Fund Finance Market Review
Trends and Developments in the Subscription Credit Facility and Fund Finance Markets
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.
# Fund Finance Market Review

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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 its 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 13th 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 add an 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. 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. 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.

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 fundraising 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. Additionally, preliminary data show the IRRs for Asia-focused Funds exceeding those of European Funds for vintage years since 2010. 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 led 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. 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. 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.
13 For more proposed sample answers to these due diligence questions, see Model Responses to ILPA’s Subscription Credit Facility Due Diligence Questionnaire.
16 Preqin Private Capital at p.5.
17 Preqin Private Capital at p.5.
Benefits of Fund-Level Debt in Acquisition Finance

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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.

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.

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) 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](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](https://www.mayerbrown.com/files/Publication/96e93616-8f87-407c-ac3c-c0d151b512b3/Presentation/PublicationAttachment/b3947934-6123-45f9-9c2f-ce336d07be75/Subscription-Credit.pdf).

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

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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 recalculation 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.
Impact of Margin Regulations on Funds’ Foreign Currency Hedging Transactions

Bryan Barreras
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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?
  o Am I incorporated, or otherwise regulated, in the United States or the European Union?
  o Is our trading relationship completely offshore and, as a result, not in scope of the US Margin Rules and/or the EU Margin Rules?
  o 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)?
  o In addition to the US Margin Rules and the EU Margin Rules, can any other regimes also be relevant?
  o 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?
  o Is my counterparty a CFTC-registered Swap Dealer or a Major Swap Participant?
  o Am I a Financial End-User?

For US Margin Rules:
  o Is my counterparty an FC or an NFC? 
  o 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 EU?
  o 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–?

For EU Margin Rules:
  o Is my counterparty an FC or an NFC+?
  o 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 EU?

• Is the relevant transaction in scope?
  o Is the product that I am trading in scope of the relevant set of margin rules?
  o Are there any exemptions available?
  o Does the transaction include any features that would take it outside the scope of any relevant exemption?
  o If an exemption is available, is it time limited?

• How do I ensure compliance with the US Margin Rules or the EU Margin Rules?
  o Do I have the necessary documentation in place (such as the ISDA Master Agreement and an ISDA Credit Support Annex)?
  o Is the documentation fully compliant with the new requirements?
  o Are the shares in the master fund within the scope of eligible collateral?
  o 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?
  o Am I operationally able to comply with the relevant requirements?

Endnotes

1 For a detailed discussion of feeder funds and the issues they present and address, see https://m.mayerbrown.com/files/Publication/d0f?daab-933e-4e11-a4df-d0594c13caaf5/Presentation/PublicationAttachment/b0e5c136-1a4f-4227-ab04-e1e59aa8a207/Feeder-Funds-Spring-2016.pdf.
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.
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.

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.


For example, Japan, Canada, South Korea, Hong Kong, Australia and South Africa have implemented their own margin requirements.

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.

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.

Even though this is unlikely, the EU Margin Rules allow shares in certain types of funds as eligible collateral.

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

Kiel Bowen
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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.]

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[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.”*
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


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.


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

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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. 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).

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 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).

Practice Note on the New Cayman Island’s Beneficial Ownership Regime

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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 its 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.
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