAttachment/b3947934-6123-45f9-9c2f-ce336d07be75/Subscription-Credit.pdf.
2. For more information on hybrid credit facilities, see *Hybrid Credit Facilities*, on page 263.
3. This risk can be further mitigated by negotiating a cross-default provision to only certain investments. Funds can also negotiate the ability to substitute non-performing assets for better-performing assets in the borrowing base.

Hybrid Credit Facilities

Introduction

Real estate, buyout, debt, secondary and other closed-end funds ("Funds") have often used subscription-backed credit facilities—also known as "capital call" or "capital commitment" facilities (each a "Subscription Facility")—to access cash quickly or as a bridge to capital calls or other permanent asset-level financing. Under these facilities, Lenders look to a Fund's uncalled capital commitments and rights to call capital as security for the loans and for purposes of calculating borrowing base availability. However, as Funds mature beyond their investment or commitment periods and most or all of the investor capital commitments have been funded, some Funds turn to net asset value ("NAV") credit facilities with availability based on the underlying portfolio investments of the Fund (each a "NAV Facility") for financing needs on account of the diminished borrowing availability under a Subscription Facility. While both Subscription Facilities and NAV Facilities continue to grow in number and use, Funds are also exploring other financing options,[1] including hybrid facilities, which provide Lenders with recourse to both the uncalled capital commitments (the typical collateral under Subscription Facilities) and the underlying investment assets (the traditional credit support under NAV Facilities). These hybrid facilities offer both Funds and Lenders added flexibility in tailoring a financing package that works for all parties.

Subscription Credit Facilities

Traditionally, Subscription Facilities have helped Funds (among other things) harmonize capital calls, both in terms of size and frequency. A Fund's governing documents typically require that its investors be provided at least 10-15 business days' notice prior to funding a capital contribution. Subscription Facilities, however, permit Funds to receive borrowings on short notice (often within one business day), permitting them to move quickly on time-sensitive investments and avoid the lead time required in calling capital from investors. Subscription Facilities also help Funds avoid the need to make frequent capital calls in small amounts for working capital and similar expenses, potentially including management fee payments.

BORROWING BASE AND COLLATERAL

Loan availability under a Subscription Facility is subject to a borrowing base, which is customarily based on the value of the pledged uncalled capital commitments of investors satisfying certain eligibility requirements, with advance rates based on the credit quality of the relevant investors. Lenders will also often impose concentration limits that specify the aggregate amount of capital commitments from a single investor or category of investors that may be included in the borrowing base. Subscription facilities may also outline certain events (i.e., investor bankruptcy, failure to fund capital contributions, material adverse changes, withdrawal or excuse rights) that exclude investors from the borrowing base calculation. Lender diligence with respect to Subscription Facilities, therefore, will likely focus on the obligations and capacity of the individual investors to fund their respective capital commitments. Subscription Facilities will also have events of default tied to the investors (e.g., if a specified percentage of investors default on capital contributions).

The chief characteristic of a Subscription Facility is the collateral package, which consists of the unfunded commitments of the limited partners in the Fund to make capital contributions and *not* of the underlying portfolio investments themselves. Subscription facilities typically involve a pledge by the Fund and its general partner of the following as collateral: (1) rights in and to unfunded capital commitments of the investors in the Fund; (2) rights to make capital calls and enforce the obligations of the investors to contribute capital; and (3) the deposit accounts into which the investors are required to fund their capital contributions.

The pledge of rights in the unfunded capital commitments and rights to make capital calls enables Lenders in a foreclosure situation to step in and make capital calls to the investors directly in the event the general partner fails to do so. Lenders can then use the incoming capital contributions to repay the debt under the facility. And with respect to the pledged deposit accounts, the Fund covenants that all the capital contributions will be funded to the collateral account (which is typically held by the Lender or otherwise subject to its control pursuant to an account control agreement).

NAV Credit Facilities

As Funds mature beyond their investment or commitment periods, they have greatly diminished borrowing availability under traditional Subscription Facilities because investors have funded a majority of their capital commitments. NAV Facilities help fill financing gaps by looking *down* to the net asset value of the underlying portfolio investments of the Fund instead of looking *up* to the investor capital commitments in determining borrowing availability. These facilities are particularly desirable to Funds that may have immediate liquidity requirements but no imminent distributions from portfolio investments.

BORROWING BASE AND COLLATERAL

NAV Facilities require a significantly different credit underwrite than Subscription Facilities, and Lenders have historically taken a cautious approach. Loan availability under a NAV Facility is traditionally limited to the “Eligible NAV” of the “Eligible Investments,” multiplied by an advance rate (which tends to be lower than other asset-based credit lines due to the lack of immediate liquidity of the portfolio investments). Eligible NAV is generally defined as the net asset value of the Eligible Investments, but this value may be adjusted for any concentration limitations. For example, there may be limits on how much value is attributable to any one portfolio investment or type of investment. Lenders will also set forth requirements regarding diversification of the underlying portfolio investments, minimum liquidity and investment strategies. Lender diligence will often focus on the historical performance of each portfolio asset and any

issues that may be related to the pledge and foreclosure on the collateral (discussed below). The Eligible NAV calculation can be tailored so that it (a) excludes the fair market value attributable to investments subject to exclusion events, write-downs or concentration limits and (b) provides adjustments and recalculations based on financial reporting delivered to the Lender. The Eligible Investments must satisfy enumerated underwriting criteria (evidence of ownership, no liens, etc.), and ongoing inclusion is subject to no specified adverse credit/exclusion events (bankruptcy or insolvency events with respect to the investments, failure by the Fund or portfolio company to pay obligations, breaches of material contracts with respect to the investments, etc.).

One of the primary challenges of NAV Facilities is the Lender's comfort with respect to the NAV calculations of the underlying portfolio investments. A Fund's organization documents, however, may contain robust valuation procedures that help mitigate these risks, and a Lender may request the right to have a third-party valuation process if the valuations provided by the Fund seem inaccurate and/or require interim reporting covenants related to adverse credit events.

One of the chief characteristics of NAV Facilities is the inclusion of certain covenants related to the underlying portfolio investments. A common covenant is that the Fund maintain a certain minimum net asset value. Lenders may also insist on mandatory prepayment provisions tied to investment performance, including following payments or other proceeds distributed from the underlying investments to the Fund. Other covenants may include prohibitions on transfers of investments during default or if an over-advance results, negative pledges, separate financial covenants beyond Eligible NAV and providing copies of all investment-related documents and compliance certificates.

In certain instances Lenders will consider NAV Facilities on an unsecured basis in the case of high-quality asset classes. However, there is still a strong preference towards a secured facility, even if complete security over the portfolio investments can be a difficult commercial request by Lenders. While the collateral varies on a case-by-case basis, Lenders will typically look to the following collateral to secure their loans: (a) distributions and liquidation proceeds from the Fund's portfolio investments; (b) equity interests of holding companies through which the Fund may hold such investments; and (c) equity interests relating to the investments themselves.

The method of obtaining a security interest in the cash distributions and liquidation proceeds is similar to Subscription Facilities— the Fund pledges its rights in collection accounts into which such proceeds are deposited and covenants that all cash from its portfolio investments will be directed into these accounts. Typically the Fund is prohibited from making withdrawals unless the borrowing base is satisfied on a pro forma basis.

Equity pledges under NAV Facilities look very similar to those in the leveraged loan market. A Lender will be able to foreclose on the equity interest collateral and either take ownership control of the interests in the holding companies or sell such equity interests and apply the foreclosure sale proceeds to its debt. However, Lenders must also be aware of any transfer restrictions or consent requirements that may compromise a valid equity pledge (particularly in the context of an equity interest in individual portfolio investments), and obtaining any necessary general partner consents to such pledge may require considerable lead time. Lenders should also be sensitive to various perfection issues, especially when non-US law may apply. Ultimately, experienced legal counsel can advise both Funds and Lenders on obstacles when developing a working collateral package.

Hybrid Facilities

Hybrid facilities represent a combination of the collateral characteristics supporting Subscription Facilities and NAV Facilities and provide both Lenders and Funds with maximum flexibility in terms of satisfying liquidity needs throughout the life cycle of a Fund. Hybrid facilities, like NAV Facilities, have been used by Funds that are nearing maturity of (or have matured beyond) their investment or commitment periods and have significant investment portfolio equity value. For example, some facilities take an aftercare approach, extending the life of an existing subscription facility by (a) modifying the borrowing base to set the advance rate for included investors to 100 percent, eliminating concentration limits or advancing 100 percent against all investors (not just certain eligible investors) and (b) adding a covenant that the Fund must maintain a minimum net asset value or comply with a debt coverage ratio. At the same time, a significant market trend has been for Funds to turn to longer-term hybrid facilities in their early stages—beginning with the first closing of investors into a Fund and extending until all of the investor capital commitments have been fully drawn down and the Funds are fully invested.

BORROWING BASE AND COLLATERAL

Hybrid facilities provide covenants that ensure there is a sufficient surplus of undrawn investor commitments (echoing Subscription Facilities), as well as ensuring the net asset value of the Fund remains above a minimum level (a NAV Facility concept). And borrowing availability unrelated to investor commitments, like under NAV Facilities, is based on the "Eligible NAV" of the "Eligible Investments."

Consequently, one difficulty for hybrid facility Lenders is the need to underwrite both investors providing collateral support in the form of uncalled capital commitments and a pool of known and potentially unknown portfolio assets (as the loans under the facility may in fact be used to purchase these assets). This means more due diligence may be required, including, in respect of the NAV collateral support, determining if there may be transfer restrictions in respect of any portfolio company assets. Lenders are addressing these concerns by relying on substantial amounts of existing data on investors (in respect of uncalled commitment collateral) and pre-agreed investment eligibility criteria, mandating a tailored investment strategy or limiting expansion of the borrowing base beyond capital commitments until sufficient assets have been acquired by the Fund in connection with NAV collateral support of the hybrid facility.

Collateral under hybrid facilities is determined on a case-by-case basis, but Lenders can provide a tailor-made solution to any Fund based on the availability and suitability of the typical collateral under both Subscription Facilities and NAV Facilities. Lenders and Funds typically cooperate in establishing a collateral package containing all or some form of the following as part of negotiating appropriate risk-adjusted pricing:

1. A pledge by the Fund and/or its general partner of its rights in and to the unfunded capital commitments of the Fund's investors, as well as rights to make capital calls and enforce the obligations of the investors to contribute capital;
2. A pledge by the Fund of deposit accounts into which (a) the Fund's investors are required to fund their contributions and/or (b) the distributions and liquidation proceeds from the Fund's portfolio investments are deposited;
3. A pledge of equity interests in the holding companies through which the Fund holds its underlying investments (particularly in circumstances where underlying portfolio investment documentation prohibits a lien being placed on the asset); and

4. A pledge of the equity interests relating to the investments themselves to the extent not otherwise prohibited as noted above.

The clear advantage of hybrid facilities is that Lenders and Funds alike can benefit from continuous funding under a single credit facility (and without the costs and inconvenience of multiple refinancings) by drawing upon the collateral packages that have historically and successfully supported both Subscription Facilities and NAV Facilities.

Conclusion

As both Subscription Facilities and NAV Facilities continue to mature, Lenders and Funds are pushing towards even more flexible financing solutions. This includes relying on the traditional subscription-backed collateral pool while also looking to the value of portfolio investments and structuring practical financing around both. This "one-stop shopping" benefits both Lenders and Funds by providing seamless liquidity without duplicating costs (both in terms of dollars and allocation of human resources) associated with refinancing or restructuring credit facilities instead of focusing energy on new opportunities.

While the atmospherics are ripe for continued growth in the Subscription Credit Facility and NAV Facility markets, it is clear that the future is trending in the direction of hybrid facilities; they combine the positive attributes of both products and can be tailored to service a particular Fund's needs while maximizing the efficiency of Lender and Fund resources. ◆

Endnotes

[1] For information on fund-level debt facilities, see *Benefits of Fund-Level Debt in Acquisition Finance*, on page 260.

Impact of Margin Regulations on Funds' Foreign Currency Hedging Transactions

Fund of hedge fund managers and their lending partners have developed products that allow the funds to utilize their liquidity facilities to ease liquidity and operational burdens associated with the funds' foreign exchange transactions. Recent changes in the margin rules in the United States and abroad may raise issues for these solutions.

Discussion

MASTER-FEEDER STRUCTURE AND FX HEDGING TRANSACTIONS

- Funds of hedge funds are often structured as master-feeder funds. Such a structure allows the investment manager to manage a single portfolio of investments in underlying hedge funds while offering its investors multiple investment vehicles, in the form of feeder funds, that are created to meet the needs of different types of investors. Feeder funds are used, among other things, to provide flexibility with respect to investor tax status, to provide different return and risk models (such as a leveraged feeder fund) or to accommodate other administrative features tailored to the needs of the investors in the master fund.[1]
- In addition, feeder funds are used to permit investors to invest using currencies that differ from the currency in which the hedge funds held by the master fund are denominated. For purposes of this discussion, we will assume a structure with a non-US Dollar-denominated feeder fund (a "Non-Dollar Feeder") investing into a US Dollar-denominated master fund.[2] In this scenario, the Non-Dollar Feeder holds US Dollar-denominated assets (the master fund shares), but is required to make any payments to its investors in a non-US Dollar currency, resulting in exposure to fluctuations in the exchange value between the two currencies (the "FX Exposure"). Because its investors are not typically seeking exposure to currency fluctuations, the Non-Dollar Feeder will hedge this FX Exposure.
- The Non-Dollar Feeder will often hedge its FX Exposure by entering into foreign exchange forward transactions (each an "FX Transaction") with a financial institution, and it will roll these transactions as they expire.[3] The Non-Dollar Feeder is not a rated or otherwise credit-worthy entity and would typically be required to post both (a) initial

margin (usually in the form of an independent amount under an ISDA Credit Support Annex) and (b) any daily mark-to-market of the FX Transactions not in its favor.[4] Because its investment strategy is to remain fully invested in master fund shares, the Non-Dollar Feeder would generally prefer to margin its obligations under FX Transactions by pledging its interest in the master fund shares.

RISE OF FUND OF HEDGE FUND FINANCING TRANSACTIONS

- One consequence of the 2008 financial crisis was to highlight both (a) the mismatch between the redemption rights offered by funds of hedge funds and the liquidity of their assets (i.e., their hedge fund portfolios) and (b) the role that liquidity facilities could play to address that mismatch. Prior to 2008, it was not uncommon for a fund of hedge funds that did not employ a leveraged investment strategy to not have a financing facility in place. In the years following the financial crisis and continuing to the present, liquidity facilities have become much more common, to the point where most funds of hedge funds above a certain size now have a liquidity facility in place with one or more financial institutions, and these facilities are often in place at the feeder-fund level— the discussion here will focus on such a facility in place at a Non-Dollar Feeder.
- Under such a facility (the "Facility"), the Non-Dollar Feeder pledges all of its master fund shares in favor of the Bank (in its capacity both as lender and swap counterparty) to secure all of its obligations under the Facility. By drafting the Facility to permit the Non-Dollar Feeder to enter into FX Transactions with the Bank (or one of its affiliates) and to include the settlement amount of such FX Transactions as an obligation secured by the pledged collateral, the parties are able to secure the Non-Dollar Feeder's obligations under its FX Transactions without requiring the Non-Dollar Feeder to keep cash on hand or to maintain the operations necessary to meet daily margin calls.[5] Note that the same result can be achieved through a facility at the master fund level by having the master fund (x) guarantee the Non-Dollar Feeder's obligations under the Non-Dollar Feeder's FX Transactions and (y) pledge its custody account in which its portfolio of investments in hedge funds is held to secure both the master fund's obligations under the Facility and its obligations under such guarantee.[6]
- Such a Facility provides a solution to the Non-Dollar Feeder's needs both for a liquidity facility and to hedge its FX Exposure, while permitting it to remain fully invested in master fund shares. From the perspective of the Bank, it has already (in connection with the liquidity facility) taken the risk decision that it is willing to lend against the master fund shares and/or portfolio of hedge funds held by the master fund, so by extending the security grant to cover obligations under the FX Transactions the Bank is able to provide an attractive solution to its fund of hedge fund clients. This solution only works so long as the master fund shares are eligible collateral to secure the FX Transactions.

THE US MARGIN RULES

- The Commodity Futures Trading Commission (CFTC) and the US prudential regulators have adopted margin regulations (the "US Margin Rules") for uncleared derivative transactions. Generally, under the US Margin Rules, the exchange of margin is required with respect to uncleared derivatives entered into with CFTC registered Swap Dealers or Major Swap Participants on or after March 1, 2017. The US Margin Rules also prescribe the types of collateral that may be delivered to satisfy the requirements thereof. Master fund shares are not a permissible collateral type under the US Margin Rules. The US Margin Rules generally apply to all types of uncleared derivatives (including FX Transactions); however, there are exceptions for certain deliverable foreign exchange derivative transactions.

THE EU MARGIN RULES

- The variation margin rules under the European Market Infrastructure Regulation (the "EU Margin Rules")[7] also went into effect on March 1, 2017. Generally, under the EU Margin Rules, the exchange of margin is required with respect to uncleared derivatives entered into between "financial counterparties" (or "FCs") and "non-financial counterparties exceeding the clearing threshold" (or "NFCs+") on or after March 1, 2017. However, entities classified as "non-financial counterparties below the clearing threshold" (or "NFCs–") are outside the scope of the requirements.
- The rules apply to all types of uncleared derivatives (including FX Transactions), but they include a few time-limited exemptions for certain types of trades. While the list of eligible collateral under the EU Margin Rules is quite broad, shares in the master fund would typically not qualify as eligible collateral.

POINTS FOR CONSIDERATION

In light of the US Margin Rules and the EU Margin Rules, fund of hedge fund investment managers and financial institutions currently engaged in or considering entering into transactions like the FX Transactions or any other uncleared derivative transactions should consider the following points to establish the scope of the margin obligation and its practical consequences:

- What is the applicable set of rules?
  - » Am I incorporated, or otherwise regulated, in the United States or the European Union?
  - » Is our trading relationship completely offshore and, as a result, not in scope of the US Margin Rules and/or the EU Margin Rules?
  - » Is there any reason that would make an otherwise offshore transaction subject to the US Margin Rules or the EU Margin Rules (such as an inter-affiliate guarantee)?
  - » In addition to the US Margin Rules and the EU Margin Rules, can any other regimes also be relevant?[8]
  - » Is there any risk of a transaction or relationship falling foul of the anti-evasion principles under the US Margin Rules or the EU Margin Rules (or any other relevant regime)?
- Is my trading relationship in scope?

  FOR US MARGIN RULES:
  - » Is my counterparty a CFTC-registered Swap Dealer or a Major Swap Participant?
  - » Am I a Financial End-User?

  FOR EU MARGIN RULES:
  - » Is my counterparty an FC or an NFC+?
  - » Am I an FC, or if I am not an EU entity, would I be classified as an FC had I been incorporated in the European Union?[9]
  - » If I am not an FC, is the aggregate volume of derivatives entered into by my global consolidated group sufficiently low for me to be classified as an NFC–?
- Is the relevant transaction in scope?
  - » Is the product that I am trading in scope of the relevant set of margin rules?
  - » Are there any exemptions available?
  - » Does the transaction include any features that would take it outside the scope of any relevant exemption?[10]
  - » If an exemption is available, is it time limited?
- How do I ensure compliance with the US Margin Rules or the EU Margin Rules?
  - » Do I have the necessary documentation in place (such as the ISDA Master Agreement and an ISDA Credit Support Annex)?
  - » Is the documentation fully compliant with the new requirements?
  - » Are the shares in the master fund within the scope of eligible collateral?[11]
  - » Do I otherwise have access to assets that are eligible collateral under the relevant rules that I may be able to post to my counterparty?
  - » Am I operationally able to comply with the relevant requirements?[12] ◆

Endnotes

[1] For a detailed discussion of feeder funds and the issues they present and address, see *"Feeder Funds"*, page 172.

[2] Subscription proceeds received by the Non-Dollar Feeder are converted into Dollars at the spot rate and used to purchase master fund shares.

[3] The FX Exposure varies based upon the performance of the master fund and investor redemptions/subscriptions, and the investment manager may choose to not fully hedge the FX Exposure.

[4] Note that where there is not a business need to have a separate entity (e.g., to act as a tax blocker), the investment manager may instead choose to have a single master fund with multiple share classes denominated in varying currencies. In such a structure, the FX Exposure is at the level of the master fund (and may be across multiple currency pairs, depending on the number of different share classes), and the FX Transactions would be entered into by the master fund. The issues and solutions presented are otherwise similar to the master-feeder structure discussed in this article.

[5] While the termination amount of any outstanding FX Transactions reduces the amount available for borrowings under the Facility, the Non-Dollar Feeder would not typically be required to make an actual borrowing under the Facility or post-cash collateral.

[6] In either structure, the Bank must be sure to draft the transaction documents to provide that the FX Transactions terminate or are otherwise collateralized by acceptable collateral upon a default under or termination of the Facility.

[7] Commission Delegated Regulation (EU) 2016/2251 of October 4, 2016. Available at: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016R2251&from=EN.

[8] For example, Japan, Canada, South Korea, Hong Kong, Australia and South Africa have implemented their own margin requirements.

[9] Please note that the European Commission has recently proposed a revised framework for regulating uncleared derivatives, and under the current draft of the legislation, the scope of hedge funds classified as FCs has been expanded. However, it is unclear whether this change will be included in the final version of the regulation.

[10] E.g., certain features could cause foreign exchange derivative transactions to not qualify for the exemptions under the US Margin Rules or the EU Margin Rules mentioned above.

[11] Even though this is unlikely, the EU Margin Rules allow shares in certain types of funds as eligible collateral.

[12] For example, margin may have to be delivered on the same day as the date of demand.

Model Responses to ILPA's Subscription Credit Facility Due Diligence Questionnaire

In June 2017, the Institutional Limited Partners Association (**ILPA**) published *Subscription Lines of Credit and Alignment of Interests: Considerations and Best Practices for Limited and General Partners* (the **Guidelines**).[1] The Guidelines noted the increased usage of subscription credit facilities (**Subscription Facilities**) and outlined the advantages of such facilities to investors (**Investors**) in private equity funds (**Funds**). A key part of the Guidelines set forth a list of due diligence questions regarding Subscription Facilities that Investors should consider asking fund managers and general partners (**General Partners**) prior to investing. Given ILPA's influence in the market, General Partners should be prepared to answer these questions in their negotiations with potential Investors. So too, Subscription Facility lenders should consider tailoring their structures, pitches and negotiations with these questions in mind. Below, we explore the model questions, set forth practice notes market participants should consider and offer suggested responses (with different options bracketed) that they can tailor to suit their specific business strategies and operating procedures.

[Preliminary note to include with responses for Subscription Facilities that have not yet been fully negotiated: The questions below have been answered based on the General Partner's expectations as of the date of this response. The final terms of any Subscription Facility may differ from the terms described below, and certain variations may be material.]

What is the stated purpose and intention of using the Subscription Facility?

The Subscription Facility can be used for working capital purposes, including:

1. To bridge capital calls, which will (a) enable the Fund to act quickly for time-sensitive investments, (b) permit the Fund to smooth out capital calls in terms of size and frequency (which lowers expenses of the Fund and expenses for Investors associated with the capital call process), and (c) eliminate or minimize the administratively burdensome and costly "true-up" process between initial Investors and later close Investors.

2. To provide access to letters of credit (by including this in a Subscription Facility, the Fund will avoid the time and expense of negotiating multiple letters of credit facilities).
3. To provide quick and economical access to foreign currencies.
4. To secure interest rate and foreign exchange hedging exposures without calling or reserving capital or incurring added borrowing expenses (the Subscription Facility allows the Fund to allocate a part of the borrowing base to secure hedging exposure without actually making any draw on the Subscription Facility).
5. To permit the Fund to bridge permanent asset-level financing so the Fund will have time to arrange asset-level financing on more favorable terms and conditions.[2]

Practice Note: The loan documentation for Subscription Facilities will likely contain a "Use of Proceeds" provision which is usually structured very broadly to offer the Fund maximum flexibility. Due to Liquidity Coverage Ratio concerns, lenders should consult counsel before narrowing the scope of this section.[3]

When is use of the Subscription Facility expected to end? When is it contractually required to end, i.e., its expiration?

The Subscription Facility will have an initial [X] year term, which the Fund can extend [with][without] lender consent for an additional [Y] years.

[Each Loan under the Subscription Facility will be repaid within [X] days [in accordance with the Fund's governing documents].]

The Fund expects to use the Subscription Facility primarily during the investment period. After the investment period, the Fund [does not plan to use a Subscription Facility] [plans to only use the Subscription Facility on a limited basis to bridge capital calls and support follow-on expenses and investments].

[The Subscription Facility will be "committed," which offers the Fund reliable access to capital at attractive pricing.]

[The Subscription Facility will be payable "on demand" but includes a [X]-day grace period prior to any call that would permit the Fund to either refinance or call capital prior to its expiration.]

What are the terms for the Subscription Facility? Covenants, coverage, reset, negative provisions?

Standard Subscription Facility material covenants and terms include:

1. Restrictions on fundamental changes to the Fund's organizational structure or documents without lender consent.
2. Restrictions on making distributions to Investors during a pending default scenario.
3. Certain limitations on Fund-level indebtedness, [which will largely mirror the corresponding provisions in the Fund's governing documents].
4. Change of control, key man and removal events [which will largely mirror the corresponding provisions in the Fund's governing documents].

Generally speaking, the General Partner believes the terms of the Subscription Facility are less restrictive than asset-level financings and are aimed at preserving the availability of the Investors' capital commitments to the Fund, the related call rights and the related mechanics.

What was the initial size of the Subscription Facility and by how much could it be increased?

The Subscription Facility is currently sized at $[X]. As the Fund completes subsequent Investor closings, the Fund will have the option to increase the Subscription Facility [with] [without] lender consent. If the target commitment level of $[X] is achieved, the Fund expects to have a $[X] Subscription Facility.

[The Fund's leverage limitations cap indebtedness at [X] percent of the uncalled commitments, which [includes] [does not include] indebtedness under any Subscription Facility.]

How many current Investors cover the Subscription Facility, i.e., "Included Investors?"

The entire Investor base factors into the lender's underwrite of the Subscription Facility and, barring very special circumstances, all Investors are responsible to fund capital contributions to repay the Subscription Facility. The Subscription Facility structure uses a "borrowing base" that must cover the amount outstanding under the Subscription Facility. The borrowing base is calculated by applying [a flat [__] percent advance rate against the uncalled capital commitments of all Investors.] [negotiated advance rates (ranging from [__] percent to [___] percent) against different classes of Investors (e.g., high net worth investors, investors' investment grade ratings)]. It is important to note that, except with respect to extremely rare, specific issues relating to individual Investors, the collateral under the Subscription Facility includes the ability to call on all Investors [(including any Investor not included in the calculation of the borrowing base)], which is equitable because all Investors benefit from the Subscription Facility.

What is the cost to initiate the Subscription Facility, and how are those expenses reported to the Investors? What is the cost to renew the Subscription Facility at the end of the term?

The fees and margins associated with the Subscription Facility will likely be notably lower than most other types of financings (e.g., leveraged loan financings).

Does the Subscription Facility cross-default in the event one of the Investors defaults?

The lender's right to call capital from Investors is simply derivative of the Fund's (or its General Partner's) right to call capital. Accordingly, because the General Partner can issue call capitals to make up shortfalls caused by another Investor's failure to make capital contributions (an "overcall"), the lender will also be able to do so. It is important to note that the Fund's ability to make overcalls is necessary to prevent a single Investor's default from effectively eliminating the Fund's ability to complete investments.

Will performance (IRRs) be calculated with and without use of the Subscription Facility?

[General Partner to answer based on its particular approach.]

Will leverage (e.g., in the case of real estate funds) be disclosed with and without use of the Subscription Facility?

[General Partner to answer based on its particular approach.]

In the event that an Investor whose commitment was used to secure the Subscription Facility needed to sell their commitment on the secondary market, how would that impact the line, the ability of the Investor to sell, and the overall partnership?

The Subscription Facility will only prohibit a transfer if it would violate sanctions provisions or would result in a violation of law. [The General Partner would, in the ordinary course, also withhold its consent to transfers that would result in these issues even if the Fund did not have a Subscription Facility.]

[Additionally, if the transferring Investor is "included" in the borrowing base, the Subscription Facility may require that, prior to the effectiveness of the transfer, the Fund make a prepayment in an amount that would cause the Fund to be over-extended on its borrowing base after giving effect to such transfer (i.e., if the transferee was ineligible for inclusion in the borrowing base and by removing the Investor's

commitment the Fund would be overdrawn on the Subscription Facility). Accordingly, the Subscription Facility will not ultimately restrict the ability of an Investor to sell its interest in the Fund; it may merely require that the Fund prepay the line (which may be done by using cash on hand or by making a capital call (including on the existing Investor)) prior to the effectiveness of any transfer.]

What impact if any will the use of the Subscription Facility have on UBTI exposure for ERISA or other tax-exempt Investors?

[The Fund's counsel should be involved in structuring a response to this question.]

Practice Note: Subscription Facilities offer wide availability to accommodate Fund structures in order to satisfy any UBTI and ERISA concerns, including the use of "clean downs" and "cascading pledges."[4]

Under what circumstances (e.g., regulatory changes) could the Subscription Facility be pulled by the lender?

[The Subscription Facility is committed and cannot be pulled by the lender.]

[The Subscription Facility is "uncommitted and on demand" and thus can be pulled by the lender at anytime on a [X]-day notice, which would permit the Fund to either refinance or call capital prior to its expiration. The Fund prefers this structure as it avoids certain fees that "committed" Subscription Facilities typically charge.]

Is LPAC approval required to open or extend the Subscription Facility? Does initiating or extending the line require any amendments to the LPA?

The Fund's governing documents do [not] require advisory board approval. [The Subscription Facility will not require amendments to the LPA.] [The Subscription Facility lender has requested the following amendments to the LPA: [XYZ].]

Practice Note: Most Funds seek comments from lenders prior to their first Investor closing in order to avoid having to amend their governing agreements.

In an event of default (EOD), what recourse does the lender have to the uncalled commitments or assets of included Investors?

The Subscription Facility will not be recourse to any asset of the Investors. It will only be recourse to the Fund (i.e., the ability to make and enforce capital calls (on a secured basis)) and the other assets of the Fund (on an unsecured basis) and other loan parties. Thus, after an Investor has funded its capital commitment, in accordance with the Fund's governing agreement (including any with respect to any overcall (as explored above)), the lender will be barred from turning to the Investor to makeup any loss it experiences on the Subscription Facility.

What process was followed by the General Partner in the selection of a lender?

[General Partner to answer based on its particular approach.]

Practice Note: While this will vary from Fund to Fund, the Fund should solicit and evaluate term sheets from multiple lenders that set forth pricing, the proposed structure, the proposed borrowing base and other key terms. Other considerations should include a lender's proven execution capabilities, commitment to the space, and track record. ◆

Endnotes

1. The Guidelines are available at https://ilpa.org/wp-content/uploads/2017/06/ILPA-Subscription-Lines-of-Credit-and-Alignment-of-Interests-June-2017.pdf.

2. Note that this list is not exhaustive and the use of Subscription Facilities by Funds will vary widely. For a more detailed description of the possible uses of subscription credit facilities, see https://www.mayerbrown.com/files/Publication/96e93616-8f87-407c-ac3c-c0d151b512b3/Presentation/PublicationAttachment/b3947934-6123-45f9-9c2f-ce336d07be75/Subscription-Credit.pdf

3. For more information on the implications of the Use of Proceeds provisions in Subscription Facilities, please see *Capital Commitment Subscription Facilities and the Proposed Liquidity Coverage Ratio,* on page 75.

4. For more information on structuring Subscription Facilities for UBTI concerns, see https://www.mayerbrown.com/addressing-ubti-concerns-in-capital-call-subscription-11-12-2012/ and for ERISA concerns, see https://www.mayerbrown.com/subscription-credit-facilities-certain-erisa-considerations-07-29-2013/

Powers of Attorney in Fund Financing Transactions

Introduction

A power of attorney ("POA") is a written agreement wherein an individual or organizational person (the "principal") provides advance authority to another party (the "agent") to make certain decisions, to execute certain documents or to act on the principal's behalf, generally or in certain circumstances. POAs can take the form of stand-alone documents or can be included within other documents (e.g., within a security agreement for a secured lending transaction). Grants of POAs are commonly included in security documents for secured lending transactions to enable the agent to take actions (e.g., direct the disposition of proceeds within the principal's account, execute and deposit checks) on behalf of the principal and usually spring into effect upon the occurrence of an agreed triggering event, such as an event of default under the related credit documents. While POAs are likely to be found in almost all secured lending transactions, there can be nuances related to how such POAs are used in a given transaction and/or jurisdiction. This article discusses some of the issues, considerations and concerns with the use of POAs in subscription credit facility transactions in the United States.

A subscription credit facility (a "Facility"), also frequently referred to as a capital call facility, is a loan made by a bank or other credit institution (the "Lender") to a private equity or other type of investment vehicle (the "Fund"). The defining characteristic of such Facilities is the collateral package, which is composed of the rights to make capital calls on the unfunded commitments of the limited partners in the Fund (the "Investors"), to receive capital contributions ("Capital Contributions") when called from time to time by the Fund's general partner or manager (the "General Partner") and to enforce the same, pursuant to a limited partnership agreement executed by the Investor and the General Partner.

Powers of Attorney in Subscription Credit Facilities

GENERALLY

POAs are widely used in Facilities in the United States and are most commonly included as grants of authority within standard collateral documents, as opposed to stand-alone documents. For example, a POA provision within a security agreement might read as follows:

> The Lender is hereby granted an irrevocable power of attorney, which is coupled with an interest, to, during the existence and continuance of any Event of Default, (a) execute, deliver and perfect all documents and do all things that the Lender considers to be required or desirable to carry out the acts and exercise the powers set forth in this Security Agreement, and (b) execute all checks, drafts, receipts, instruments, instructions or other documents, agreements or items on behalf of any Pledgor, as shall be deemed by the Lender to be necessary or advisable to protect the security interests and liens herein granted or the repayment of the secured obligations, and the Lender shall not incur any liability in connection with or arising from the exercise of such power of attorney, except as a result of its own gross negligence or willful misconduct.

Under such a POA, upon the occurrence of an "Event of Default", the Lender could take any of the specifically aforementioned actions or other unspecified actions that the Lender deems necessary or advisable to protect its security interests and the liens granted under the security agreement, without the requirement to provide prior written notice or obtain written or other consent from the pledgor/principal granting the power of attorney. It is generally understood that a Lender could utilize the POA to, among other things, issue capital call notices, initiate litigation against an Investor in connection with the enforcement of remedies available under the limited partnership agreement, or establish a new bank account of the Fund, in each case in the name of the General Partner. Any such actions would be taken in the name of and on behalf of the General Partner and not in the name of the Lender.

It is generally understood that to be enforceable under New York law, a POA must generally, at a minimum: (a) be clearly stated in writing and (b) be signed and dated by a principal with the capacity to grant the POA. If the power of attorney states that it takes effect upon the occurrence of a contingency (e.g., the occurrence of an event of default under a loan agreement), the power of attorney takes effect only at the time of that occurrence and is not in effect before the occurrence. Depending on the jurisdiction for applicable governing law, and/or the purpose of the POA or other factors, there may be additional requirements that may be dictated by statute, case law, or otherwise. Such other requirements could include execution by a witness, the inclusion of specific statutory language or otherwise take a specific form.

It is also important that any granted POA is irrevocable, such that the granting party cannot freely revoke the authority or powers provided in the POA. Generally, a POA coupled with an interest or given as security will be irrevocable unless the parties add express language to preserve the revocability of the POA.[1] New York courts have held that a POA will only be irrevocable to the extent that (a) the POA affects the legal relations of its creator, (b) the authority under the POA is held by the creator for the benefit of the creator or another third party, (c) the POA was given for consideration and (d) the POA was given to secure the performance of a duty (other than any duty to the creator by reasons of agency).[2]

OTHER USES OF POWERS OF ATTORNEY IN FACILITIES

While POAs have always been an important component of the security package in a Facility, there are also some uses of a POA outside of inclusion in a broader collateral package. First, a Lender could rely on a power of attorney where a pledge of typical Facility collateral is not available. Such a scenario could arise where the limited partnership agreements or other constituent documents, other contracts or local applicable laws may prohibit the direct grant of security over the right to call Capital Contributions from

Investors. This could also arise where the Fund has already granted security over the right to call Capital Contributions from Investors to another creditor. Lastly, we have seen such a POA in the context of equity commitment enhancements where a full grant of security over the right to call Capital Contributions from Investors was not otherwise contemplated. In such scenarios, it is common for the POA to take a more detailed form than the example set forth above that is typically included in a security agreement. Such a POA would typically be expected to contain fairly detailed descriptions of the specific actions that are able to be taken thereunder by the Lender. In such scenarios, Funds and Lenders should take care that the POA does not contravene or conflict with any applicable restrictions on an outright draft of security over the right to call for Capital Contributions from Investors.

Another scenario where a Lender may rely more heavily on a POA is where the Fund's limited partnership agreement leaves uncertainty over which entity has the rights or the ability to call for Capital Contributions from Investors and the related authority to pledge such rights as security for a Facility. This could arise where a General Partner of a Fund has delegated certain categories of rights to an investment manager for the Fund pursuant to an investment management agreement, where the Fund is organized as a corporation or a limited liability company with a board of directors, or in jurisdictions where the rights to call capital belong to the Fund alone, notwithstanding that the General Partner may issue capital call notices. In these situations, it is typical not only to take a standard grant of security over the right to call Capital Contributions from Investors but also to supplement such grant with a POA from any applicable parties who may have rights to call capital.

Conclusion

POAs are one more tool that can provide a Lender with rights in connection with a Fund's ability to call Capital Contributions from Investors. Drafted properly, POAs can provide a Lender with the ability to take immediate action after an agreed triggering event, such as the occurrence of an event of default under the Facility documentation, without the need to provide prior written notice to or obtain the consent or cooperation of the Fund or an order of a court. Lenders can benefit from consulting an experienced counsel who is knowledgeable about Facilities, POAs and coordinating with applicable local counsel to draft security or other documentation that is likely to achieve the desired effect and be upheld by the courts in insolvency or other stress scenarios. ◆

Endnotes

1. *See Rest.3d Agen §3.12; see also NY General Obligations Law Sec. 5-1511(3)(a).*
2. *See Ravalla v. Refrigerated Holdings, Inc., No. 08-cv-8207 (CM), 2009 U.S. Dist. LEXIS 23353, at *10-11 (S.D.N.Y. February 25, 2009).*

Practice Note on the New Cayman Island's Beneficial Ownership Regime

Special thanks to Tina Meigh, Partner at Maples and Calder, for contributing this article to the *2017 Fall Fund Finance Market Review*. The views expressed are the author's own and do not necessarily represent the views of Mayer Brown.

What Is The New Beneficial Ownership Regime?

Under recently passed legislation (the "Regime"), Cayman Islands companies and Cayman Islands limited liability companies ("LLCs") are now required, unless an applicable exemption applies, to maintain a beneficial ownership register that records details of the individuals who ultimately own or control more than 25% of the equity interests or voting rights of the company or LLC or who have, directly or indirectly, rights to appoint or remove a majority of the company directors or LLC managers. The register is also required to include details of certain intermediate holding companies through which such company or LLC interests are held.

The new Regime codifies a commitment agreed upon between the Cayman Islands and the United Kingdom to enhance existing, robust arrangements on the exchange of beneficial ownership information to assist law enforcement agencies in combating tax evasion, money laundering and the financing of criminal enterprises.

Whilst there are specified exemptions to the Regime (which broadly seek to exempt those entities already subject to a certain level of regulatory oversight), those companies and LLCs that fall within the Regime's ambit (each, an "In-Scope Entity") will be required to maintain a beneficial ownership register. Each In-Scope Entity is required to take "reasonable steps" to identify certain information including whether there is any individual who qualifies as a beneficial owner under the Regime and whether any legal entities that are registered in the Cayman Islands (including foreign companies) would meet the definition of a beneficial owner if they were an individual.

Why Is It Important to Fund Finance Market Participants?

It is important for lenders in any financing transaction to assess the relevance of the new Regime to the transaction, and, in particular, the potential impact of the issuance of a restrictions notice by an In-Scope Entity (which may well be downstream of the borrower and obligor parties). A restrictions notice may

be issued by an In-Scope Entity to its equity holder (the "Equity Holder") when certain information regarding the ownership or control of the company share or LLC interest (the "Interest") that the In-Scope Entity is entitled (and, indeed, required) to obtain from the Equity Holder has not been provided. Failure to provide such information is also a breach of law by the Equity Holder (even where that Equity Holder is otherwise exempt from the Regime) and, accordingly, it follows that a restrictions notice can only be served in circumstances where there has been a breach of law by the Equity Holder.

Once a restrictions notice has been issued, it is important to be aware that its effect goes beyond simply a restriction on transfer of the Interest in respect of which it has been issued.

Where a restrictions notice has been issued in respect of an Interest, any transfer or agreement to transfer the Interest is void, no rights are exercisable in respect of the Interest, no shares may be issued (in the case of a company) or additional rights granted (in the case of an LLC) in respect of the Interest or in pursuance of an offer made to the Interest-holder, no payment may be made of sums due from the In-Scope Entity in respect of the Interest, whether in respect of capital or otherwise, and (other than in a liquidation) an agreement to transfer any of the following associated rights in relation to the Interest is also void: (a) a right to be issued with any shares (in the case of a company) or granted additional rights (in the case of an LLC) in respect of the Interest; or (b) a right to receive payment of any sums due from the In-Scope Entity in respect of the relevant interest.

One important point to note in the context of fund financing transactions is that a restrictions notice can never be issued in relation to limited partnership interests in a Cayman Islands partnership (as the Regime applies only to companies and LLCs), nor will any restrictions notice (or its impact) apply to or otherwise impinge upon any capital call rights attaching to those limited partnership interests. As such, the enforceability of the main collateral package in subscription financing transactions should not be affected by the Regime.

However, it is clear that the issuance of any restrictions notice has far reaching and potentially significant importance in a financing transaction, if , for example, an Interest is subject to a security interest (for example, in a portfolio company financing where the fund incorporates a Cayman Islands company to borrow money for investment and the shares in that new company are secured in favour of the lender) or if the transaction documents reference or otherwise capture any rights, interests or obligations relating to an Interest, for example, by virtue of collateralization tests or borrowing base thresholds (for example, in any net asset value or asset–backed facilities where the underlying securities owned by the fund could include Interests or rights relating to Interests, that are subject to security granted in favour of the lender).

How Can Parties Address the Beneficial Ownership Regime?

The good news for lenders is that, under the Regime, no restrictions notice can be served in respect of any Interest where such Interest is subject to a security interest granted to a third party who is not affiliated with the person holding such Interests and, should any such restrictions notice be inadvertently served, there is a process for setting it aside. More broadly, there is also a process for any "aggrieved" third party to apply to have a restrictions notice set aside where the Court is satisfied that a restrictions notice is unfairly restricting the rights of the third party.

This will, in practice, reduce the risk to lenders in any secured transaction given that there is unlikely to be an affiliation between the fund borrowers and the lending institution.

It is also worthwhile to note that regulated investment funds (and those funds operated or

managed by regulated managers) will be outside the scope of the Regime and Interests of those regulated investment funds will therefore not be capable of being subject to any form of restrictions notice.

However, parties in unsecured and corporate transactions will need to closely consider the assets involved in the transaction, and will need to place significantly greater reliance on the representations, warranties and undertakings contained in the transaction documents. In particular the transaction provisions relating to continuing compliance with all applicable laws will need to be scrutinized to confirm that they adequately address any concerns related to the Regime (an Equity Holder in full compliance with the Regime cannot have been issued a restrictions notice). Lenders and, indeed, counterparties generally will want to ensure that they are as protected as possible and easily able to enforce their security interests. To that end, lenders will want to consider what actions a fund borrower is required to undertake under the transaction documents to address the Regime and restrictions notices, particularly at the time of enforcement. We are regularly working with funds, lenders and other counterparties to ensure that the transaction documents properly address the potential issues raised by the Regime. ◆

SPRING 2018

In this Spring 2018 edition of our *Fund Finance Market Review*, we discuss noteworthy developments in the subscription credit facility and fund finance markets and provide our views on the continued proliferation of private credit funds. We also explore the various forms of credit support available in the fund finance space and analyze unencumbered asset pool facilities as well as fund financing for series LLCs.

Finally, we discuss customary default remedies available in fund finance and proffer a potential guide to the accompanying foreclosure process.

Spring 2018 Market Review

Our outlook for the fund finance market for 2018 is positive, as we expect the market to build upon the successes experienced over the last calendar year. In 2017 strong credit performance, record-breaking fundraising and product expansion fueled significant market growth. In addition to a significant uptick in the number of traditional subscription credit facility (each, a "Subscription Facility") closings, Mayer Brown closed a record number of alternative fund financings. As expected with any mature market, however, we did see episodic defaults and borrowing base exclusion events in 2017. Such defaults were primarily technical in nature, and the exclusion events were isolated in respect of individual investors (each, an "Investor") and did not indicate broader systemic issues for the Subscription Facility market or the private equity fund (each, a "Fund") asset class. Below, we expand on our views on the state of the fund finance market as well as current trends likely to be relevant in 2018.

2017 Fundraising and 2018 Outlook

Fund fundraising experienced a banner year in 2017. Investor capital commitments ("Capital Commitments") raised in 2017 exceeded $453 billion, representing the largest amount of capital raised in any year, according to Preqin.[1] This continues the upward trend experienced in 2016 and is only the second year ever in which total fundraising has exceeded $400 billion.[2]

As we predicted in our last Market Review, Investors continued to flock to a smaller group of preferred sponsors in a flight to perceived quality, with fewer funds being closed but with a larger total Fund size.[3] This trend was evidenced by numerous Fund asset classes raising their largest single funds ever—including buyout, infrastructure and private debt Funds.[4] So too, consistent with prior years, we witnessed significant growth in the number of Facilities in favor of single managed accounts (also known as funds-of-one)—a trend we think will continue in 2018.

The rise of private credit and direct lending Funds (both in number and size) has been notable as they continue to fill the gap in the lending market left by traditional banks scaling back their lending operations in light of regulations imposed as a result of the last recession.[5] Notwithstanding recent indications that regulators may ease pressure on traditional banking institutions, many market participants expect that the leverage loan markets will continue to be popular with private credit arms of less-regulated Funds. Thus, the trend of sponsors forming credit funds has continued its upward trajectory through 2017 with many sponsors recruiting traditional bankers to Funds in order to increase their capacity and fine-tune their expertise. This optimism in the private credit and direct lending asset classes was evidenced by 136 vehicles closed and over $107 billion being raised for funds in this sector last year.[6] While we expect 2018 to continue this trend, many market participants expect fundraising to ease as a result of the fact that dry powder is also at a record high as a result of successful fundraising.[7]

Consistent with prior years, most of the capital raised in 2017 originated in North America with North American-focused private equity Funds raising $272 billion and Europe-focused funds raising $108 billion.[8] Additionally, Preqin's data indicates that Investors continue to have a positive outlook on the industry, with 63 percent of Investors having a positive perception of private equity and a majority seeking to increase their allocation in the longer term.[9]

Product Diversification

Consistent with this data, our experience and anecdotal reports from a variety of market participants strongly suggest that the Subscription Facility market continues steady growth and is as robust as ever. We also continue to see diversification in fund finance product offerings, including hybrid, umbrella and unsecured or "second lien" facilities. In particular, "Alternative Fund Financings," such as fund-of-hedge fund financings, management fee lines, 1940 Act lines (i.e., credit facilities to Funds that are required to register under the Investment Company Act) and net asset value credit facilities have garnered more interest by Funds and lenders alike. We have also seen more open-ended Funds interested in Subscription Facilities. Accordingly, many lenders have customized their loan programs to capitalize on this need. For more information on these alternative financings, including structural considerations, please visit our webpage at www.mayerbrown.com/experience/Fund-Finance/.

Trends and Developments

TAX REFORM

The recent Tax Cuts and Jobs Act passed into law by the United States will significantly impact Funds and their portfolios. In addition to the much-publicized drop in US corporate income tax rates, changes in the tax rates for "pass-through" entities and the ability to repatriate overseas earnings, the legislation altered the tax treatment with respect to "carried interest."

Carried interest refers to equity interests that the general partner or sponsors of a Fund may receive as compensation. By characterizing this compensation as equity, the general partner or sponsor will benefit from a lower long-term capital gains tax rate (as opposed to ordinary income or short-term capital gains) on such compensation. The deduction for "carried interest" has largely survived the tax reform with certain tweaks to how and when it is calculated. One of the most significant is that in order to obtain long-term capital gain treatment, the required asset holding period has been changed from at least one year to at least three years. Additionally, amounts that fail to meet the three-year test are not treated as ordinary income but rather are treated as short-term capital gain. In addition to the carried interest, other changes to the tax code also affect Funds and Facilities, which among others, include:

Deductibility of interest expense - The limitation of deductibility of interest expense on debt negatively impacts the private equity industry as Funds often rely upon leverage to finance transaction purchases and sales. Previously, there was no limit on the amount of interest that could be deducted. Favoring the use of leverage by Funds, a company can now only deduct interest expense equal to 30 percent of its EBITDA (earnings before interest taxes, depreciation and amortization) (and, after 2022, 30 percent of EBIT (earnings before interest and taxes)). This will likely result in a higher cost of capital and may affect valuations for assets making them relatively more expensive.

Long term Capital Gains - As noted above, the changes now require Funds to own companies for three years before getting lower capital gains tax treatment, although real estate Funds are exempt from this requirement.

Excise Tax on University Endowments - Certain private colleges and universities will be subject to a 1.4-percent excise tax on their net investment income. Given that these endowments are frequent Investors in

Funds, this will likely impact their strategic planning and the investable assets available for private equity allocations.

Others - Other changes that may have an impact include limitations on the usage of net operating losses and limiting UBTI loss offsets to income to require such offsets from the same unrelated business (and not other businesses as was previously permitted). Additionally, the taxation of gains and losses on partnership interests owned by foreign investors have also changed and may also negatively affect their tax position when they choose to dispose of such investments in private equity funds. The totality of the impact of the tax overhaul on Investors in Funds and Funds themselves remains to be seen, and an experienced tax advisor is necessary to determine the impact on any particular set of Investors and Funds.

FLEXIBLE BORROWING BASE APPROACHES AND BRIDGE FACILITIES

Traditionally, lenders in the United States have employed one of three standard borrowing base approaches for Facilities: (1) a borrowing base of only highly rated "included" investors with a high advance rate; (2) a low advance rate across all investors for a larger fund; or (3) a two-tier approach, which provides for both highly rated included investors with a high advance rate and a designated investor class, where the latter has a lower advance rate. However, in the case where a Subscription Facility is being looked at during the early stages of fundraising, lenders have not always had the flexibility to optimize the borrowing base approach to best fit a Fund's needs, and Funds have had to make a decision as to the best approach for their borrowing base, guided by an estimate of what their final investor pool will be. More lenders have started to respond to this issue by offering flexible borrowing base approaches. One approach consists of single bank bridge facilities until a final investor closing. This can help in that the Fund can determine what borrowing base will ultimately work best. Other lenders have included an option in the loan documentation that permits the Fund to switch to an alternative borrowing base approach within a short window of time after the final investor closing. Another approach being used with more regularity is to increase advance rates once investors have funded a predetermined percentage of committed capital. Likewise, as we have noted in prior Market Reviews and above, more lenders are offering "hybrid" credit facilities—where the borrowing base is calculated off both the uncalled capital commitments and the assets of the Fund.

INCREASED SCRUTINY

Given the significant growth of the Subscription Facility market, many lenders have reported that they are being audited by internal risk officers and bank regulators with greater frequency. Among other things, these audits have focused on how lenders calculate and monitor the overall credit exposure to each Investor, the lender's portfolio management systems and whether the lender has an action plan for both market-wide disruptions and credit-specific defaults. In response, we are working with many lenders to adopt a standardized approach to track investor-by-investor and fund-by-fund exposure, restructuring their compliance and portfolio management programs, and adopting a written policy on how best to address default and foreclosure scenarios. (For more information on possible foreclosure remedies, see *Default Remedies under a Subscription Credit Facilities: A Guide to the Foreclosure Process*)

LENDER RESPONSES TO TECHNICAL DEFAULTS

In response to the increased focus by regulators and auditors and in the rise in the number of technical defaults, lenders are starting to require more robust collateral monitoring provisions. For example, more lenders now require that the collateral accounts be held at the agent bank rather than a third-party depository. Generally, Funds establish their treasury management relationships ahead of entering into a Subscription Facility, resulting in lenders

often agreeing to use the existing accounts held at a third-party institution as the collateral accounts. In such event, such accounts are subject to a lien permitting the agent to take control of the account during an event of default, including if a mandatory prepayment is not made. However, more lenders are now implementing the approach used in the broader loan markets, which provides a collateral sweep mechanic during the pendency of a mandatory prepayment from a collateral account, rather than simply using the control over the account as a default remedy. Given this approach is operationally difficult with an account that is not at the agent bank (due to the need to block and unblock an account multiple times), another route to achieving this result is requiring the accounts be held at the agent bank. This permits intermittent account blocks and sweeps to be achieved in a simpler and less costly manner.

ADDITIONAL EXCLUSION EVENTS

As reported in our last Market Review, market participants have been closely monitoring the impact of currency controls imposed on Investors by foreign regulators. As more Investors have defaulted under their capital commitment in light of these currency controls over the last quarter, many lenders are now contemplating adding a specific "exclusion event" to Subscription Facility loan documentation that would remove Investors subject to these restrictions from a Subscription Facility's borrowing base. We expect that this exclusion event and other exclusion events aimed at even larger geopolitical issues may develop over the next year to become common.

Industry Conferences

FUND FINANCE ASSOCIATION GLOBAL FUND FINANCE SYMPOSIUM IN NEW YORK

Once again, Mayer Brown will be a platinum sponsor at the Global Fund Finance Symposium. Held in New York City on March 21, 2018, this year marks the symposium's eighth anniversary. As the founding institution of the symposium, Mayer Brown is proud to support the Fund Finance Association and the significant growth of the conference—as well as the addition of the European Fund Finance and Asia-Pacific Fund Finance symposiums. Building on the prior success, we expect this year's symposium to bring together leading market participants to share their insights on the trends affecting the fund finance industry.

FUND FINANCE ASSOCIATION WOMEN'S EVENT

Mayer Brown is proud to host the next Women in Fund Finance event on March 20, 2018, in our New York office. The Women in Fund Finance Speed Networking Event is an opportunity to meet with some of the leading names in alternative investment for an evening of networking and conversation. To register for this event or to learn more, please go to www.womeninfundfinance.com/events.

MAYER BROWN MID-YEAR MARKET REVIEWS

Mayer Brown will also host Mid-Year Market Reviews in New York City and Chicago this autumn. These Mid-Year Market Reviews traditionally address market developments in fund finance and focus on providing real-world advice on how such developments should be addressed by market participants. For more information on these events or to register, please email Dena Kotsores at dkotsores@mayerbrown.com.

Conclusion

After 2017 ended with steady growth in the fund finance market, and given the fund closings achieved through year end, we expect an uptick in the number of fund financings to occur in the near term—especially in favor of private credit funds and single managed accounts. While the impact on the recent tax reform remains to be seen, we envisage that overall health of the market for Subscription Facilities and other Fund Financings will continue through 2018. ◆

Endnotes

[1] *Preqin Global Private Equity & Venture Capital Spotlight*, January 2018, p. 10.

[2] *Id.*

[3] *Preqin Q4 2017 Fundraising Update*, December 2017.

[4] *Id.*

[5] For more information on this trend, see *"Leveraged Loan Regulatory Uncertainty Presents Opportunities for Direct Loan Funds"* on page 185.

[6] *Id.*

[7] Fund Manager Says Red-Hot Private Debt Market May Cool Off, *Institutional Investor Online*, January 21, 2018, by Alicia McElhaney.

[8] *Preqin*, p. 10.

[9] *Id.*, p. 10

Default Remedies under Subscription Credit Facilities: Guide to the Foreclosure Process

Although the growing market for subscription-backed credit facilities (each, a "Subscription Facility") has witnessed very few defaults or similar events necessitating non-consensual enforcement actions (each, a "Default"), Subscription Facility lenders and other secured parties thereunder (the "Secured Parties") nevertheless should understand and, if necessary be prepared to quickly enforce their rights in the collateral pledged under such Subscription Facility—a point consistently reinforced by both bank regulators and risk teams at many of our clients. Similarly, private equity fund borrowers (each, a "Fund") and fund sponsors should also understand the remedial actions a Secured Party may take under a Subscription Facility so that they can be prepared to respond appropriately should a Default arise and the Secured Parties elect to exercise their enforcement rights. Although certain rights and remedies may be available to Secured Parties following a Default, in most circumstances the most effective method of managing a Default will be for the Fund and the Secured Parties to develop a mutually agreeable strategy on how best to address the Default. In the event that the parties cannot agree on a strategy to work through the Default, the relationship between the Fund and the Secured Parties has turned sour or if the circumstances warrant an immediate exercise of remedies (e.g., the investors have moved to remove the Fund's general partner or change the investment manager or the Fund or investment manager has committed fraud), the Secured Parties may determine exercising remedies in lieu of negotiating a workout is necessary.

To that end, this legal update examines the rights and remedies typically available to Secured Parties following a Default under customary, agented Subscription Facility documentation and provides recommendations for additional, preemptive actions that Secured Parties should consider incorporating into their standard policies to prepare for the contingency of a Default. It is important to note, however, that certain remedies discussed herein may be stayed or otherwise may be found to be ineffective or unenforceable under bankruptcy or other applicable law, particularly if the Fund has been, or is subject to, certain insolvency proceedings. While

this update includes a general discussion of the legal principles applicable to possible enforcement scenarios, the Secured Parties seeking to exercise remedial measures under a Subscription Facility should always consult appropriate counsel with respect to Fund bankruptcies or other specific Defaults.

Background

A Subscription Facility is typically secured by a lien on, among other things, the Fund's (or its general partner's) ability to (a) issue and direct capital calls, (b) receive capital contributions and (c) enforce default remedies against "defaulting investors" pursuant to the Fund's governing document. The lien on this collateral is granted in favor of the Subscription Facility's collateral agent (the "Agent") and is perfected under United States law by filing a Uniform Commercial Code ("UCC") financing statement in the applicable filing office.[1] Additionally, Subscription Facilities generally require that the Fund grant a security interest in favor of the Agent in the deposit or securities account into which capital contributions are deposited by investors when called by the Fund (or its general partner) (the "Collateral Account"). Perfection of the lien on the Collateral Account is usually achieved either by requiring the Collateral Account to be held at and maintained with the Agent, as account bank, or by the entry into a tri-party control agreement over the Collateral Account among the Fund, the Agent, and the account bank at which the Collateral Account is held and maintained.[2]

Remedies

While most market participants have a general understanding of the basic nature of Subscription Facility collateral, sometimes overlooked is how an Agent, acting for the benefit of the Secured Parties, would practically enforce remedies against such collateral following a Default. The following table sets forth (a) certain actions that Agents and Secured Parties might contemplate prior to actually enforcing remedies following a Default (referred to below as the "Pre-Enforcement Stage") and (b) remedies typically available to the Agent and Secured Parties that should be considered once the decision to enforce remedies has been made following a Default (referred to below as the "Enforcement Stage"). Every Default scenario is unique, and the Agent and Secured Parties must take into account the specific facts and circumstances giving rise to the Default when determining the approach to take. Accordingly, the following table should be treated as a list of potentially available remedial options and not as a preordained, step-by-step guide. Similarly, while certain action items below have been categorized as either "Pre-Enforcement Stage" or "Enforcement Stage," the actual facts and circumstances surrounding a particular Default scenario may lead to different timing of any specific action or actions. Upon the occurrence (or suspicion) of a Default, and certainly prior to the exercise of any remedy, Secured Parties should consult with competent legal counsel, and no remedial actions should be initiated without careful planning; Funds would likewise benefit from consulting with counsel when it becomes apparent a Default may arise.

Pre-Enforcement Stage

ACTION	COMMENTARY
1. CONSULT LEGAL COUNSEL	Both in-house and external counsel should be consulted prior to taking remedial measures, and ideally as soon as a Default appears reasonably likely to occur. Engaging counsel early in distress scenarios usually is more time- and cost-efficient, as the parties may be able to negotiate an amendment, forbearance or other consensual (and mutually agreeable) resolution of a Default rather than requiring enforcement actions to be taken. Likewise, engaging in an open dialogue with counsel well before enforcing rights and remedies helps to ensure a more complete understanding of the facts surrounding the Default, thus enabling the Secured Parties to obtain full and informed advice from counsel. Additionally, legal counsel should be consulted in the Agent's (and Secured Parties') confirmation of the actual existence of a Default prior to any remedy being taken. Secured Parties could potentially expose themselves to liability should they take remedial measures in the absence of an actual default under the Subscription Facility documentation or in a manner that courts later determine to be improper. With that in mind, Secured Parties should work with counsel to mitigate the risk of a lender liability claim in a Default scenario. For example, legal counsel may suggest the Secured Parties obtain a declaratory judgment against the Fund prior to enacting any remedies. Legal counsel will also help the Agent understand its obligations, including to the lending syndicate, and the requisite notice and voting requirements that may govern enforcement actions. Finally, external counsel representing the Agent in the documentation of the Subscription Facility may be prohibited from representing the Agent in an enforcement scenario (e.g., the Fund oftentimes will waive a client conflict in connection with documenting the Subscription Facility so long as such counsel agrees to resign as counsel for the Agent in the event of any adverse proceeding or enforcement scenario related thereto). If this is the case, the Agent will need time either to seek a waiver of the conflict or to engage new counsel (in which case, new counsel will need to be apprised of the Default and to work through various pre-enforcement items with the Agent).
2. REVIEW FILES TO MAKE SURE DOCUMENTS ARE ORGANIZED AND COMPLETE	The Agent and its counsel should ensure their loan files are current and complete. All Subscription Facility documentation (including all notices sent between the parties, loan requests, borrowing base certificates and compliance certificates) and investor documents (including subscription agreements, side letters and "most favored nation" elections that have been delivered before and after the Subscription Facility has closed) are well organized to enable the Agent to act quickly, if needed.
3. CONFIRM UCC FILINGS ARE VALID AND REFRESH LIEN SEARCHES	As a rule, UCC financing statements expire five years after the date on which such financing statements are filed, unless renewed by the Secured Party, and financing statements are also occasionally misfiled by filing offices. The Agent should confirm that all UCC financing statements filed during the term of the Subscription Facility remain valid (and, if not, the Agent should promptly resolve any issues regarding such financing statements with the assistance of counsel). New lien searches will not only confirm that the UCC financing statements were properly filed, but also may show any new tax, judgment or other liens on the assets of the Fund, or other new obligations or competing liens that may have attached to the collateral. Understanding the universe of what else is "out there" as it relates to the Secured Parties' lien on the Subscription Facility collateral will help the Agent determine how much flexibility it may have in enacting remedies.

ACTION	COMMENTARY
4. CONFIRM DELIVERY OF INVESTOR NOTICES	In many non-U.S. jurisdictions, perfection and priority of the Agent's security interest requires that the investors receive notice of the Subscription Facility and the grant of a security interest to the Agent thereunder. While most Subscription Facilities require these notices to be delivered both in connection with the initial closing of the Subscription Facility and promptly upon a new investor joining the Fund, the Agent should confirm that all applicable investors (including those having joined in subsequent investor closings) have received investor notices, particularly since the Fund may have failed to strictly comply with this delivery requirement after the initial closing of the Subscription Facility.
5. REVIEW THE ACCOUNT CONTROL AGREEMENT (ESPECIALLY IN RELATION TO TIMING AND NOTICE REQUIREMENTS)	While a well-drafted control agreement will provide the Agent with perfection control over the Collateral Account on day one, most control agreements for a Subscription Facility require advance notice to be provided by the Agent to the account bank as a prerequisite for the Agent to exercise exclusive control over the Collateral Account (typically two or more business days). Agents contemplating taking remedial steps following a Default should factor such timing into their decision-making process. Similarly, many control agreements prescribe specific notice procedures, particularly with respect to the Agent delivering a notice of exclusive control over the Collateral Account (e.g., notices of exclusive control must be sent by fax and signed by a specific officer of the Agent for whom the account bank has received evidence of incumbency or authority). Agents therefore should familiarize themselves with any express notice requirements and be prepared to act quickly to comply with any such requirements.
6. REQUEST UPDATED INVESTOR CONTACT INFORMATION	If it needs to issue a capital call to repay outstanding obligations under the Subscription Facility, the Agent will need the contact information for each investor. While investor subscription agreements should contain contact information for each investor, such contact information is typically current as of the date the investor joined the Fund (and such information frequently changes after such date). Accordingly, in a Default scenario the Agent should promptly request updated investor contact information from the Fund, even if the Fund is otherwise required under the Subscription Facility documentation to provide ongoing updates of such investor contact information. While most Subscription Facilities require prompt notice of any changes to such investor contact information, the Fund may not have strictly adhered to this requirement (and, in any event, having contact information confirmed, up-to-date and readily available will assist and make more efficient any foreclosure process undertaken by the Agent and/or the Secured Parties).
7. GAIN ABILITY TO "POST" TO THE INVESTOR PORTAL	Most Funds issue capital calls via Internet portals to which each investor has access rights. In the event the Agent plans to or must issue a capital call as part of taking remedial measures after a Default, issuing such capital call via the Internet investor portal will likely be the most efficient way of doing so. Investors presumably will be more inclined to fund their capital contributions on time (and without challenging such capital call) if the Agent's process of calling capital following a Default largely mirrors the Fund's typical capital call process (and delivery means), with which the investors are already familiar.

ACTION	COMMENTARY
8. REFRESH GOVERNING DOCUMENT AND INVESTOR DOCUMENT DILIGENCE, ESPECIALLY RELATED TO CAPITAL CALL MECHANICS AND EXCUSE RIGHTS	The Agent and its counsel should refresh their diligence of the Fund's governing document provisions relating to capital calls (e.g., the period within which investors must fund capital contributions when called), the calculation of capital calls (e.g., whether capital contributions must be funded "pro rata" when called) and any applicable investor excuse rights or overcall limitations. The Agent should account for any investor excuse rights or overcall limitations in its initial capital call in order to avoid having to issue multiple capital calls to the investors.
9. TAKE INVENTORY OF ALL DEFAULTS	The Agent should thoroughly review all existing Defaults under the Subscription Facility. If a material Default has occurred, an increased risk exists that other technical Defaults or undiscovered material Defaults have also occurred. All Defaults should be addressed and evaluated in connection with any assessment of how to best proceed.
10. PREPARE RESERVATION OF RIGHTS LETTER AND/OR A NOTICE OF DEFAULT	The Agent should consult with counsel to determine if it should send a written notice of default or a reservation of rights letter to the Fund. Such written notice of default or reservation of rights letter can help establish a documentary precedent acknowledging the Agent's attention and response to the Default.
11. CONDUCT A SITE VISIT	The Agent will typically have the right to conduct a site visit to the Fund to review the Fund's books and records, even if no Default has yet occurred or exists. After a Default, however, the Agent should consider conducting a site visit to collect any needed data that could potentially be helpful in the enforcement process (e.g., investor contact information, investor correspondence, applicable records relating to the use of loan proceeds).
12. ORGANIZE CONFERENCE CALLS WITH THE SECURED PARTIES	The Agent should hold conference calls with their counsel, the Secured Parties, and where applicable, the Fund and their counsel, to examine the nature of the Defaults, any mitigating or aggravating circumstances and to determine the best course of action.
13. ORGANIZE CONFERENCE CALLS WITH INVESTORS OR THE FUND'S ADVISORY BOARD	The Agent may also consider organizing (likely with the Fund) Investor and/or Advisory Board conference calls to identify any Defaults or other issues for the Investors, gauge their reaction and remind them of their contractual obligation to make capital contributions.

ACTION	COMMENTARY
14. OPEN REPLACEMENT COLLATERAL ACCOUNTS	The Agent may also consider opening one or more replacement Collateral Accounts, held at the Agent, to mitigate operational risk associated with the account bank. Additionally, most control agreements permit the account bank to terminate the control agreement governing the Collateral Account by giving prior notice (typically, thirty days). In a Default scenario, an account bank may wish to extract itself from the dispute and simply terminate the control agreement or close the Collateral Account. In order to avoid a scenario wherein the Agent temporarily lacks a Collateral Account (or control of such accounts for perfection purposes), the Agent may wish to open one or more new Collateral Accounts as a matter of course. Nevertheless, due to ERISA concerns and requirements often included within the governing document of the Fund, replacement Collateral Accounts may need to be opened in the name of the Fund (in which case the Agent may need to use the power-of-attorney granted in the Subscription Facility documentation to open such replacement Collateral Accounts). For any replacement Collateral Account, the Agent should ensure it places a "blocked at all times" instruction on such account to avoid any operational risk with a shifting control concept.
15. CALCULATE OUTSTANDING OBLIGATIONS	The Agent should calculate the existing outstanding obligations under the Subscription Facility (including unpaid principal, letter of credit liabilities, accrued interest, unused fees, letter of credit fees, agency fees, facility fees, obligations under any secured hedges and fees and expenses of counsel), which will assist the Agent in understanding the total risk inherent in a Default scenario.
16. PREPARE FOR CASH COLLATERALIZATION OF LETTERS OF CREDIT	Letter of credit issuers should consider opening cash collateral accounts for any outstanding letters of credit and preparing related documentation (e.g., control agreements over such cash collateral accounts).
17. REQUEST PRE-SIGNED CAPITAL CALL NOTICES	The Agent should also consider requiring the Fund to deliver pre-signed, but undated, capital call notices in escrow (which could then be delivered by the Agent, via the power of attorney granted under the Subscription Facility documentation). Possession of (and ability to deliver) these pre-signed capital call notices in the form typically delivered to investors, and signed by the individual who typically signs such capital call notices, could allow the Agent to recover from the investors more efficiently.

ACTION	COMMENTARY
18. PREPARE CAPITAL CALL NOTICES	The Agent should consider preparing capital call notices, using the most recent capital call notices delivered to investors as a template (unless in possession of pre-signed capital call notices, as discussed above). Investors receiving a capital call notice in the same form typically delivered by the Fund will increase the likelihood that investors will fund their capital contributions on time (and without challenging the call). Additionally, the most recent capital calls will oftentimes include each Investor's current notice information (hence one reason why most Subscription Facilities require that all capital call notices (and not simply an exemplar copy) be delivered to the Agent concurrently with the distribution to the investors). The Agent should also consider how it frames the purpose of the capital call (a description of which is typically included in each capital call notice). The facts and circumstances surrounding the delivery of a capital call by the Agent (including if a Default exists) will help determine the proper tone and message describing the purposes of the capital call (and the Agent should consult with experienced counsel to discuss proposed approaches).
19. IDENTIFY INTERNAL CONFLICTS OF INTEREST	To avoid lender liability claims, Secured Parties should, prior to any enforcement following a Default, be aware of, and account for, any actual or potential conflicts of interest affecting the Secured Parties.
20. REQUEST ADDITIONAL COLLATERAL	To mitigate risk, the Agent and Secured Parties may also consider requesting additional collateral (e.g., cash collateral and other assets of the Fund (including the Fund's equity positions in portfolio companies)).
21. RESTRUCTURE THE SUBSCRIPTION FACILITY DOCUMENTATION	The Agent and Secured Parties additionally should consider using the Default to negotiate a restructuring of the Subscription Facility (e.g., restricting the borrowing base mechanics, adjusting pricing, imposing additional mandatory prepayment and/or notice requirements).
22. CONSIDER REQUIREMENTS FOR (INCLUDING CONCESSIONS FOR) WAIVER OF THE DEFAULT	In the event the Secured Parties decide to not impose remedies following a Default, the Agent should work with counsel to document a waiver of the Default (including any potential fees or other consideration therefor). Documenting waivers is especially important to protect the Secured Parties' position and to guard against a potential claim that, through a "course of dealing," the Secured Parties have effectively waived their rights to enforce remedies relating to certain types of Defaults in the future.
23. ASSIGN OR PARTICIPATE THE LOAN	Individual lenders may want to consider whether they wish to remain "in the deal" in an enforcement scenario, including potential foreclosure on the collateral or if they instead prefer to seek to assign or participate their interest in the loan to an existing lender or to another third party.

Enforcement Stage

ACTION	COMMENTARY
1. CHARGE DEFAULT INTEREST	Depending on the specific Subscription Facility documentation, the Agent (or the Secured Parties) may need to affirmatively elect to charge default interest.
2. SUSPEND THE AVAILABILITY OF LIBOR LOANS	In order to mitigate losses associated with break-funding, LIBOR conversions and continuations may be blocked.
3. TAKE EXCLUSIVE CONTROL OVER THE COLLATERAL ACCOUNT	The Agent may be entitled to sweep the Collateral Account to repay obligations or, if the control agreement does not require a daily sweep, simply freeze funds deposited in the Collateral Account (and the ability for the Fund to withdraw such funds or issue instructions related thereto) while an acceptable resolution with the Fund is negotiated.
4. NOTIFY INVESTORS OF THE DEFAULT	In certain circumstances, the Agent might consider distributing notices to the investors informing them of the occurrence of a Default under the Subscription Facility. This approach can be advantageous in certain Default scenarios, such as where the general partner has (or may have) committed fraud against the investors (thus creating an increased risk that the investors might be less likely to cooperate with the Fund in funding capital contributions).
5. INSTRUCT THE FUND TO ISSUE A CAPITAL CALL	While the Agent cannot always count on a cooperative Fund post-Default, in many cases (except, perhaps, where fraud has been committed and other similar events), the odds of a full recovery will likely be optimized if the Fund (or the general partner) itself issues a capital call in form and manner consistent with the Fund's (or the general partner's) standard practice. Many Subscription Facilities will specifically grant the Agent the right to instruct the Fund (or its general partner) to issue such a post-Default capital call as a stand-alone contractual remedy (in addition to the security interests granted in the collateral).
6. ISSUE A CAPITAL CALL VIA THE POWER OF ATTORNEY	If in possession of pre-signed capital call notices, the Agent may consider utilizing the power of attorney granted in the Subscription Facility documentation to deliver such capital call notices to the investors. Alternatively, the Agent could potentially use its power of attorney to prepare and sign capital call notices (as the Fund's attorney-in-fact). Using the power of attorney (instead of the collateral assignment, as described below) could prove useful in avoiding certain ERISA concerns relating to issues of privity between the Agent and the investors.
7. ISSUE A CAPITAL CALL VIA THE COLLATERAL ASSIGNMENT	In other circumstances, particularly where the Fund (or its general partner) has committed fraud against the investors, the investors may be more inclined to fund a capital call if such capital call is issued in the name of the Agent (as collateral assignee of the Fund).
8. PREPARE OVERCALL CAPITAL CALLS	If the Agent made a capital call, while such initial capital call is pending, the Agent should prepare a second set of capital call notices for use should a shortfall occur in connection with funding the initial capital call as a result of a defaulting or excused investor failing to fund all or a portion of its required capital contribution.

ACTION	COMMENTARY
9. ENACT DEFAULT REMEDIES AGAINST INVESTORS	The Agent can enforce (or leverage its right to enforce) the enumerated remedies set forth in the Fund's governing document against any defaulting investor. This course of action, however, likely should be a remedy of last resort (e.g., to be used if an overcall on the non-defaulting investors (to make up funding shortfalls due to defaulting or excused investors) is still insufficient to recoup all amounts due and owing to the Secured Parties), and the Agent should consult with counsel prior to any such enforcement.
10. TERMINATE THE REVOLVING COMMITMENTS	Terminating the revolving commitments will "term-out" the obligations.
11. ACCELERATE THE MATURITY DATE AND DECLARE ALL OBLIGATIONS DUE AND PAYABLE	Accelerating the Subscription Facility maturity date and declaring all obligations thereunder immediately due and payable will enable the Agent to demand prepayment of all obligations prior to the scheduled maturity or repayment date (which, as noted above, would help mitigate added risk during the process of enforcing rights and remedies following a Default).
12. APPLY THE ENFORCEMENT PROCEEDS	The Agent should allocate post-Default remedial proceeds received from the Fund in accordance with the enforcement waterfall found in the Subscription Facility documentation, including to cash collateralize letters of credit, to settle secured hedges and to pay expenses.
13. ENACT REMEDIES UNDER THE UCC, OFFSET LAWS AND OTHER APPLICABLE LAW	In the event available remedies contemplated in the Subscription Facility documentation (and as described above) do not adequately result in the Fund's full repayment of the Fund's obligations thereunder, the Agent should consider other possible remedies available under the UCC or other applicable law – including offset, litigation and pursuing relief under applicable insolvency laws.

Conclusion

While the Subscription Facility market has historically experienced very few instances of Defaults, and even fewer requiring the exercise of many of the above described remedies, Funds, Agents and Secured Parties should be familiar with available remedial options under Subscription Facility documentation and Fund constituent documentation following the occurrence of a Default. Although the table provided above sets forth a litany of such remedial options, some of those options may not be available or recommendable in any particular situation, and market participants should always consult with experienced counsel to effectively manage a Default without exposing themselves to undue risk or liability. ◆

Endnotes

1 Under UCC § 9-310, a financing statement must be filed to perfect all security interests (other than those security interests perfected via a different method (e.g., via control) expressly enumerated in the UCC).

2 Under UCC § 9-314, a security interest in a Collateral Account may be perfected by control (e.g., if the Collateral Account is a deposit account, the Agent has a perfected security interest in the Collateral Account if the Collateral Account (1) is held at and maintained with the Agent; (2) the Fund, the Agent and the account bank have agreed in an authenticated record that the account bank will comply with instructions originated by the Agent directing disposition of the funds in the Collateral Account without further consent by the Fund or (3) the Agent becomes the account bank's customer with respect to the Collateral Account).

Forms of Credit Support in Fund Finance

In the fund finance market, there are a wide array of financing structures that are utilized by private investment funds ("Funds") to improve liquidity and/or obtain leverage and a variety of collateral and credit support packages that lenders rely upon for repayment.[1]

While the fund finance market has unique characteristics when compared to other types of corporate borrowers, the types of credit support used by Funds and lenders have much in common with traditional lending facilities and rely heavily on tried and true lending instruments. This article will examine three types of credit support commonly used in the fund finance market: (i) the unfunded equity capital commitments of limited partners of a Fund ("Capital Commitments"), (ii) a guaranty ("Guaranty") and (iii) an equity commitment letter ("ECL"). Each of these forms of credit support are broadly accepted cornerstones of fund finance that provide a suitable and reliable means by which a Fund can access debt while providing a lender with an enhanced credit profile in any transaction.

Capital Commitments

Perhaps the most well-known type of credit support in the fund finance market is the unfunded Capital Commitments of third-party investors in a Fund. Under a subscription-backed credit facility or a capital call facility ("Subscription Facility"), a Fund and its general partner pledge (a) the rights to the unfunded Capital Commitments of the limited partners, (b) the right of the general partner of the Fund to make a call ("Capital Call") upon the unfunded Capital Commitments of the limited partners after an event of default and to enforce the payment thereof pursuant to the terms of the partnership agreement, and (c) the account into which the limited partners fund capital contributions in response to a Capital Call, in each case in order to secure the obligations of the Fund owing to a lender.[2] Upon a default by the Fund under the Subscription Facility, a lender may enforce the right of the general partner of the Fund to make a Capital Call upon the unfunded Capital Commitments of the limited partners and require the payment of capital contributions pursuant to the terms of the

partnership agreement. As contrasted with other types of credit support, such as a Guaranty, the obligation of the limited partners to honor their Capital Commitments and make capital contributions in response to a Capital Call will run directly in favor of the Fund as opposed to the lender.

Capital Commitments, however, do not necessarily need to be pledged as collateral in support of repayment obligations and can be used as credit support in facilities that are not a standard Subscription Facility. For instance, in connection with a Fund level credit facility that is secured by all or a portion of the Fund's underlying investment portfolio, the collateral pledged by the Fund may consist of deposit or securities accounts or the equity shares held by the Fund in a portfolio company and various rights relating thereto. For these types of facilities, the unfunded Capital Commitments may be viewed by a lender as a potential source of repayment rather than as a direct part of the collateral. To support this view, the loan documents for such a facility may include representations, warranties and covenants related to the amount of unfunded Capital Commitments that must be maintained by the Fund for the duration of the facility, with the expectation that if the underlying assets of the Fund are insufficient to repay the facility, there is another liquid and substantive source of repayment that the Fund may rely upon. This type of credit support may provide the Fund with needed flexibility to avoid placing a lien on the Capital Commitments, which may in fact be prohibited under the terms of the partnership agreement, while allowing a lender to rely on the Fund's access to the Capital Commitments as a potential source of repayment. Using Capital Commitments as credit enhancement may provide a Fund with significant debt opportunities while at the same time bolstering its credit profile in the eyes of a lender.

Guaranties

A second type of credit support commonly used in the fund finance market is a Guaranty. A Guaranty is an agreement by one entity ("Guarantor") in favor of a lender to support the repayment by a principal obligor of its outstanding obligations to such lender in connection with a credit facility. The Guarantor is most commonly a Fund that provides a Guaranty in support of the obligations incurred by one of its subsidiaries or portfolio companies, but a Guaranty may also be provided by a sponsor, a feeder fund or portfolio company, in each case to support repayment by the Fund of its obligations. Guaranties have wide applications in the fund finance market, and the use of a Guaranty may be preferable in a scenario where a portfolio company incurs debt but does not itself have the ability to call upon the unfunded Capital Commitments of the parent Fund. The Fund may agree to provide a Guaranty in such instance in order to provide the appropriate amount of credit support requested by the lender to support the repayment obligations of the portfolio company. The obligation of the Guarantor to make payments under a Guaranty on behalf of the principal obligor, should it default on its obligations, runs directly in favor of the lender.

There are several types of Guaranties employed in the fund finance market, and they will vary both in scope of the guaranteed obligations and the liability of the Guarantor thereunder. The scope of a "bad-boy" Guaranty, for instance, is typically limited to losses incurred due to certain bad-acts or material misrepresentations made by the general partner of a Fund under a credit facility, but will not be triggered by the Fund's financial ability to make payments to the lender. Payments from the Guarantor under a "bad-boy" Guaranty will only be required if the loss results directly from the bad-act or false misrepresentation specifically covered by the terms of such Guaranty. Whether a Guaranty is a guaranty of payment versus a guaranty of collection is another distinction. A guaranty of payment will typically be an absolute and unconditional

Guaranty that permits the lender to seek payment directly from the Guarantor without any obligation to first seek payment from the principal obligor. A guaranty of collection, also known as a conditional guaranty, will require that the lender exhaust its remedies against the principal obligor (including, without limitation, foreclosing on any collateral) prior to seeking payment from the Guarantor. Under New York law, a guaranty of payment is presumed unless the parties have otherwise explicitly agreed that the Guaranty is a guaranty of collection.[3]

The relationship of the Guarantor to the principal obligor is as important as the substance of the Guaranty itself. Upstream guaranties (i.e., a Guaranty given by a subsidiary of a Fund), cross-stream guaranties (i.e., a Guaranty given by a sister entity or other affiliate of a Fund) or downstream/parent guaranties (i.e., a Guaranty given by a Fund to support a portfolio company) are all potential types of Guaranties that may be employed in the fund finance market. Understanding the nexus between the Guarantor and the principal obligor will allow a lender to assess the validity of a Guaranty and whether the Guarantor has received adequate and fair consideration in exchange for providing the Guaranty. This analysis is fundamental to the enforceability of the Guaranty, is particularly relevant in respect of an upstream or cross-stream Guaranty, and will be necessary to help avoid any fraudulent transfer defenses that other creditors of a Guarantor may invoke if a Guarantor is later deemed insolvent after making a payment under the Guaranty.[4] Experienced legal counsel can assist both Funds and lenders in navigating the specifics of using a Guaranty as credit support.

Equity Commitment Letters

A third commonly used form of credit support in the fund finance market is an ECL. An ECL is an agreement that evidences a commitment to contribute capital or other financial support by one entity (the "ECL Provider") in favor of another entity (the "ECL Recipient") and may be used to demonstrate to a lender that the ECL Recipient has additional resources for the repayment of its obligations under a credit facility.[5] Use of an ECL may be more expedient or efficient in some instances than arranging for other types of credit support and provide a potentially significant credit enhancement. ECLs have broad application in the fund finance market, but the most common scenario for employing an ECL is when a Fund issues an ECL in favor of one of its portfolio companies to support repayment of debt incurred by such portfolio company. A lender may be wary of relying strictly on the performance of a portfolio company for purposes of repayment, and the use of an ECL by a Fund in this instance will provide added comfort to the lender that there are additional sources of repayment available to the portfolio company. There are a variety of applications for an ECL, and the use thereof does not need to be limited to the Fund/portfolio company scenario described here for illustration.

An ECL should be distinguished from other similar arrangements, such as a keepwell agreement, pursuant to which a sponsor may undertake to monitor and safeguard the financial health of a Fund, or a letter of support/comfort letter, the purpose of which is to provide a lender with some assurance that a Fund will be able to meet its obligations to such lender. In the fund finance market, an ECL should be viewed as a *commitment* by the ECL Provider to contribute capital to the ECL Recipient and stands in contrast to a keepwell agreement or letter of support/comfort letter that are merely statements of *intent* rather than an actual commitment to undertake financial support. The obligation of the ECL Provider to contribute capital under and pursuant to the terms of the ECL runs in favor of the ECL Recipient, with only the ECL Recipient having the right to enforce the terms of the ECL. A lender, however, may be specifically designated as a third-party

beneficiary under the terms of the ECL, and the rights of the ECL Recipient under and pursuant to the ECL can also be collaterally assigned to a lender under a credit facility.

Each ECL is a bespoke instrument that implements the specific level of credit support required and the conditions under which such credit support will be available. For purposes of the fund finance market, an ECL will also likely include, among other things, waivers of defenses, counterclaims and offset rights (including with respect to those rights arising under the US Bankruptcy Code that may pertain to a bankrupt ECL Recipient) in respect of the ECL Provider's obligation to contribute capital to the ECL Recipient and other suretyship-related defenses that may be available to an ECL Provider under applicable law. Experienced legal counsel can assist both Funds and lenders in tailoring an ECL to achieve the necessary level of credit support while ensuring that it is distinguishable from other types of credit support.

Comparing Capital Commitments, Guaranties and ECLs

While Capital Commitments, Guaranties and ECLs can each be used as credit support in the fund finance market, the nuances specific to each type of credit support will dictate the effectiveness of the applicable credit support when applied to a specific lending arrangement.

As noted above, the use of unfunded Capital Commitments as credit support (as opposed to being pledged to the lender as collateral under a Subscription Facility) will run in favor of the Fund. The lender, by placing parameters around maintaining a certain level of unfunded Capital Commitments, is effectively relying on a liquidity test and ensuring that capital will be available to the Fund in order to repay indebtedness owed the lender. The lender will not have the ability, however, to enforce the payment of the unfunded Capital Commitments when used simply as credit support as opposed to collateral. In contrast, a Guaranty is credit support that runs in favor of the lender and allows the lender to seek payment directly from the Guarantor. With direct recourse to the Guarantor under a Guaranty, a lender will effectively have two sources of repayment – the principal obligor and the Guarantor. An ECL will artificially create two sources of repayment (the ECL Recipient and the ECL Provider), but the ECL will only run directly in favor of the ECL Recipient. The use of a collateral assignment of an ECL, however, will permit the lender to enforce the terms of the ECL on behalf of the ECL Recipient.

Conclusion

The use of Capital Commitments, Guaranties and ECLs are all appropriate ways to provide credit enhancement in the fund finance market and can be utilized effectively in numerous situations. Each of these types of credit support, while tailored to the particular characteristics of fund finance, are not novel to fund finance and are widely accepted forms of credit support in lending generally. Despite the prevalent use of these forms of credit support, the effectiveness of the credit enhancement and the strength of the credit support provided thereby must be determined on a case-by-case basis. The strengths and weaknesses of Capital Commitments, Guaranties and ECLs must be determined by analyzing a variety of factors including the proposed credit structure, the supporting documentation and the specific language included therein. Only after a detailed review can any of these forms of credit support be viewed as the preferred solution in a given financing. When used properly and with the assistance of experienced legal counsel, each method of credit support can provide a creative solution that delivers needed access to debt and liquidity for a Fund and appropriate credit support for a risk-averse lender. ◆

Endnotes

[1] For a detailed update on current trends and developments in the fund finance market, please see Mayer Brown's *Spring 2018 Market Review*, on page 285.

[2] For a more detailed description of the subscription facility market and features of the subscription-backed credit facility product in general, please see our article "*Fall 2016 Market Review*" in *Fund Finance Market Review,* Fall 2016 on page 195.

[3] NY Gen Oblig L § 15-701 (2016).

[4] See *Restatement (Third) of the Law of Suretyship and Guaranty § 9*.

[5] Equity commitment letters are often used in more traditional acquisition financings as evidence that the acquisition vehicle has sufficient funds to complete the acquisition but are equally effective in the fund finance market as a commitment to ensure repayment of the indebtedness incurred by a Fund or one of its portfolio companies.

Lending to Series Limited Liability Companies: Subscription Credit Facility Considerations

Introduction

As the private equity asset class continues to expand[1] and private equity fund managers respond to demand by investors for ever-more bespoke products and tailored investments, there has been an increase in the use of alternative fund structures to accommodate such demand. In addition to the proliferation of separate accounts, funds-of-one and co-investment structures, the use of vehicles that employ series, cell or other asset and liability segregation technology has increased, bringing with it opportunities and potential challenges when leverage at the fund or individual series level is sought.

The use of series in a limited liability company (a "Series LLC")[2] offers many potential benefits to a private equity fund (a "Fund") manager and its investors; however, for lenders interested in advancing credit to a Series LLC or a series thereof, it is important to understand how Series LLCs differ from traditional forms of limited liability entities. This article discusses the nature and benefits of Series Entities in the private equity context[3], as well as potential issues that lenders will want to take into account when considering advancing credit to a series under a Series Entities secured by investor capital commitments.[4]

Background

A Series LLC is generally created pursuant to the laws of the applicable jurisdiction of formation. A defining feature of a Series LLC is the ability to create an unlimited number of segregated subunits or series (each, a "Series") under the umbrella of a single "master" LLC (or LP), permitting each Series to have separate members, managers, equity interests, assets, liabilities and business objectives associated to it, with an internal liability shield as among the Series that is intended to be enforceable against creditors and other counterparties. This is in contrast to a traditional limited liability company, which may have different classes of members that have different rights, assets or liabilities associated with such class, but such internal organizational structure is not intended to impact the obligations and liability of the limited liability company as against creditors and counterparties.

At its heart, the Series structure promises the ability to segregate the assets and liabilities of each Series, such that the liabilities and other contractual obligations of any given Series may be enforced only against the assets of that particular Series and not the assets of any other Series or the "master" entity itself, so long as the relevant statutory formation and procedural requirements are met.[5] In this respect, a Series LLC with liability segregation promises owners the personal liability protection as against third parties of a limited liability company, while also permitting contractual flexibility to effectively create mini-LLCs under the Series LLC umbrella, whose activities are insulated from each other and the Series LLC itself. Thus, in the Fund context, each Series can have different investors, with different investment strategies and commitment periods associated with it, as if each Series was an individual stand-alone vehicle.

In the context of a Fund formed as a Series LLC, each Series may be governed by a common master Fund-level limited liability company (an "Operating Agreement"), or by both a Series-specific Operating Agreement (or supplement or addendum) and a master Fund-level Operating Agreement. Each such Operating Agreement may provide different operational, distribution, and membership mechanics with respect to each Series, and each Series may be administered by a separate manager, although the same manager (or general partner) is often used for all Series in a Series LLC. Funds may use Series LLC technology to facilitate establishment of different Investor commitment periods for each Series and to house separate investments in individual Series, thereby permitting investors to commit capital to the Fund for particular periods or specified uses.[6]

Other potential benefits to implementing a Series structure include reduced formation and administrative cost. In some States, use of a Series LLC allows a Fund to avoid registering multiple entities with the State of organization, maintaining multiple registered agents and filing multiple sets of annual reports and tax returns. Further, rather than requiring a Fund sponsor to form a new entity each time new investor capital is raised, the Fund's Operating Agreement may provide for the creation of additional Series from time to time. Funds that use a master Fund-level Operating Agreement to govern each Series may also reduce legal costs associated with the creation and negotiation of multiple fund vehicles and Operating Agreements. Aside from possible savings attributable to reduced long-term formation and start-up costs, use of Series Entities may result in minimized filing costs, State franchise fees and compliance costs as well as tax savings as compared to creating separate entities instead of Series of a Series LLC.

While there are many potential benefits to a Series LLC organizational structure, there may be risks in certain circumstances as well. There remains uncertainty as to the State and federal income tax treatment of Series Entities and the Series within a Series LLC, as well as their treatment for employment tax purposes.[7] In addition, as more fully described below, it is not clear whether the separate liability protection of a Series will be upheld by the courts of a State that has not enacted legislation providing for Series provisions for State law liability purposes.[8] Further, accountants, lawyers and other service providers may not have sufficient familiarity with the series structure to provide adequate advice on the unique issues that may arise in relation to a Series LLC.

Facility Structure and Loan Documentation; Special Considerations for Series Entities

The basic loan documentation for a Facility advanced to a Series under a Series LLC borrower is similar to the loan documentation typically used for a Fund that does not have a Series construct and will usually include the following: (a) a credit agreement that contains all of the terms of the loan, borrowing mechanics, conditions precedent, representations, warranties

and covenants, events of default and miscellaneous provisions typically found in a commercial credit agreement; (b) a promissory note; (c) a pledge or security agreement pursuant to which the Lender is granted a security interest in the Collateral; (d) account control agreement(s) over the account(s) into which investors fund Capital Contributions in response to a Capital Call to perfect the Lender's security interest therein and permit the Lender to block withdrawals from such account(s); (e) Uniform Commercial Code financing statements filed in respect of Article 9 collateral against the applicable debtors; and (f) other customary deliverables such as officer's certificates certifying as to the relevant organizational documents, resolutions and incumbency signatures, opinion letters and other diligence deliverables, as appropriate. While the basic loan documents required under a Facility made to a Series under a Series LLC are comparable to those under a Facility made to a traditional commingled Fund, there are a number of potential issues that should be considered during the underwriting and documentation process, as more fully described below.

A. OPERATING AGREEMENT PROVISIONS.

As with any Fund finance product, the Operating Agreement of a Series LLC will need to be scrutinized prior to execution of a Facility to ensure that the Operating Agreement contains adequate Facility-related provisions. In addition, because the assets and liabilities of a Series in a Series LLC are often intended to be separate and distinct from those of another Series and the Series LLC itself, the Lender will need to confirm whether the Operating Agreement adequately provides for such segregated liability. This is particularly important in determining the borrower structure, understanding which Capital Commitments are associated with (and thus available to) which Series, and assessing the potential impact on one Series of debt being incurred by another Series. For example, in the Operating Agreement for a Series LLC, one would expect to see prohibitions on the ability of the Fund manager to issue a Capital Call to, incur indebtedness on behalf of, or grant a security interest in the assets of, one Series to repay indebtedness incurred with respect to another Series. As such, the borrowing base for a Facility involving a Series LLC would need to be established on a Series-by-Series basis, with several liability among the Series. As described above, however, there are Funds that employ Series technology for reasons other than asset and liability segregation, in which case, a joint and several Series-borrower structure may be permissible, which would impact how a Lender underwrites a Facility.

B. STATE LAW; RECOGNITION BY COURTS; BANKRUPTCY CONSIDERATIONS.

A Lender that is considering offering a Facility to a Series of a Series LLC will want to understand whether the Fund's state of formation, as well as the governing law of the Facility, recognizes a Series LLC structure. The Series LLC was first recognized under Delaware law in 1996, and under current Delaware law, a Series is authorized, in its own name, to enter into contracts, hold assets, grant liens and security interests in those assets, and sue and be sued.[9] As of the date of publication of this article, however, only about a third of states recognize the Series LLC, and among the states that do, there is no uniformity in law.[10] In order for the segregation of assets and liabilities of a Series to be recognized, some states require specific legal hurdles to be cleared during the formation process, including the use of specific language applicable to the Series in the Operating Agreement, and some states require certain procedures to be maintained during the life of the Fund, such as the maintenance of separate books and records with respect to each Series. Other states, such as Illinois, require each Series to publically register with the state. Understanding the State's Series LLC statutes will help a Lender assess whether the necessary formalities have been observed by the Series LLC,

whether it is possible to structure a Facility to a Series of a Series LLC on a Series-by-Series basis and whether the Facility should contain statute-specific covenants.

As the Series LLC is a relatively new creature of state law, there is limited jurisprudence addressing the interrelation between states that have statutes that provide for the segregation of assets and liabilities between Series and those that do not, and it is not settled whether courts in states that do not have Series LLC statutes would recognize the segregation of assets and liabilities across Series formed under the laws of another state with a permitting statute. Further, the treatment of a Series LLC and the Series thereof under the US Bankruptcy Code is uncertain.[11] It is unclear whether Series may constitute a "debtor" under the Bankruptcy Code and thus if a Series may file bankruptcy independent of the Series LLC and other related Series, and whether a bankruptcy court would uphold the segregation of assets and liabilities if a Series related to a Series Borrower or the Series LLC itself was subject to a bankruptcy proceeding.[12]

In addition, a Lender should be aware that the application of the equitable doctrine of substantive consolidation could impact the outcome of a bankruptcy case involving a Series LLC. The substantive consolidation doctrine permits a Bankruptcy Court to disregard the separate legal existence of entities when they are determined to operate more as a single entity instead of as separate individual entities. Because the internal liability shield afforded by a Series LLC does not hold when a Series LLC fails to satisfy the statutory requirements for achieving separate liability, a Series LLC may be at greater risk for being substantively consolidated than individual limited liability companies that sit under a parent limited liability company.[13] As such, to minimize the risk of substantive consolidation, a Lender to a Series of a Series LLC will want to ensure that the Series borrower is acting in its own name (which is clearly identified in the Operating Agreement), is generally acting independently of each other Series), maintains separate books and records, does not commingle assets or prepare consolidated financial statements, and is not cross-accelerated, cross-guaranteed or cross-collateralized with any other Series or the Series LLC. Accordingly, it may be prudent for a Lender to require that the Operating Agreement of each Series and/or the Series LLC, and any debt instrument entered into by any Series or the Series LLC and a Lender, contain provisions (i) acknowledging the segregation of assets and liabilities between the Series, (ii) providing that a creditor has recourse only to the assets of the particular Series to which the debt relates and not to the assets of the Series LLC or any other Series, and (iii) providing that a creditor shall not be entitled to petition for the liquidation or bankruptcy of any Series or the Series LLC on the basis of the failure of a borrower Series to repay any debts or liabilities owing to a creditor. On the other hand, assuming no third-party creditor has a lien on the Capital Commitments related to any other Series, one can envision scenarios under which substantive consolidation resulting in elimination of the internal liability shields in a bankruptcy proceeding could potentially benefit a Facility Lender by increasing the pool of Investors upon which a Capital Call could be made to repay indebtedness. A review of the relevant state statues and case law may reveal that other state-specific provisions should also be included in the loan documentation for Facility to a Series.

C. SECURITY INTEREST AND PERFECTION MATTERS.

State law governing the formation of the Series LLC and the Series must be carefully considered in connection with secured Facilities, as such laws will inform what steps should be taken by a Lender to perfect its security interest in the Collateral. As a threshold issue, a Lender will need to confirm how the Capital Commitments are held, as Series LLC statutes often permit multiple alternatives; for example, the Capital

Commitments under the Operating Agreement may be held by the Series LLC itself, through a nominee or by a particular Series of the Series LLC, and if held by a Series, it is not always clear what the name of the Series may be. A Series may or may not be a legal person separate from its related Series LLC under the laws of its jurisdiction of formation; if the Series is not a separate legal person, then the Series possibly cannot be a "debtor" for purposes of Article 9 of the Uniform Commercial Code (the "UCC"). As a result, consideration should be given as to whether the Series LLC, in addition to the Series borrower itself, should be included as a grantor under the security and pledge documentation and in the related UCC financing statement filings.

Assuming the Series can be a "debtor" under Article 9 of the UCC, the Series may not necessarily be a separate "registered organization" for Article 9 purposes, unlike the Series LLC itself to which the Series is associated.[14] This is relevant for the UCC Article 9 rules for determining where to file a UCC financing statement and the legal name of the Series to use in a UCC filing. Under UCC Article 9, a "registered organization" is "located" for Article 9 purposes in the State of its jurisdiction of formation.[15] Thus, for example, a Lender would file a UCC against a Delaware limited liability company in Delaware; however, if the Delaware limited liability company is a Series LLC and the borrower Series has its sole place of business in New York, then it may be the case that a UCC filing against the Series should be in New York and not in Delaware.[16]

Further, the legal name of the Series to use for purposes of filing a UCC financing statement may be uncertain given the Lender may not be able to look to the "registered organization" naming rule (i.e., one looks to the registered organization's name as stated on the public organic record most recently filed with the organization's jurisdiction of formation (e.g., a certificate of formation for a Delaware limited liability company)). For example, if the Operating Agreement of ABC, LLC provides for Series 2018-1, is the legal name of such Series "ABC, LLC, Series 2018-1" or "Series 2018-1 of ABC, LLC" or "Series 2018-1"? In some cases, the Operating Agreement or certificate of formation of the Series LLC, as applicable, may refer to a Series in multiple ways. Because of such uncertainties, it may be prudent for a Lender to file multiple financing statements and require that the Fund specifically name each Series in the Operating Agreement and refer to each Series in a consistent way throughout the Operating Agreement and in its business dealings. In light of these ambiguities, careful legal analysis will be needed in order to ensure that the Lender's security interest in relation to a Series borrower is adequately granted and properly perfected. A Lender will also want to consider what legal opinions are feasible in light of the potential uncertainty around these collateral issues and what level of opinion comfort it will need in extending a Facility to a Series.

D. OTHER FACILITY CONSIDERATIONS.

As mentioned above, in connection with documenting a Facility, the Lender should consider whether Series-specific and statutory-related restrictions are appropriate. The parties may agree that the creation of a new Series or any change to the name or structure of an existing Series shall require Lender approval. The parties may also agree whether any new Series will require Lender approval as a general matter and also prior to such Series being added as a Borrower and receiving its own borrowing base under a Facility (as may be done in a legally several umbrella Facility structure). It is not unusual for such Facilities to include ongoing representations and warranties to be given by the Fund to the Lender as to various statements of fact relating to the operating of the Series to address the consideration and issues described above. In conceptualizing how to address some of the unique features of a Series LLC, Lenders may look to some of the

technology used in credit facilities to Irish collective asset-management vehicles and Cayman Islands-exempted segregated portfolio companies, which employ segregation technology not dissimilar to a Series LLC (albeit, under different legal regimes).

Conclusion

As more Fund sponsors consider implementing Series LLC structures because of the cost and administrative benefits they may offer, the number of Facilities featuring a Series LLC is likely to grow in the coming years. Lenders considering advancing a Facility to a Series of a Series LLC should be aware that there remains uncertainty surrounding the treatment of a Series under State law and the Bankruptcy Code but that there are techniques available to help mitigate the related risks. With adequate legal and credit due diligence and careful structuring, Lenders may be able to arrange credit Facilities to Series that meet the needs of its Fund clients while also adequately protecting the Lenders' downside credit risk.

Please feel free to contact the authors with questions regarding Facilities to Series LLCs or the various structuring alternatives and considerations attendant to such Facilities. ◆

Endnotes

1 *See*, e.g., *Private Capital: Record-Setting Pace in 2017,* Preqin Ltd., docs.preqin.com/press/Fundraising-2017.pdf.

2 Note that some states, including Delaware, also permit both limited partnerships and trusts to elect a series structure. *See Del. Code Annotated, Title 12, §3806(b), Del. Code Annotated, Title 17, §218.*

3 This article provides a basic overview of certain potential benefits and challenges of lending to Series LLCs. Specific reference to the enacting statutes of a particular jurisdiction and the terms of the constituent documents of a Series LLC borrower must be undertaken in assessing the suitability of lending to a Series LLC or any Series thereof. This article is not a comprehensive treatment of the subject.

4 By way of background, a subscription credit facility, also known as a capital call facility (a "Facility"), is a loan or line of credit made by a bank and other credit institutions (each, a "Lender") to a Fund that is secured by (a) the unfunded commitments (the "Capital Commitments") of the investors to fund capital contributions ("Capital Contributions") to the Fund when called from time to time by the Fund (or its general partner, managing member or manager (a "Manager")), (b) the rights of the Fund or its Manager to make a call (each, a "Capital Call") upon the Capital Commitments of the investors and the right to enforce payment of the same, and (c) the account into which investors fund Capital Contributions in response to a Capital Call (collectively, the "Collateral").

5 *See*, e.g., Del. Code Annotated, Title 6, §18-215(b), which requires that various corporate formalities be followed in order to establish a Series LLC and achieve asset and liability segregation, including the certificate of formation and Operating Agreement including notations as to the limitation of liabilities, maintenance of proper books and records, and accounting for the assets and liabilities of each Series on a separate basis.

6 There are numerous other potential applications of the Series construct in a Fund context. Series LLC technology may be used to facilitate co-investments and as a means to internally track revenue streams and asset allocations within a Fund. A Fund-of-one may use Series LLC mechanics to manage investment activities and annual spending with a particular manager, using, for example, a new Series corresponding to annual commitment periods or to cap Capital Commitments with respect to particular investments. In such cases, the need for a liability shield as between various Series within a particular Series LLC may or may not be a primary factor in selecting a Series LLC organizational type.

7 Proposed federal tax regulations have been promulgated but to date have not been finalized. Under Proposed Regulation §301.7701-1, 75 Fed. Reg. 55,699 (2010), each Series within a Series limited liability company agreement would be treated as a separate entity for federal income tax purposes and have its own classification for such purposes (e.g., a partnership, an association taxable as a corporation or disregarded).

8 For a comprehensive discussion of the subject, see Thomas E. Rutledge, *"To Boldly Go Where You Have Not Been Told You May Go: LLC, LLPs, and LLLPs in Interstate Transactions," 58 Baylor L. Rev 205 (Winter 2006).*

9 *See Del. Code. Sec. 18-215(c).*

10 At its annual conference meeting in July of 2017, the National Conference of Commissioners on Uniform State Laws approved a proposed uniform state law titled the "Uniform Protected Series Act," which is intended to allow assets within an LLC Series to be protected from the credit and other liability risks associated with assets owned by such LLC or other LLC Series. It remains to be seen how many States will enact Series legislation based on the proposed Uniform Protected Series Act.

11 For additional discussion, *see ABA Commercial Law Newsletter, "Secured Lending to Series of LLCs: Beware What You Do Not (and Cannot) Know,"* Norman M. Powell, November 16, 2015.

12 *Id.*

13 In comparison, in the situation of multiple separate

limited liability companies existing under a parent limited liability company, a court would undertake a veil-piercing/alter-ego analysis to determine if the separate legal existence of the limited liability companies should be disregarded. The factors considered by courts under the veil piercing/alter ego doctrine are often similar to those applied in a substantive consolidation analysis. A detailed discussion of the substantive consolidation doctrine is beyond the scope of this article.

[14] For a detailed discussion of these and related issues concerning the intersection of Article 9 and Series LLCs, *see "Dissonance in the Attempt to Harmonize LLC Series and Article 9,"* Norman M. Powell, UCC Law Journal, Vol. 46 (November 2015).

[15] *See UCC Official Text Section 9-307(e).*

[16] *See UCC Official Text Sections 9-307(b)(2)-(3)* .

Structural Changes in Hedge Fund Financing Transactions

A fund of hedge funds ("FoHF") is an investment vehicle that offers its investors exposure to a portfolio of hedge funds selected by the investment manager of the fund. The investment manager uses his/her knowledge, diligence and expertise to select and manage the hedge fund portfolio, saving his/her investors from the need and the operational and resource commitments to do so. In implementing their investment strategy, FoHFs often utilize financing transactions for various purposes, among them to provide leverage and liquidity. Regardless of purpose, because these funds have no natural life span, the financing transactions typically remain in place for lengthy periods of time. And because of their relatively long durations, these transactions often require amendments to accommodate changes to the fund, transaction or structure of the pledged collateral. While many such amendments are routine in nature and may require limited legal analysis, amendments related to, or arising out of, certain changes to the structure of the fund or its investment portfolio present potential legal issues that should be considered in detail.

Discussion

The hedge funds that comprise the investment portfolio of a FoHF typically offer liquidity only through redemptions, and these hedge funds have the ability to restrict redemptions upon certain events. During the 2008 financial crisis and the resultant reduction in the value and liquidity of investments in hedge funds generally[1], many FoHFs were faced with investor redemption requests and often restricted or delayed access to their hedge fund investments (through to the implementation of gates or the suspension of redemptions). Among other things, the crisis highlighted the importance of financing transactions to FoHFs as a tool to manage their liquidity requirements— such transactions could be drawn upon to meet investor redemption requests if a FoHF was unable or reluctant to redeem its underlying hedge fund investments. As a result, such funds now typically maintain financing transactions even if they are not pursuing a leveraged investment strategy, potentially for the duration of the fund. Given the many changes that such a fund can undergo during its life, these financing transactions often require amendment or modification, and such

amendments can be routine or they can be quite complex and present potential legal, regulatory, structural and other issues. This article will highlight some common changes to the structure of a financing transaction that present legal issues to be considered and addressed.

Change of Custodian

Most FoHFs hold their hedge fund portfolios through a third-party custodian (as opposed to holding the hedge funds directly), and this is especially true for funds with financing transactions in place. A typical FoHF financing transaction is secured by, among other things, a pledge of the fund's hedge fund portfolio. Having this portfolio held through a custodian in a securities account substantially simplifies the collateral structure and allows the bank[2] to perfect its security interest by entering into a control agreement with the custodian.[3] The custodian also serves as an institutional third party that the bank can rely on for reporting and to control ordinary-course investments, movements of cash and redemptions of the hedge fund portfolio (and ultimately to effect redemptions of the portfolio of hedge funds in the event the bank needs to enforce its remedies under a financing transaction following an event of default).

Because the custodian plays such a key role in these financing transactions, a proposed change of custodian by the fund raises issues that need to be properly considered and addressed (such as whether the bank will consent to the change), as well as the following:

- Many custodians that serve FoHFs have a global presence, so it is not uncommon for a change of custodian to result in a change of applicable law with respect to the bank's security interest[4], requiring local counsel in the new custodian's jurisdiction to be engaged and new security documents to be executed.
- Operationally, re-registering the hedge fund portfolio to the new custodian may take several months, during which time the bank will require a perfected security interest over the custody accounts at both the prior and new custodian (as well as reporting from both custodians during this time).
- The Hague Securities Convention, which became effective in the United States in April 2017, has been especially relevant for FoHF financing transactions due to both the nature of the pledged collateral and the global presence of the custodians that serve this market, as mentioned above. The Hague Securities Convention should be considered for any financing transaction, especially those with a non-US custodian (in part due to its "qualifying office" requirement).[5]

Change of Fund Structure

A change in the structure of the fund would typically take the form of the addition or removal of feeder funds and/or guarantors, which could involve a new jurisdiction (if any such entity was formed in a different jurisdiction). This could be requested in order to provide leverage or liquidity at the level of a feeder fund, to gain access to additional collateral or to facilitate derivatives transactions (such as foreign-exchange transactions) at a feeder fund. While not as common as adding or removing an entity, a change of jurisdiction of the fund could be requested by the fund. Such a change with respect to the fund may be sought as a way to increase the investor base available to the fund. Some issues to be considered here include:

- The ability of an entity to provide a guaranty, or the extent of such guaranty, may be limited and/or restricted (and, even if not strictly limited, may raise fiduciary concerns that should be considered). In addition, certain jurisdictions impose additional requirements with respect to guaranties.
- Because of the affiliation between a feeder fund and a master fund, a pledge consent is typically obtained from the master fund (if the feeder fund is pledging its master fund shares), and such consent may grant other rights to the bank (which again may raise

fiduciary concerns that should be considered). Whether any additional security is required (such as a guaranty from the master fund) will need to be determined.

- Certain jurisdictions require funds to engage a local custodian. To the extent the fund wishes to continue to use its existing custodian, a sub-custody arrangement may be requested by the fund, which raises the points mentioned under "Change of Custodian" above.

Change of Form of Transaction

A change to the form of the financing transaction (for example, from a note purchase or a derivative transaction to a credit facility) is not common and, when it does occur, it is typically at the request of the bank, most commonly in response to regulatory requirements or the transfer of the transaction to a different group within the bank. One example that led to such changes was the implementation of the Dodd-Frank Act, which affected certain FoHF financing transactions that were in the form of derivatives transactions.

Another change to be considered here is the addition or replacement of a bank in the transaction. Because financing transactions with FoHFs have traditionally been in the form of bilateral or occasionally club transactions, the financing documents do not always include the mechanics to easily add or replace a bank.

- While a change to the form of a financing transaction presents a number of issues, one in particular to highlight here is the security interest of the bank. To the extent the pledged collateral remains the same (which may not be the case if the original transaction was a derivative transaction where the bank owned the hedge fund portfolio), the bank will want to maintain the priority of its security interest (or put in place a new or revised security interest, if necessary).[6]
- A principal consideration when adding or replacing a bank is whether all banks will be party to the same financing agreement. While utilizing a single financing agreement (with an agent to act on behalf of the banks) may be mechanically simpler, the banks may wish to employ their own collateral valuation models and/or have different pricing and other terms and therefore prefer separate agreements (and the fund may also prefer separate agreements for similar reasons), necessitating an intercreditor agreement and/or some form of sharing or segregation of the fund's hedge fund portfolio as collateral.

Other Matters Requiring Consideration

While this article has focused on structural changes to financing transactions, there are other changes that arise in order to maintain such long-dated transactions that should be mentioned as well. To note just a few, these include: (i) facility increases (due to, e.g., organic growth of the fund or an increase in the use of leverage); (ii) maturity extensions (to keep the facility in place); (iii) revisions to investment guidelines and/or haircut models (e.g., to accommodate changes in the portfolio of hedge funds); and (iv) breach cures (e.g., to reflect changes in the collateral or the operations of the fund over time). While these changes tend to be relatively routine and often require a simple amendment, procedures and/or responsibilities should be put in place to ensure that these changes are properly authorized and addressed in a timely and proper manner and to ensure that any legal issues that may arise are identified and considered.

Finally, there is one last point that should be noted with respect to amendments to transactions. The form of the amendment to address any of the matters raised herein can affect the rights of the parties to these transactions. Care should be taken to ensure that the amendment does not constitute a novation of the existing transaction (unless this is desired), especially if any agreements are being amended and restated, as this could result in the termination of the related security interest.[7]

Conclusion

Financing transactions with FoHFs can be an attractive product. For the funds, they can address liquidity and leverage requirements and can be used to facilitate transactions such as derivatives that would otherwise require the fund to hold cash. As for the bank, as these transactions often remain in place for as long as the fund itself remains active, they can provide long-term relationships with funds and fund managers. However, they require attention and maintenance to address the needs and changes of the fund and to protect the security interest, and other benefits, of the bank providing the financing. ◆

Endnotes

1 Hedge fund industry assets under management (AUM) decreased from more than $2 trillion in 2007 to less than $1.5 trillion in 2008. Hedge fund AUM remained below $2 trillion until late 2013. BarclayHedge – Hedge Fund Industry Assets Under Management – Historical Growth of Assets.

2 FoHF financing transactions take the form of, among others, credit facilities, note issuances and derivative transactions. For ease of presentation, this article generally discusses credit facilities—most issues presented herein are relevant to each of these transaction forms.

3 See the Mayer Brown article *"Fund of Funds Financing: Secondary Facilities for PE Funds and Hedge Funds"* on page 201, for a discussion of the pledge of a securities account holding assets that may be subject to transfer restrictions.

4 Because the pledged asset is the fund's custody account and the rights related thereto, a pledge under the law of the custodian's jurisdiction is usually required.

5 See www.mayerbrown.com/files/Publication/4aaa2cb9-a25f-4b4f-aa79-d282bc9d4032/Presentation/PublicationAttachment/3307e5af-af83-4ec9-847c-dad50de4cf9c/170511-UPDATE-BF-Lending-FundFinance.pdf for a discussion of the Hague Securities Convention, which includes the requirement to maintain a qualifying office.

6 See www.mayerbrown.com/Amended-and-Restated-Financing-Agreement-Should-Clearly-State-If-Not-Intended-as-Novation-11-29-2016/ for a discussion relating to maintenance of security interests.

7 See ibid for a discussion relating to amending and restating financing transactions.

Unencumbered Asset Pool Credit Facilities: An Alternative to Subscription, NAV and Hybrid Products

Introduction

As the fund finance market continues to expand, we have seen a growing interest among real estate and other private equity funds (each, a "Fund") in unleashing the value of their assets to optimize investment returns. In order to meet the financing needs of these Funds, a growing number of banks and other credit institutions (each, a "Lender") are providing credit facility products supported by a pool of the Fund's unencumbered assets (each a "UAP Facility"). While loan availability under UAP Facilities is most often based on the value of a Fund's unencumbered real properties, recently we have seen unencumbered private equity assets serve as a basis of loan availability in an increasing number of transactions. In light of this trend, this article will discuss common features of UAP Facilities and compare UAP Facilities to subscription-backed credit facilities (also known as "capital call" or "capital commitment" facilities, and each a "Subscription Facility"), net asset value credit facilities (each a "NAV Facility") and hybrid credit facilities (each a "Hybrid Facility").

Common Features of Subscription Facilities, NAV Facilities and Hybrid Facilities

Loan availability under a Subscription Facility is subject to a borrowing base, which is typically tied to the value of the pledged uncalled capital commitments of investors satisfying certain eligibility requirements, multiplied by an advance rate. Subscription facilities commonly outline certain events (e.g., investor bankruptcy, failure to fund capital contributions, withdrawal or excuse rights) that exclude investors from the borrowing base calculation. In connection with a Subscription Facility, a Lender will customarily receive a pledge by the Fund and its general partner of their respective rights: (1) in and to unfunded capital commitments of the investors in the Fund; (2) to make capital calls and enforce the obligations of the investors to contribute capital; and (3) to the deposit accounts into which the investors are required to fund their capital contributions.

In contrast to Subscription Credit Facilities (which look "up" to capital commitments of investors to determine loan amount availability), NAV Facilities look "down" to

the net asset value of the underlying portfolio investments of the Fund in determining borrowing availability. Consequently, NAV Facilities may be particularly useful for mature Funds in which the investors have already funded a majority of their capital commitments and the Fund has deployed this equity for purposes of assembling a portfolio of investments. Loan availability under a NAV Facility is customarily limited to the net asset value of the "Eligible Investments," multiplied by an advance rate, subject to certain adjustments and limitations. Similar to Subscription Facilities, Lenders under a NAV Facility will typically impose certain eligibility criteria when determining which Eligible Investments to include in the borrowing base (including considerations based upon investment strategy, liquidity and diversification of investments), and ongoing inclusion is subject to the absence of specified adverse credit/exclusion events (e.g., liens, bankruptcy or insolvency events with respect to the investments; failure by the Fund or portfolio company to pay obligations; breaches of material contracts with respect to the investments; etc.). Although some Lenders will consider NAV Facilities on an unsecured basis in the case of high-quality asset classes, most Lenders will require a pledge of collateral that typically includes: (1) distributions and liquidation proceeds from the Fund's portfolio investments; (2) equity interests of holding companies through which the Fund holds such investments; and (3) in certain cases, equity interests relating to the investments themselves.[1]

Hybrid Facilities represent a combination of the collateral characteristics supporting Subscription Facilities and NAV Facilities an approach that allows Funds and Lenders maximum flexibility in structuring the credit facility. And although Hybrid Facilities were originally utilized by Funds nearing the end of their investment period (and following the accumulation of portfolio investments), they are now also being put in place at the time of the initial investor closing to provide seamless funding throughout a Fund's lifecycle. In determining loan availability under a Hybrid Facility, Lenders will typically look down to the net asset value of the underlying portfolio investments of the Fund, as they would in a NAV Facility; however, unlike a NAV Facility, Hybrid Facilities almost always include a borrowing base component tied to undrawn investor commitments and covenants that ensure there is a sufficient surplus of uncalled capital commitments. As a result, hybrid facility Lenders typically coordinate between product groups and share institutional knowledge in order to provide bespoke collateral support solutions in the form of uncalled capital commitments and a pool of known and potentially unknown portfolio assets (as proceeds from the Hybrid Facility may be used to purchase these assets). And because support for a Hybrid Facility is typically made up of some combination of the collateral pledged under Subscription Facilities and NAV Facilities, both Lenders and Funds are able to craft customized liquidity solutions based on the availability and suitability of such collateral.

Common Features of UAP Facilities

Unlike Subscription Facilities (which look to the uncalled capital commitments of certain investors) or NAV Facilities and Hybrid Facilities (which primarily look to the net asset value of Eligible Investments), UAP Facilities look to the value of a subset or pool of the Fund's and/or its affiliates unencumbered assets to determine loan availability and are unsecured. Lenders will only give borrowing base credit with respect to assets that are unencumbered, meaning the assets are free and clear of all secured indebtedness and liens and encumbrances, and the value of such assets is typically multiplied by an advance rate and subject to certain deal-specific adjustments. Similar to Subscription Credit Facilities, NAV Facilities and Hybrid Facilities, Lenders will often impose additional borrowing base eligibility requirements when determining loan availability under a UAP Facility. For example, in a UAP Facility where the unencumbered asset pool is real

estate, common eligibility criteria include requirements that: (1) the owner of the property has no secured or unsecured indebtedness with respect to the property, subject to certain carve-outs; (2) the owner of the property has the rights to create liens on the property to secure its indebtedness and to sell, transfer or otherwise dispose of the property; (3) the property is fully developed and the improvements thereon are completed; (4) the property is wholly owned by the Fund or an affiliate thereof; (5) the property is located within a specific geographic area; and (6) the property is in compliance with laws and regulations and is free from major architectural deficiencies, title defects, environmental conditions or other adverse matters. Likewise, UAP Facilities typically provide mechanics for removal of unencumbered assets that may cease to satisfy the eligibility criteria and addition of unencumbered assets that meet the eligibility requirements after the closing of the facility.

The ability to add and remove assets from the availability pool provides the Fund with tremendous flexibility relating to its financing options for such assets. In many cases, a Fund may utilize a UAP Facility during the process of acquiring a portfolio of investments due to the efficiency of adding assets to the line. Thereafter, a Fund may optimize individual asset pricing and liquidity by negotiating secured financing terms (and simply removing the asset from the UAP Facility pool). And although UAP Facilities are commonly comprised of unencumbered real estate assets, in recent years we have also seen Lenders extend credit to Funds and their affiliates based on the net asset value of unencumbered private equity assets. The borrowing base for these UAP Facilities have included pools of equity interests in a Fund or portfolio company, portfolio company indebtedness and equity securities issued by an entity in connection with collateralized loan obligations.

In terms of UAP Facility covenants, perhaps the most prominent provision is the negative pledge with respect to the unencumbered assets (meaning that the Fund and the other loan parties agree not to pledge the unencumbered assets receiving borrowing base credit to secure indebtedness). And unlike a NAV Facility, which will typically prohibit liens on all assets of the Fund and its affiliates (subject to specific carve-outs), the negative pledge featured in a UAP facility is customarily limited to the unencumbered assets receiving borrowing base credit and the equity of the entities holding such assets, thus affording the Fund and its affiliates the flexibility to encumber properties that are excluded from the borrowing base to meet ongoing business needs. UAP Facilities typically also include financial covenants applicable to the Fund and/or its affiliates, such as maximum leverage ratios, maximum indebtedness levels, minimum net worth, interest coverage, fixed charge coverage, etc. These covenants serve to give the Lender comfort as to the financial health of the applicable loan parties.

While the nature and extent of the collateral is a distinguishing feature of Subscription Credit Facilities, NAV Facilities and Hybrid Facilities, UAP Facilities, by contrast, are typically unsecured. As such, Lenders will often require each owner of the unencumbered assets included in the borrowing base to fully guaranty the obligations under the UAP Facility to the extent that such owner is not a direct borrower under the facility. UAP Facilities also often include specific financial covenants addressing the unencumbered assets used to support the borrowing base, such as minimum asset value, minimum number of assets and concentration limits with respect to such assets (e.g., no more than a certain percentage of the aggregate value of unencumbered assets is attributable to any single unencumbered asset or no more than a certain percentage of assets are located in a single jurisdiction). Some UAP Facilities include

a covenant that the Fund will grant a security interest in some or all of the unencumbered assets included in the borrowing base if certain performance metrics are not satisfied. Further, UAP Facilities may also be structured without a borrowing base, in which case the Lenders rely on financial and other covenants to monitor the asset pool and financial condition of the Fund.

Conclusion

As the fund finance market matures, Lenders and Funds continue to explore new and innovative ways to finance investments and otherwise obtain liquidity from existing pools of assets. Alongside the rise in NAV Facilities and Hybrid Facilities, we have seen a number of Funds in recent years seek out financing under UAP Facilities for a growing number of asset classes. Because UAP Facilities provide Funds with an alternative method for satisfying financing needs and optimizing returns for Fund Investors, we expect to see continued growth of these facilities in the coming years. ◆

Endnote

[1] For further discussion of NAV and Hybrid Facilities, see *"Net Asset Value Credit Facilities"* in the *Mayer Brown Fund Finance Market Review* Summer 2013, starting on page 44.

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