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PREFACE

We are pleased to present the fourth edition of *Global Legal Insights – Fund Finance*, now well-known in the market as the "Pink Book". Cadwalader, Wickersham & Taft LLP is pleased to serve as the contributing editor.

The fund finance market has had quite the decade-long run. Many of our businesses and practices have expanded far beyond our initial visions. This growth has kept many of us very busy and created extensive opportunities, both for our firms and as individuals. Yet, very little complacency can be felt creeping into the market. Rather, the rate of innovation is accelerating and entrepreneurial thinking and new product development are at the forefront. We have tried to deliver this book with both aspects in mind: an appreciation of the market's successful past, along with optimism about future innovations.

In producing this edition, we have gathered the views and insights of the world's leading fund finance legal practitioners. They were asked to focus on new substance and product evolutions – we want each edition of this book to deliver fresh insight. We are very pleased with the end product. My sincere thank you to all of the authors for their contributions to making this book a success.

As with its predecessors, this book commences with 24 product- and market-oriented chapters. These chapters in many cases get to far greater depth than in prior editions. Then, 19 jurisdiction-specific updates follow. Our hope is that we have provided a comprehensive global update in a single volume.

My sincere thanks to Rory Smith, Andrew Schofield and the rest of the terrific team at Global Legal Group Ltd. You supported the fund finance market long before we became the cool kids. We appreciate all of your work publishing this book.

Next year will be the 5th edition of the Pink Book. Like all good things, this publication must evolve to stay relevant. Rory and I are working on several ideas in that regard. We would welcome your feedback on how we can make the Pink Book better.

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Michael C. Mascia
Cadwalader, Wickersham & Taft LLP

INTRODUCTION

Dear Industry Colleagues,

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

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

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

Our next event is the 10th Annual Global Fund Finance Symposium on February 12–14, 2020 at the Fontainebleau Hotel in Miami Beach. To celebrate this milestone anniversary as well as our industry's collective growth and successes, the FFA wanted to "go big" in Miami. With that in mind, we are so excited to have announced that our keynote speakers will include both Hillary Rodham Clinton and Earvin "Magic" Johnson. To have Secretary Clinton speaking in February during the massive run-up to the Democratic party primary elections throughout the spring is just going to be sensational. And Magic will be joining us the week of the NBA All-Star game in Chicago. It is so exciting for our industry and a great reflection on how far we have come to be able to attract speakers of this magnitude. With these headline speakers, our expectation is that attendance at the Symposium will increase materially this year. In fact, we hope our keynote speakers can help attract leaders at the banks, law firms and funds, so that our collective leadership can see how dynamic of an industry we have all built. We hope you can join us. For information on sponsorship or attendance, please email info@fundfinanceassociation.com, or visit our website at www.fundfinanceassociation.com.

Later in the year, the 6th Annual European Fund Finance Symposium is set to take place in London on July 8th and the 4th Annual Asia-Pacific Fund Finance Symposium follows in Singapore later in the year. We also have a host of other events in the planning stages with our Women in Fund Finance, Next Generation and Diversity initiatives. More details on these and other upcoming events are available on our website.

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

Sincerely,

Jeff Johnston, *Chairman*, Fund Finance Association

Hybrid and asset-backed fund finance facilities

Leon Stephenson
Reed Smith LLP

Overview

There has been substantial growth in the fund finance market over recent years, with more and more funds seeking subscription line or capital call facilities from lenders.

Capital call or subscription line facilities are debt facilities provided by lenders to funds where the recourse of the lender is to the uncalled investor commitments of the fund. The bank will generally provide a short-term facility to the fund to effectively bridge the commitments of the investors of the fund. Therefore, the bank's credit risk is on the investors of the fund and their obligations to provide monies to the fund when called upon to do so. This requires detailed credit analysis by the bank on the creditworthiness of the investors they are effectively lending against, usually carried out by assigning each investor a rating together with an advance rate against each investor. Many banks have been and are still entering this market.

With the rapid growth of these facilities, there have been substantial pressures on pricing as lenders compete between each other for this business. More recently, there has been a significant growth in the market for net asset value (NAV) or asset-backed facilities. These are fund finance facilities provided by lenders to the fund or to a special purpose vehicle (SPV) owned by the fund, that are not secured against the undrawn investor commitments, but rather the underlying cash flow and distributions that flow up from the underlying portfolio investments.

Therefore, lenders under these facilities are 'looking down' for recourse against the underlying investments rather than 'looking up' to the investor commitments. The credit analysis that is required to be undertaken by the banks for these types of facilities is very different from that needed for subscription line facilities. For pure asset-backed and NAV facilities, the creditworthiness of the investors of the fund is much less important than the value of the underlying assets.

Nevertheless, these asset-backed facilities are still provided to the same fund managers who are also looking for subscription line facilities, and therefore this is an opportunity for lenders to widen the products they currently provide and to deepen the relationships they have with their fund clients. Providing asset-backed facilities can allow lenders to continue to provide liquidity lines to their clients, even when the investment period of a fund has terminated and there are no uncalled capital commitments remaining. Very often, the pricing a lender can obtain for these NAV facilities is higher than for subscription line facilities, so there is a tendency in the market for traditional lenders of subscription line facilities to move into more asset-backed facilities.

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

There is a wide range of different funds focusing on different types of investments that may benefit from utilising such facilities. Secondary funds that acquire and hold limited partnership and other equity interests in funds can borrow from banks secured against the limited partnership interests that the secondary fund holds or is about to acquire.

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

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

There has also been a recent growth in NAV facilities being provided to real estate and infrastructure-focused funds. This usually involves teams at banks, who have traditionally been focused on financing against individual assets, now looking to provide financing against a portfolio of assets. In the real estate finance context, financing would take the form of a loan secured by a mortgage over the property and, in the infrastructure context, this would often be a project finance structure with security against the project cashflows and direct agreements in place at the asset level. If lenders already have a good understanding of the underlying assets, whether infrastructure or real estate, and can get their heads around lending higher up in the fund or corporate structure of the borrower, then there are real opportunities for these teams to provide portfolio-wide NAV financing against multiple real estate or infrastructure assets.

Although very different types of funds may utilise these facilities and for different purposes, the key characteristics of these facilities are that they are generally provided at the fund level or directly below the fund level, and the primary source of repayment will be from the underlying assets. The other difference between these NAV fund financing facilities and mezzanine or other holdco facilities is that the NAV fund finance facilities usually have recourse against the cashflows of all or a multitude of the underlying assets, whereas mezzanine facilities are often only provided to one underlying investment.

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

For secondary funds, it is important for a bank to ensure that it has direct rights to any distributions that are payable to the secondary fund from the limited partnership interest it holds. It may be commercially and legally difficult to get direct security over these limited partnership interests, so often security is just taken by the lender over the shares of a SPV entity that will be set up to hold all of the limited partnership interests the lender is lending against.

The typical structure would involve the secondary fund first establishing an SPV vehicle. If the limited partnership interests have not yet been acquired by the secondary fund, then this SPV vehicle would directly acquire the various limited partnership interests. If the limited partnership interests are already held directly by the secondary fund, then the secondary fund will attempt to transfer all of the limited partnership interests to be financed into a new SPV vehicle. The lender will then lend directly to the SPV and take security over the shares of the SPV, and over any bank accounts of the SPV into which distributions from the underlying limited partnership interests are paid. On enforcement, the lender will take control of the SPV and enforce over the SPV's bank accounts so that it will be the sole beneficiary of any distributions that are paid up to the SPV.

For direct lending funds, the lenders will usually take security over the benefit of the underlying loan portfolio (not too dissimilar to the security that may be granted to a lender under a CLO warehousing facility). The lenders will analyse the underlying loan portfolio of the fund to establish what level of loan-to-value ratio it can provide. There will be eligibility criteria that will need to be met for a particular loan to be included in the asset pool that the lender is lending against. The eligibility criteria may require that the underlying loan is senior-secured, not subject to any default, and is provided to an underlying borrower that has a minimum EBITDA located in a particular jurisdiction or geography.

Furthermore, there may be certain borrower concentration limits applied to the collateral assets, so that no group of loans with the same borrower (or affiliate of borrowers) can exceed a certain percentage of the whole portfolio of collateral assets. Often the lender will also want to limit the proportion of underlying borrowers of the loans that are in a particular industry. Some lenders structure these facilities as a loan facility; others as a note purchase facility not too dissimilar to a securitisation structure.

A lender may structure such facilities as a note purchase facility in order to facilitate its ability to sell down a portion of the debt to other noteholders who would like to participate. Certain lenders may not insist on security directly over the loans themselves, but rely on NAV covenants alone and blocked accounts into which the proceeds of such loans are paid. For these facilities, it is important to have strong undertakings on group entities to pay all proceeds into these accounts over which the lender has control. Other lenders will want direct asset security over the loans, which often is provided by way of a general floating charge or single security agreement over all of the assets.

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

For private equity funds, lenders often take security over the shares in the relevant holding companies of the private equity fund that acquired the underlying investments.

Usually, the lenders providing these facilities to private equity funds may be structurally subordinated to other lenders that have provided finance which is secured directly against the underlying portfolio companies. These facilities generally carry higher risk as the portfolio of assets is not as diversified as the facilities provided to direct lending and credit funds with diversified and numerous assets. These types of facilities may also be known as 'holdco' loans and essentially amount to mezzanine financing, albeit with recourse to cashflows from multiple rather than single investments. Providing financing to holdcos secured against the shares of the holdcos rather than the underlying assets of the portfolio companies means that the lender has less control over the assets of the portfolio assets, normally resulting in higher pricing of such loans.

However, for many private equity funds that invest in emerging markets (such as Africa or Central and Eastern Europe), it may be difficult to obtain competitive financing locally against the assets of each portfolio company situated in such jurisdictions. Therefore, it may be much more attractive to seek financing from lenders who are able to offer NAV facilities at the holding level, secured against cashflows of a number of portfolio companies, with the benefits that diversification provides. This is particularly interesting to lenders if the private equity fund has not put in place a lot of leverage at the portfolio company level. Although the underlying portfolio companies of these emerging markets funds may be located in the emerging markets themselves, it is very likely that the holding vehicles that sit between the fund and the portfolio companies are located in offshore jurisdictions with a more flexible and tested legal regime.

Structure and terms

Unlike subscription line and capital call facilities that typically take the form of a revolving credit facility, NAV and Asset-Backed Fund Finance Facilities usually take the form of term loan facilities. If the facility is being provided to allow for a certain liquidity event or to bridge a particular exit of one of the investments, then the tenor may be quite short (e.g. six months to 18 months). However, if the fund is entering into the facility shortly following fund-close as part of a leverage strategy, the facility will have a longer tenor, perhaps five years or more.

The key covenant in such facilities is the loan-to-value covenant (LTV). This is the financial ratio of the amount of the financial indebtedness of the borrower against the net asset value of the portfolio that will be securing the facility. For credit funds and secondary funds, LTV ratios range from 10% to as high as 60%, depending on the diversification of the underlying assets. Such facilities may contain an "LTV grid" which allows the borrower to benefit from higher LTV ratios, and therefore a higher facility amount provided by the lender in the event that more assets are placed into the portfolio. Likewise, the interest rate payable on the facility may decrease, the more diversified the portfolio.

The eligibility criteria of the portfolio (i.e. the list of conditions that need to apply to the underlying assets for them to be eligible for the purposes of lending against them) will often be listed in a schedule to the facility agreement. The lender may also require a veto right on the acquisition of the assets, although there is usually strong push-back from the fund on this. The fund will argue that it alone should decide which assets can be purchased and, as long as such assets comply with the eligibility criteria, the fund should be allowed to select which assets will serve as collateral assets. The existence of veto rights will be much more prevalent in NAV facilities to PE funds where the number and concentration of investments is likely to be much higher than a credit fund. If there were a clear and precise set of eligibility criteria for a financing to a credit fund, the fund would not expect the lender to then have a separate veto right on whether each new asset can be treated as eligible collateral.

These term loans often have cash-sweep and amortisation features, so that all or a portion of any distributions that are paid up to the borrower from the underlying investments go first to repay outstanding utilisations under the facility. The amount of such cash-sweep may vary depending on the LTV that exists at the point in time that such distribution is paid. There may be a specific obligation to sweep all available cash, or the lender may just rely on the LTV covenant compliance, so that a prepayment would only be needed if failure to do so would cause an LTV covenant breach.

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

As discussed previously, for NAV facilities to credit funds it is quite usual for just one overriding single security document taking security over all of the loan portfolio (notwithstanding different governing laws of the underlying loan agreements) to be entered into. However, if there is a high proportion of the NAV allocated to loans in a particular jurisdiction, it is then worth the borrower and lender discussing whether separate asset security should be taken in that local jurisdiction as well, to ensure valid and locally perfected security.

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

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

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

For facilities provided to direct lending and credit funds, the terms of the underlying loan agreements will need to be diligenced very carefully. The provisions relating to transfers and assignments of the loans (typically entitled "Changes to the Lenders") must be reviewed to see whether the underlying borrower has any consent or consultation rights prior to the fund transferring its loan to the lender on enforcement. In relation to facilities provided to private equity funds, if security has been granted over shares in a holding company that owns the underlying assets, it is important that no change-of-control provisions are triggered in senior facilities agreements or under material contracts entered into by the portfolio companies.

Even if the lender and borrower take the view that there are too many loan documents to be diligenced prior to entering into the facility, we would still strongly recommend that copies of all of the loan documents be made available to the lender prior to the putting in place of the NAV facility. If there is ever a default on the NAV facility in the future, the lender needs to be sure that it has the underlying documents, so that it knows where and how to enforce without breaching terms of the underlying loan agreements.

Furthermore, if the private equity fund does not own 100% of all of the assets but has joint venture arrangements with other third-party equity investors, then it is very important for the lenders to due-diligence any joint venture or shareholders' agreements that have been entered into. There may be restrictions on the ability of the joint venture shareholders (i.e. the private equity fund or one of its holding companies) to transfer its shareholding in the joint venture entity. Sometimes this can be worked around by inserting a wholly owned topco above the joint venture shareholder, and giving security to the lender over the shares in the newly formed topco. In any event, the provisions of these shareholders' agreements need to be looked at very carefully.

There may also be confidentiality restrictions in the shareholders' agreements that prevent disclosure by the private equity fund to the lenders without the other joint venture parties' consent. If the private equity fund also has asset-level senior loan financing, then a NAV lender would also want to understand whether these senior loans contain change-of-control provisions that would require the underlying borrower to repay the senior facility in full. This is important because it may not be in the best interests of the NAV lender to enforce its share security and trigger a mandatory prepayment of any senior loan if the underlying portfolio company does not have available cash to repay it.

The lender will want to make sure there is tight security over the bank accounts into which the distributions from the underlying assets flow. More often than not, the lender will require a new account to be opened with it, and require the borrower to direct that all distributions be paid into this account. The lender needs to understand how distributions flow from the underlying operating companies up to the holding vehicles, and to ensure that cash is moved into an account secured in favour of the lender as soon as possible.

In some instances, lenders that are lending to a special purpose vehicle owned by the fund will require a guarantee or other shareholder support to be provided by the fund to further enhance the security for the asset-backed facility. However, lenders need to be careful and ensure that if this is the proposed structure, no borrowing limits of the fund are exceeded. Furthermore, if the fund has a subscription line facility, the terms of the subscription line finance documents will need to be reviewed to ensure there are no restrictions on other financial indebtedness and that there are no negative pledges included.

If there are borrowing and guaranteeing limits at the fund level, it may be that an equity commitment letter is provided to the NAV lender instead of a guarantee. An equity commitment letter (or ECL) is a letter that is addressed by the fund to the SPV borrower, pursuant to which the fund agrees that it will capitalise or provide funds to the SPV borrower as and when needed by the SPV borrower. Depending on the jurisdiction of the entities concerned and the way in which the ECL is drafted, this may not amount to a guarantee and so avoid breaching any guarantee limitations in the funds limited partnership agreement.

There has been a recent trend for some asset-backed/NAV lenders requiring second-ranking security/recourse to the undrawn commitments of investors. If the fund has, or is intending to also have, a subscription line lender provide financing to the fund, this can give rise to detailed discussions on intercreditor arrangements, with the subscription line provider and asset-backed lender negotiating to get the strongest position possible with respect to the fund's assets.

These intercreditor discussions focus on important issues like cross-defaults between the asset-backed facility and the subscription line facility; restrictions on payments going to and from the fund when there is a default under the asset-backed facility or the subscription line facility; and standstill periods during which one lender must wait until the other lender has decided whether to enforce. A more detailed discussion about so-called "hybrid" facilities is provided towards the end of this chapter.

Information

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

Valuations

These facilities typically have detailed provisions in relation to valuation of the underlying assets. An independent valuation agent may need to be appointed by the borrower (in agreement with the lender). The lender will usually want to make sure that the valuation agent owes a contractual duty to the lender (on a reliance basis) and this may be documented through a specific engagement letter with the valuation agent that is addressed to both the borrower and the lender, or through a separate reliance letter. The valuation agent will be required to provide periodic valuations (e.g. every quarter or, in some circumstances, every month) to the lender. There will also be times when the latest valuation will need to be used to determine a particular course of action under the facility agreement. For example, an LTV ratio may need to be determined prior to any acquisition or sale of an asset. Only if the LTV exceeds a given threshold will the relevant acquisition or sale of the collateral asset be permitted.

In addition, there will usually be provisions in the facility agreement that allow the lender to seek an alternative valuation if the lender does not agree with the valuation provided by the valuation agent or the fund. The amount of deviation needed between the lender's calculation of the value of the portfolio and that of the valuation agent may be negotiated between the borrower and the lender before the lender has the right to instruct a separate valuation. Sometimes the valuation methodology is set out in a schedule to the facility agreement so that the borrower and the lender agree the principles and terms on which the underlying assets are valued. There will be further discussions between the lender and the borrower about who should bear the cost of the valuation, and in what circumstances.

Some lenders do not wish for an independent valuation agent to be appointed, but instead prefer to value the assets themselves internally. If a lender has the experience and resources to do this, then it is clearly to the benefit of the lender. However, borrowers may have concerns about this and wish to provide for some objectivity on the lender's calculation. This may be resisted strongly by the lender, and lead to negotiations between the borrower and the lender to find a compromise position. The fund's starting point in relation to valuations will usually be that the lender should rely on the valuations that the fund provides to its investors. This may be fine for lenders, provided that it has a right to have the investments separately valued if it believes that the funds valuation is inaccurate.

Hedge funds and funds holding highly liquid assets

Asset-backed facilities to hedge funds are structured very differently from those asset-backed funds facilities provided to closed-ended funds such as secondary, direct lending and private equity funds. The hedge fund often segregates the investments it wishes to use as collateral into separate securities accounts with a bank. The securities intermediary that holds the investments becomes the legal owner of the investments by signing the relevant subscription agreements of the hedge fund. However, the hedge fund remains the beneficial owner of the investments.

The hedge fund then provides security over its entitlement or rights to the hedge fund investments, while the owner of the assets remains the same. This security can take the form of an account charge (if the account is in the UK) or a security agreement and control agreement (if the account is located in the US). This structure can avoid any restrictions on transfer that exist in respect of the underlying assets. If there is then a default under the facility agreement and the lender wants to be repaid, it can direct the account bank (as the case may be, in accordance with the control agreement or acknowledgment of the account charge signed by the account bank) to redeem the hedge fund interests, and for the proceeds once received to be paid over to the lender.

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

Securitisation regime

The European Securitisation Regulation, Regulation 2017/2402/EU (ESR), came into force from 1 January 2019. The ESR sets out certain obligations with respect to transactions which amount to a securitisation. There is a risk that some NAV facilities that are provided by lenders against loan assets could amount to securitisation transactions and therefore have the ESR applied to them. An analysis should be undertaken by the lender's and borrower's lawyers when commencing a NAV loan-on-loan transaction to establish at the outset whether the ESR applies.

The ESR is only intended to apply to entities established in the European Union, so borrowers established in Luxembourg and Ireland (two of the most popular jurisdictions for credit funds) could fall within the regulation. Part of the analysis will be to determine whether the repayments to the NAV lender are reliant only on the underlying cashflows from the loan assets, or whether it has recourse to other cash flows/assets (such as undrawn commitments of a fund).

If it is determined that the transaction does amount to a securitisation, then the NAV lender needs to ensure that there is a 5% interest (risk retention) retained by an entity referred to as an "original lender", "originator" or "sponsor" for the life of the securitisation. Furthermore, there are certain disclosure requirements that the NAV Borrower will need to fulfil to the NAV lender and the regulator, including the submission of a transaction summary prior to closing of the transaction and ongoing reporting using the applicable reporting templates. There are severe penalties on both the fund borrower and the NAV lender if they do not comply with the requirements of the ESR.

Key developments

There are an increasing number of new lenders entering this market, as the returns are generally higher than the returns available for subscription line and asset-backed facilities. These new entrants to the market are not only the existing banks that provide fund finance facilities, but also credit and special situations funds that are searching for sufficient yields.

A perfect example of where this product can prove highly desirable to a private equity fund is when there is some sort of urgent liquidity required at the fund level but there are no imminent distributions from portfolio investments foreseeable. A fund may need to make distributions to its investors to, for example, ensure such investors can make new investments into the fund managers' new fund. The lenders of these facilities (which are often established as funds themselves) may provide interesting financing structures that allow them to provide capital by obtaining preferred priority distribution rights in the waterfall set out in the limited partnership agreement of funds. This allows financing to be made available other than by way of debt at the fund level. Obtaining capital by way of preferred stock means that the finance provider effectively sits as preferred limited partner in the fund.

There has been some recent growth in the provision of these preferred share facilities. A number of new funds have been created recently to provide these facilities to other funds. They are most helpful at the end of the life of the fund, where borrowing limits in the partnership agreements prohibit additional debt at the fund level, and such facilities may be a tax-efficient way of getting additional capital to the end of life fund.

There are also credit and special situations funds providing NAV facilities who will lend directly to a subsidiary of the fund holding one asset, but then take a fund-level guarantee in order to have recourse to distributions coming up from other investments in the portfolio.

Therefore, having access to this liquidity can ensure fund managers continue to fundraise successfully. Alternatively, a follow-on expense or investment may need to be made by the fund. If its investor commitments are fully drawn, the fund may have an urgent and pressing need for short-term liquidity until distributions come up from the investment portfolio.

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

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

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

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

Hybrid facilities

There has been a continued increase in the use of 'hybrid' facilities. These are facilities provided by lenders that look down to the value of the underlying assets, but in almost all cases, there will be covenants that ensure there is sufficient headroom of undrawn investor commitments. These facilities are particularly useful to funds that are looking for long-term financing facilities that are available from the fund's first close until the end of the life of the fund, when all of its commitments have been fully drawn down and the fund is fully invested. A lot of banks have found it challenging to make such facilities available. This is mainly because different parts of banks will have expertise with respect to analysis of investor commitments and the value of the underlying assets, respectively. However, some banks have been very successful in having their CLO teams and fund finance/financial institutions teams collaborate closely together to allow this offering to be put forward to their fund clients.

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

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

We have seen the growth of hybrid facilities that are put in place when the fund is heavily invested but there are still some undrawn investor commitments remaining. The bank will provide financing against the underlying assets of the fund by way of term debt, but the fund may also need a working capital facility to finance fund expenses and follow-on investment.

One of the structures we have put together involves a tranche A facility that is a revolving credit facility of a modest amount to finance the fund expenses, and a tranche B facility that is a term loan facility of longer duration. If the fund already has an existing subscription provider who provides a facility of a relatively small amount (due to a limited number of undrawn investor commitments remaining), then it may make sense to 'take out' this subscription facility and replace it with the tranche A facility made available by a lender under the hybrid facility. This means that the fund only needs to deal with one fund finance provider, which may have cost and execution benefits to the fund. Many funds have the ability to recall capital distributed to the investors after the investment period. Some lenders are able to lend against this recallable capital and to treat it in the same way as undrawn commitments. In end-of-life hybrids, it is quite common for a lender to include this recallable capital in its borrowing base or LTV covenants.

Certain lenders are able to lend against a blended financial covenant that consists of a ratio of the total debt of the borrowers as against the aggregate value of: (i) the undrawn investor commitments; (ii) the NAV of the fund; and (iii) the total amount of cash held in accounts secured in favour of the lender. This provides a neat solution to a fund, which is able to utilise the facility at the start of the life of the fund when the investor commitments are large, but then continue to utilise it as investments are made and the NAV increases.

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

The year ahead

The range of these types of facilities will continue to grow as different funds with different strategies begin to realise the benefits of funds finance facilities that don't just look to the undrawn commitments of the funds. The arrival of Brexit, and other uncertainties in the economy, have caused many funds to hold investments for longer than they historically did. This increases the need for end-of-life funds finance, as such assets require continued follow on liquidity, and investors demand repayment of their interests in the fund.

Asset-backed facilities secured against diversified loan portfolios are fast becoming another structural way of lenders providing financing against such portfolio, and then distributing risk to investors that would typically invest in securitisation structures. Provided that the asset-backed facility allows lenders to freely transfer their commitments, it could be an alternative to, and potentially simpler than, undertaking a full securitisation programme. However, care needs to be taken to ensure that the European Securitisation Regulation is analysed and its obligations adhered to.

Hybrid facilities seem to be a perfect way for lenders to develop strong relationships with funds, and enable the lender to 'stay with them' from the start until the end of the fund's life, increasing the chances of the lender picking up ancillary business. There are certainly more lenders providing hybrid facilities, and who are able to lend against undrawn commitments and the value of the underlying assets. This trend is set to continue and should provide funds with more certainty around their fund-level financing throughout the life of the fund.

Finally, funds finance is much more prominent and understood by funds and an accepted norm by their investors. The increased number of lenders entering the market means that a variety of different fund financing solutions are available to meet the demands of the expanding fund industry.

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Subscription line lending: Due diligence by the numbers

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Introduction

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

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

The due diligence review described below focuses on a standard U.S.-based subscription line facility. Many fund structures include offshore (non-U.S.) entities. Consulting experienced counsel in each key jurisdiction is imperative, as offshore legal requirements may influence credit decisions. In the event that lenders and their fund customers are looking at a hybrid or NAV facility, the due diligence requirements will include those discussed below, but will expand into additional areas. For example, much more attention will be paid to the fund's investments. The required diligence for a hybrid or net asset value (NAV) facility will depend on the exact structure of the facility, and is beyond the scope of this article.

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

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

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

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

Generally speaking, the LPA sets forth the relationship between the fund, the general partner and the investors; the Obligor Organizational Documents determine the authority and the ability of the general partner and the other obligors to enter into the facility; and the Management Agreement governs the interaction between the management company and the fund.

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

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

- *Separate LPAs*. Each fund, including each alternative investment vehicle and parallel fund, will have its own LPA. Typically, the LPA for a fund starts out as a short form that is used to establish the fund in its chosen state or jurisdiction. In connection with the first closing of investors into a fund, the LPA is typically amended and restated to include specifics about the capital commitments, the capital call process, and the ability of the fund to enter into credit facilities and pledge fund assets, as well as specific provisions addressing concerns raised by investors. It is important to note that the LPA is a living document that likely will change with circumstances over the life of the fund, including future closings of investors into the fund.
- *Borrowing*. The LPA should clearly permit the fund to borrow (and, to the extent funds will be jointly and severally liable under the credit facility, guarantee the obligations of the other funds included in the credit facility). The LPA may include limitations on borrowings, including on the amount a fund may borrow, on the amount of time borrowings may remain outstanding under a credit facility, and on the permissible use of the borrowings. Each of these provisions should be reviewed and a determination made as to whether the credit agreement should expressly reference these limitations. Recent focus on the use of subscription lines by funds to enhance the internal rate of return (IRR) has brought more scrutiny by investors to the practice, and limitations on the term of borrowings in LPAs are now more common.

- *Capital commitments*. The LPA should contain an irrevocable commitment of the investors to fund capital when called (subject to certain limitations that may be set forth in the LPA or other governing documents), expressly allow the fund (or the related general partner) to call capital to repay borrowings, to pledge the unfunded capital commitments of the fund's investors, to assign the right to make capital calls and to enforce the obligations of the fund's investors to fund their capital commitments.

  In situations where the LPA does not expressly permit this pledge and assignment, the fund should confirm to the lenders that the fund's counsel will give a clean legal opinion on these powers or, in the alternative, the lenders should determine if an amendment to the LPA is necessary. If neither of those options is available, the investors (especially investors included in the borrowing base, if that is the intended loan structure) should be required to acknowledge and consent to the pledge and assignment. Of course, if the LPA expressly prohibits the assignment of the rights of the fund and the general partner, the LPA will need to be amended to eliminate the prohibition.
- *Waiver of counterclaim, defences and setoffs*. Lenders and their counsel should review the LPA for a waiver of counterclaim, defences and setoff from the investors. The inclusion of this provision in the LPA (or in the subscription agreement, where it may also appear) gives additional comfort to the lender that an investor will not (or that a court will not permit an investor to) deduct amounts the investor believes it is owed by the fund from the investor's required capital contributions under the LPA and the subscription agreement.
- *Third-party beneficiary provisions*. LPAs typically contain a provision that expressly prohibits those not party to the LPA from having the benefit of the provisions of the LPA. Lenders should seek to have the lenders and their agent under a credit facility carved out from that prohibition, so that they are third-party beneficiaries of the LPA. If the fund balks at such a broad carve-out, lenders should, at a minimum, seek modifications such that they are beneficiaries of the provisions governing the right to call capital, the right to enforce remedies against defaulting investors and the right to pledge assets to secure borrowings of the fund. The lenders may enforce the provisions of the LPA independently in their own capacities, which would supplement the general partner's assignment to the lenders of its rights under the LPA (whereby the lenders step into the shoes of the general partner upon a default to exercise those rights).
- *Investment period.* Generally, LPAs contain an investment period, during which the fund and the general partner have the ability to call capital from the investors for certain purposes. The review of the provisions governing the investment period should focus on when capital calls are permitted and for what purpose. A lender will want the right to call capital to repay fund indebtedness at all times, whether before or after the termination of the investment period. Some LPAs (whether because they are older-vintage LPAs or based on previous iterations of an LPA, or because of investor negotiation or otherwise) do not expressly permit capital calls to repay fund indebtedness after the expiration of the investment period, but instead permit capital calls only after the expiration of the investment period for follow-on investments, payment of fund expenses and for investments that have been committed to prior to the expiration of the investment period.
- *Investment period termination or suspension*. Lenders should review LPAs to determine in what circumstances their right to call capital or the investment period may be terminated. One provision that may impact the investment period is the so-

called key man provision, which provides that the investment period may be terminated or suspended if certain named individuals are no longer involved in the day-to-day operations of the fund. While an investor vote may reactivate the investment period under the terms of the LPA, the agreement may also provide that, in the period prior to that vote, capital calls are permitted only to the extent they would be permissible after the expiration of the investment period. Lenders should determine whether the termination or suspension of the investment period should result in a default of the subscription line, a suspension of borrowing or some other limitation on the credit facility.

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

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

Subscription agreements are generally form agreements entered into by each investor in a fund. Typically, an investor will subscribe to a fund as a limited partner, although an investor may also subscribe as a member or other equity holder, depending on the type of entity. No matter how an investor subscribes to a fund, the subscription agreement will provide key information regarding the investor, which a lender should confirm in its diligence review.

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

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

Remember to check for and review side letters

A side letter is an individual agreement between an investor and a fund that alters the general terms of the investor's investment in the fund by superseding some of the applicable terms in the LPA or subscription agreements, or by adding additional terms to the agreements and commitments between the fund and the investor. Certain investors require side letters because of regulatory or tax requirements that are specific to the investor. Other investors, particularly investors with large capital commitments, may request special economic or other benefits as a condition of their investment.

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

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

- *Sovereign immunity*. Government entities, such as public pensions and sovereign wealth funds, may have immunity from contract claims and other lawsuits unless they waive their immunity. Sovereign immunity provisions may provide for a waiver or may reserve the rights of such investors to waive their immunity. Some jurisdictions may not permit waivers of sovereign immunity except through legislation. Other jurisdictions waive sovereign immunity if an investor is engaging in "commercial acts". Lenders should be mindful of the sovereign immunity laws of different jurisdictions, and how they may affect an investor's obligations to contribute capital to a fund.
- *Pay-to-play*. Funds sometimes use placement agents in their fund-raising process. However, as a response to corrupt practices in connection with governmental investors, state legislatures and other regulatory agencies have begun to restrict or ban the use of these agents, to limit "pay-to-play" abuses that have resulted from their use. Pay-to-play schemes typically involve the payment to placement agents or other intermediaries by a fund to steer investors to the fund, which can sometimes violate laws or regulations, particularly when the investor is a government entity. Typically, side letters will provide a representation from the fund that it has not used a placement agent to obtain the investor's investment, and that no payments were made to any employee, affiliate or advisors of the investor to obtain an investment. Different jurisdictions will vary in the remedies available in the event of a pay-to-play violation, but these remedies could be as severe as providing the investor the right to cease making capital contributions.
- *Overcall and concentration limits.* Overcall provisions (discussed above in the context of LPAs) limit the amount an investor is obligated to fund to cure the shortfalls created by another investor's failure to fund its called capital commitment. Concentration limits restrict a single investor's total capital commitment or capital contribution to a percentage of the aggregate capital commitments or capital contributions of all investors. Like an overcall provision, a concentration limit could restrict a lender's expectations that the commitments of all investors are available to repay an extension of credit under a loan facility.
- *ERISA*. ERISA regulations restrict how much of an interest an employee retirement pension plan can own in any class of equity interests in a fund before the fund is considered a "plan asset" under ERISA. If the fund is a plan asset, the manager of the fund is deemed a fiduciary of each ERISA investor in the fund, which would require the fund manager to comply with additional regulations under ERISA that could significantly curtail its investment strategies. Investors may have provisions in side letters that provide them with the right to exit a fund in the event that the fund is deemed a plan asset.

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

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

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

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

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

of the advisor and its personnel for the previous 10 years. A registered adviser, in addition, must file a Form ADV, Part 2, Brochure, which contains investor-directed information.

- *Uniform Commercial Code (UCC) searches*. At an absolute minimum, lenders should order UCC searches from the applicable governmental authority in each jurisdiction in which a pledgor of the subscription facility's collateral is organized, to confirm that there are no intervening liens on this collateral.
- *Other information searches*. Lenders often will conduct searches of other public and governmental filings, databases, and records, including non-UCC lien searches (that is, tax and other liens), bankruptcy filings, judgment filings, litigation filings, PATRIOT Act filings, and certificates of status/standing and qualification to do business. These searches are all part of a comprehensive risk and credit analysis.

Request standard loan closing documents

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

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

Conclusion

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

Acknowledgments

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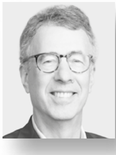

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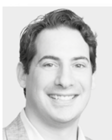

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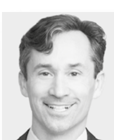

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Derivatives at fund level

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Overview

This chapter highlights some key structural and documentary legal issues that should be considered by any manager thinking about entering into derivatives transactions at fund level. The observations made in this chapter are drawn from experience in the European fund finance and derivatives markets and are not tailored to any particular derivatives strategy.

This chapter does not provide detailed legal and regulatory analysis in relation to particular issues by reference to the laws of any particular jurisdiction. Any manager who intends to enter into derivatives transactions at fund level should obtain legal and regulatory advice under the laws applicable to the proposed parties to the transaction and to the transaction itself, which should be tailored to the particular characteristics of the parties, the fund's constitutional documents, and the circumstances of the transaction. At the time of writing, it will be particularly relevant for UK managers to understand the legal and regulatory consequences of the UK's exit from the EU.

Introduction

There are a wide variety of reasons why a manager may consider entering into derivatives transactions, but derivatives use can generally be split between those of a speculative nature and hedging. At one end of the spectrum, funds can use derivatives to speculate in the active pursuit of investment return and, in so doing, may be expected to enter into a wide array of derivatives transactions.

At the other end of the spectrum, derivatives can be used purely to hedge against the economic impact of a particular risk. Examples of risks that a manager may wish to mitigate with derivatives use are: foreign exchange (forex/FX) exposure (for example, covering the currency exposure for a EUR fund that will be drawing EUR amounts from investors to fund a particular investment that is denominated in GBP); and interest rate exposure (for example, covering the risk of an adverse movement in interest rates increasing the amount required to be paid on borrowings made by the fund). For many managers, FX and interest rate hedging will be all that the derivatives strategy needs to cover. This chapter will focus on the use of fund-level derivatives for pure hedging purposes.

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

As such, it is most appropriate for the vehicle, not the fund, to hedge the interest exposure on the acquisition finance facility. The lenders under the acquisition finance facility may require that hedging be put in place, as an important part of their protections against a borrower payment default. If interest rates increase, the borrower will have the benefit of the derivatives to help fund the increased interest payments that it owes under the acquisition finance facility. In such a scenario, it is inappropriate for a derivatives transaction to be entered into at fund level.

Potential advantages and disadvantages of entering into derivatives at fund level

Any manager deciding whether to enter into derivatives at fund level will need to consider its specific circumstances carefully. In addition to legal considerations, it will need to understand the accounting, regulatory and tax treatments of the derivatives. It will also want to consider the operational impact of the derivatives upon the fund.

Main advantages of entering into derivatives at fund level

The primary benefit of entering into derivatives at fund level is that the risk protection is at the level where risk is borne by the fund. Where a particular risk directly affects a fund, it may not be commercially possible to hedge that risk at anywhere other than the fund level.

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

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

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

Main disadvantages of entering into derivatives at fund level

Although derivative transactions of this kind are entered into with the intention of increasing performance or mitigating risk, they may carry a downside exposure which the fund must manage.

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

Additional operational burden may arise as a result of the regulation of derivatives – regimes such as the European Markets Infrastructure Regulation (EMIR) and the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) impose not insignificant obligations on parties entering into derivatives transactions. These include to report on, and actively mitigate the risk of, their derivatives transactions. Specified classes of derivatives face even more onerous regulatory obligations, including requirements to clear specified classes of derivatives through approved clearing houses, and to post cash as credit support (margin/collateral).

If, commercially or as a matter of regulation, the derivatives transaction involves an obligation to post margin, the manager must monitor and respond to margin requirements, which may be on a daily basis. Many managers do not have the in-house resources to manage such processes, nor ready access to liquidity (particularly those managers who would need to rely on calling unfunded commitments from their investors – which typically have a notice period of several business days). Even for those managers that do have access to such liquidity, the deployment of cash as margin may have an adverse impact on fund returns, which can be significant.

Consequently, careful analysis of any regulatory obligations needs to be made by any manager who is considering entering into derivatives at fund level. Examples of the pace of regulatory change include the amendments made to EMIR, which came into force on 17 June 2019 (EMIR Refit).

Funds are one of the sectors most affected by the changes brought in by EMIR Refit. By way of example, EMIR Refit broadened the definition of "Financial Counterparties" (parties that are in-scope for material obligations under EMIR, such as mandatory posting of variation margin), capturing a broader range of funds than was previously the case. However, EMIR Refit has also provided for a carve-out from the variation margin requirement in respect of certain types of OTC derivatives, which is expected to benefit most funds.

Under EMIR Refit, the mandatory exchange of variation margin on physically-settled FX forwards and physically-settled FX swaps will only apply to transactions between "the most systemic counterparties". For the time being, the better view is that "the most systemic counterparties" would only refer to credit institutions and MiFID investment firms established in the EEA (or equivalent entities located in a third country). Further regulation will need to be implemented at EEA level to clarify the position. EMIR Refit has also created a new "Small Financial Counterparty" classification, exempting certain financial counterparties from the requirement to clear their trades.

When assessing how EMIR Refit might have an effect on a fund's hedging strategy, it is worth noting that regulatory impact can be reduced by careful structuring of the derivatives or by using an appropriate vehicle to enter into the trades.

There may be additional regulatory considerations in the event of a no-deal Brexit which, at the time this chapter went to print, remains a possibility. An example of this would be the possible divergence between regimes as a result of how EMIR and its requirements will apply within the UK (or to UK managers) post-Brexit by virtue of how the UK on-shored version of EMIR will operate and will be enforced by the relevant authorities, following the transition from EU to UK competence. As a result, there is a degree of uncertainty in respect of the regulatory landscape as it relates to derivatives in the UK, and managers are advised to work with their legal counsel to understand any potential implications for their funds.

The use of derivatives at fund level also adds a layer of complication in relation to other fund-level transactional documentation. As analysed in more detail later in this chapter, a manager will need to consider carefully the interaction between any credit agreement and derivatives documentation.

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

Constitutional considerations when entering into derivatives at fund level

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

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

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

An express prohibition on entering into derivatives in the fund's constitutional documents is potentially the end of the matter, unless there are clear commercial justifications for seeking an alternative method of authorisation, such as an express investor consent. Such express prohibitions are, however, relatively rare, although beware side letter provisions which may (deliberately or inadvertently) restrict the use of derivatives. In older funds, it is possible for constitutional documentation to be silent on derivatives use, which may create its own issues – particularly if the fund's legal counsel (who might not be retained to advise on any derivatives) is required to give a capacity opinion on the fund's ability to enter into derivatives transactions.

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

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

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

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

Constitutional limitations in relation to granting credit support for derivatives transactions

If, commercially or as a matter of regulation, the derivatives transaction will need to be collateralised or supported by a fund guarantee (for example, if the derivatives are being entered into by a fund-owned or treasury vehicle), then the manager will need to ensure that giving that credit support is permitted under the fund's constitutional documentation:

(a) *Security*. Fund documentation will frequently circumscribe the fund's ability to grant security. This may be prohibited or limited by reference to either the value of collateral that may be posted or the assets over which security may be granted. There may also be limitations on giving security in respect of the liabilities of an investee company. The manager will need a clear understanding of how any such limitations operate and will need to ensure that the limitations are not breached.

Security under derivatives contracts may be effected in a number of ways, including by the creation of security interests over collateral (for example, under the ISDA 1995 Credit Support Deed (Security Interest – English law)) or by way of title transfer of collateral (for example, under the ISDA 1995 Credit Support Annex (Transfer – English law). Where collateralisation is mandatory as a matter of regulation, parties will often use the ISDA 2016 Credit Support Annex for Variation Margin (VM) (Title Transfer – English law).

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

If guarantees are so limited, then the manager will need to understand how the guarantee obligation is to be valued for the purpose of ensuring compliance with the limitation. For example, is the maximum contingent exposure used, or is the accounting value placed upon the guarantee used?

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

Constitutional limitations on the ability to draw investor commitments to make payments in respect of derivatives transactions

The manager will also need to consider any ongoing requirements under the proposed derivatives transaction to make payments or to post collateral. The proposed source of any required liquidity will need to be identified. If the manager will use investors' uncalled commitments, then it will need to confirm that commitments can be drawn down for this purpose. If the fund also has a subscription facility or other credit agreement where the available facility is calculated by reference to uncalled commitments, the manager will also need to factor into its use of such a facility the effect of payments funded from undrawn commitments.

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

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

The extent of any contractual restrictions will be a matter for the fund to determine by reference to the specific finance documents that it has in place. However, the starting position would be to assume that any credit agreement on reasonably market standard terms will restrict the fund's ability to incur debt, give guarantees and grant security – subject to a relatively narrow suite of permissions and a general permission "basket". This is now considered in more detail.

<u>Contractual limitations under credit agreements in relation to entering into derivatives transactions</u>

Limitations commonly appear in credit agreements that directly address the ability of the fund to enter into derivatives transactions:

(a) *Restriction on entering into derivatives transactions*. The underlying credit agreement should be reviewed for a restriction on entry into derivatives transactions. Although a blanket ban is unlikely, other restrictions are more common, such as limits around speculative derivatives and around derivatives lasting beyond a maximum duration.

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

<u>Contractual limitations under credit agreements in relation to granting credit support for fund-level derivatives transactions</u>

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

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

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

(b) *Guarantees*. If a fund guarantee will be provided, then the manager will need to ascertain whether any finance documents limit its ability to do so. This could be by way of a direct limitation on the giving of guarantees, or an indirect limitation where another restriction is broad enough to apply to guarantees (such as guarantees being designated as financial indebtedness for the purposes of the limitation on financial indebtedness or for any leverage-style financial covenant). If so, the manager will need to understand how the guarantee will be valued for the purpose of the limitation. Equally, to the extent that it is commercially agreed that a derivatives counterparty can share in a subscription lender's security package, the benefit of any guarantee given under the finance documents may extend to that derivatives counterparty. In each case, the specific terms of the relevant finance documents will need to be considered.

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

(d) *Priority arrangements*. As a precondition to the manager successfully negotiating permissions under its credit agreement for the fund to enter into derivatives (and any related security or guarantees), the credit agreement may require that the derivatives counterparty joins into a priority agreement that regulates the relative ranking of the rights of the lenders under their loans, and of the derivatives counterparty under the derivatives. Such priority arrangements are, however, rarely seen – probably because: (i) subscription lenders are prepared to rely on their security over the investors' uncalled commitments (and may not allow a derivatives counterparty to take bilateral security – whether second-ranking (noting the conceptual difficulties under English law with second-ranking assignments) or otherwise – over those uncalled commitments) and NAV; and (ii) other lenders at the fund level would satisfy themselves that any such exposure was limited by ensuring that any baskets permitting such activities were relatively low.

To the extent that a derivatives counterparty is permitted to share in a lender's security package, which is considered in more detail below, this can usually be dealt with by including some relatively simple intercreditor-style provisions in the credit agreement.

<u>A shared security package between a fund's lenders and its hedge counterparties</u>

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

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

The onus is on the manager to allocate a sufficient portion of the borrowing base to the secured hedging. In determining how much to allocate, the manager will be required to balance the need for headroom (to take account of potential mark-to-market fluctuations in the derivatives transactions) with the fact that any headroom will (further) reduce the borrowing base for the purposes of the credit agreement.

If the fund's exposure under the secured hedging exceeds the amount of borrowing base allocated to that secured hedging, the manager would typically be required to: (i) increase the amount of borrowing base allocated to those hedging transactions; (ii) post collateral for the excess (on a bilateral basis in favour of the derivatives counterparty); or (iii) wholly or partially close out some derivatives transactions to eliminate the excess.

Option (i) assumes, of course, both that the fund has capacity within its borrowing base to do so, and that by doing so it would not exceed the overall cap on the amount of its borrowing base which can be allocated to secured hedging. Option (ii) requires careful analysis of where the relevant collateral will be sourced, and the impact of applying that collateral for that purpose. Option (iii) would result in the partial loss of the hedge and, potentially, costs to the fund if the derivatives to be closed out are out-of-the-money.

From the lenders' perspective, it is critical to ensure that any claims of a derivatives counterparty under secured hedging transactions which exceed the borrowing base allocated to those transactions rank behind the lenders' claims. The relevant derivatives counterparty should only rank *pari passu* with the lenders to the extent its claim is equal to or less than the borrowing base allocated to the derivatives.

Further issues to consider under credit agreements in relation to the fund entering into derivatives

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

(a) *Cross-default.* This is potentially very serious; for example, a minor breach of a technical nature under the fund's derivatives documentation, which is not a concern for the derivatives counterparty, might nevertheless trigger an event of default under the fund finance documents – potentially resulting in a default under the credit facility as well.

If the manager has to give a cross-default trigger under the fund's credit facility, the fund should seek to include language in the credit agreement to mitigate its effect – for example, by limiting cross-default triggers which can be set off by derivatives documentation breaches to: (i) material derivatives documentation breaches only (like a payment default); (ii) hedging documentation breaches in respect of exposure in excess of an agreed threshold amount; (iii) actual derivatives documentation events of default rather than just potential events of default; or (iv) derivatives documentation events of default in respect of which the derivatives counterparty actually takes enforcement action.

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

Derivatives use may impact upon a number of financial covenants:

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

(c) *Availability of subscription facility*. Derivatives transactions may impact upon the availability of a subscription facility (or other credit agreements, where the facility limit is dictated by the level of uncalled commitments). This is because the terms of the credit agreement may require that, when calculating the borrowing base, the uncalled commitments be reduced by the amount of any derivatives liabilities (and any guarantee given in relation to derivatives transactions).

More generally, if the manager proposes to use a subscription facility to fund payments, or to fund collateral in respect of its derivatives transactions, then the manager will need to ensure that the subscription facility allows such use, and that it can be drawn down quickly enough to meet the timing of the payment.

Issues to consider under the derivatives documentation

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

(a) *Recourse*. The manager will need to ensure that its derivatives documents reflect the correct separation of liability and recourse across its fund structure (for example, if hedging is only for liabilities relating to some investors or fund-owned vehicles but not others).

(b) *Cross-default*. The manager should carefully consider the extent to which a default under any credit agreement could give rise to a termination right under its derivatives documents (for example, under paragraph 5(a)(vi) (Cross-Default) of the 2002 ISDA Master Agreement). The manager should seek to include language to mitigate the effect of any such trigger (but this is likely to prove difficult if the derivatives counterparty is a lender under the credit agreement).

(c) *Additional termination events.* Derivatives counterparties will usually seek to include additional termination events (ATEs) in their derivatives documents, unless the manager has a very strong negotiating position or embedded relationship with the derivatives counterparty. This can have serious repercussions for the fund:

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

   The problem with this ATE is that a reduction in the fund's uncalled capital commitments is not necessarily a sign that it is in financial difficulty. Indeed, managers will be actively seeking to draw down investor commitments in order to invest them. A focus on uncalled commitments makes sense in the context of a subscription facility, but careful consideration is required when such provisions appear in derivatives documentation (particularly because the duration of the average subscription facility will often be shorter than the duration of the derivatives transactions being entered into). For example, where commitments have been invested, it may be appropriate for a component of fund NAV to be counted in the test in place of the deployed commitments, similar to the mechanics used in hybrid fund finance facilities.

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

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

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

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

Conclusion

Looking ahead, challenges such as Brexit (which may affect cross-border derivatives arrangements) and potential further regulatory developments (including under EMIR) are likely to be of concern to managers considering entering into derivatives, whether at the fund level or otherwise. However, the enduring popularity of fund-level hedging, in particular, does not seem to show signs of abating.

In a time of reduced returns – owing to high asset values caused by fierce competition and an abundance of capital waiting to be deployed – managers are increasingly seeking to preserve hard-fought gains by protecting themselves against the potentially damaging consequences of unhedged forex and interest rate risks.

Although the analysis for any particular fund is fact-specific, the points in this chapter are issues that any manager may wish to bear in mind when assessing its use, or proposed use, of derivatives transactions.

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Do subscription facilities purr – or do they roar?

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Introduction

The subscription facility is a significant and global financing tool for investment funds seeking efficient access to capital. Borrowers utilise subscription facilities in a variety of ways, ranging from short-term borrowings (used primarily to bridge liquidity needs *in lieu* of making investor capital calls frequently and/or at irregular intervals) to long-term leverage (which seeks to increase the overall fund size and serve as a permanent source of capital).

Subscription facilities are now a financing staple used by a wide variety of (principally closed-ended) funds, with different investment strategies, across the full range of asset classes in North America and around the globe, most notably in Europe (in particular the UK) and Asia, where the market is continuing to significantly expand. As the use of leverage by funds has become ubiquitous, investors are becoming increasingly accustomed to, and more educated about, the use of such facilities, and fund structures have evolved in many cases to offer investors a menu of levered and un-levered fund products to choose from.

Over the years, the number, size, variety and complexity of investment funds have grown, and subscription facilities have adapted to the changing landscape, with fund sponsors and lenders collaborating to develop financing solutions designed to address the evolving needs of fund borrowers and their investors. Indeed, a "cookie-cutter" subscription facility is a myth. The subscription facility market today is robust and sophisticated, continuously attracting new entrants on both the borrower and the lender side, as it caters to increased demands and has resulted in the need for customised liquidity solutions in virtually every case to suit the particular profile of the underlying fund.

For example, while an uncommitted "accordion" (a feature which allows a borrower to increase the size of an initial facility, subject to lender consent and credit approval) has historically been a frequent component in these financings, we continue to see a rising number of facilities that are not legally committed at all (or that contain committed and uncommitted "tranches", both of which are available from the outset). Also, the increased competitiveness of the market has led to better pricing and, in some cases, improved flexibility of terms for borrowers, but other recent events have prompted the lender community to further scrutinise the fundamentals behind the borrowing base composition as well as the fund operating documents, in order to offset their risk.

This chapter looks at the breadth of the types of subscription financings and trends currently in the marketplace by examining select aspects of facilities for various kinds of investment funds in the US and UK markets.

Fangs and claws – Subscription facility fundamentals

Subscription facilities are effectively a form of "asset-based lending", where the ability to borrow is determined principally by reference to the value of certain eligible assets that the borrower (or a related entity) provides as collateral for such loan and which count towards the "borrowing base" against which a bank will advance. A subscription facility's collateral package is anchored by the commitments of the fund's investors that have not yet been funded.

These financings tend to be structured as revolving credit facilities, so that the borrower has fast access to liquidity for the purposes of making investments, without having to call equity capital and wait for the contributions to be received. The short period required to draw advances (typically one to three days) enables quick execution of underlying asset acquisitions. It also allows funds to avoid inefficient holding of cash for covering expenses, and the facilities often provide additional flexibilities, such as availability of foreign currencies and letters of credit.

Subscription facilities are typically secured by: (i) the unfunded capital commitments of the fund's investors; (ii) the right to make capital calls from investors, and receive proceeds of such capital calls in the form of contributions; (iii) the bank accounts into which the capital contributions are funded; and (iv) certain rights related to the foregoing (including the right to enforce against such investors), as well as the documentation evidencing such rights (including subscription agreements of the investors and organisational documents of the fund).

Because the collateral for a subscription facility is intrinsically tied to the obligation of the investors to make capital contributions, lenders closely scrutinise the investor base of the fund and the legal relationship between the investors and the fund. The types of investors and the life-cycle stage of the fund will determine what structure the optimal borrowing-base takes.

Investors may be considered eligible, and therefore an "included investor" (usually institutional investors with a certain rating and/or sufficient financial strength) or a "designated investor" (other investors meeting certain criteria). Alternatively, they may be ineligible due to restrictions on their ability to fund certain investments, or being below a certain threshold of creditworthiness. It is important to note that the uncalled commitments of ineligible investors still form part of the collateral, leading to over-collateralisation, and that an eligible investor may become ineligible due to certain exclusion events, such as a decline in its financial position (including bankruptcy).

After determining the basic composition of investors that will be included in the borrowing base of the subscription facility, the parties negotiate appropriate advance rates and applicable concentration limits in respect of these investors. Advance rates are the basic measure of the amount of credit a lender will allow a borrower, and are generally expressed as a percentage of the included investors' (up to 90–100%) and designated investors' (up to 70%) uncalled capital commitments.

However, there are other potential approaches to categorising investors – for example, a now common segment of the US market functions on the basis of a "simplified" borrowing base with a "flat" advance rate against an aggregate investor pool, which generally encompasses all of a fund's investors, regardless of eligibility criteria or exclusion triggers (which is similar to the "coverage ratio" principle used in traditional subscription lines in the UK market).

We also increasingly see further bifurcation of advance rates, depending on additional supporting criteria. For example, there may be a higher advance rate afforded from the moment in time at which capital commitments over a certain threshold (sometimes referred to as a "hurdle") have already been funded; this feature caters to the natural cycle of an investment fund because, as capital is drawn, the amount of credit support available for a subscription facility decreases. However, a higher advance rate may alleviate or even equalise these consequences – and, from a lender's perspective, the diminished uncalled capital is counterbalanced by the investors having more "skin in the game". Another similar refinement is a fluctuation of the advance rate based on the value of assets in the fund, when as the value of fund assets increases over time, so does the percentage applied to uncalled commitments.

Concentration limits present a further refinement of how the overall borrowing base credit is distributed among various classes of investors, and are generally determined based upon the makeup of a particular fund's investor pool. Lenders often look to reduce risk through diversification, and thus aim to calibrate the classes of investors within the borrowing base in order to achieve a certain level of diversity and ensure that, from their perspective, no disproportionate amount is advanced against the uncalled capital commitment of any investor of a particular class, either individually or in the aggregate for such class – so, for example, historically there has been much focus on limiting the amount of credit that is attributed to such investor categories as individuals (natural persons) and their tax and estate planning vehicles.

A variation of this principle that we have seen banks increasingly propose is that they seek to ensure the largest investor (no matter what class or category it would have otherwise been in) doesn't constitute more than a certain percentage of the overall fund commitments. On the other hand, in order to increase flexibility, lenders may consider holidays or waivers in respect of concentration limits (e.g. not apply them during a "ramp up" period while the borrower has had a first fund closing, but is still in fundraising stage and therefore the initial investor pool is more concentrated than it ultimately will be).

From a legal perspective, sponsors and lenders alike pay attention to the organisational documents of the fund, which (within the statutory framework applicable to the particular fund entity in question) set forth the contractual obligation of the investors to fund capital if and when called. Express provisions, in addition to the general powers of the fund, authorising the borrower (or its general partner, manager or other controlling person) to incur debt and grant liens (including, importantly, a pledge of the uncalled capital commitments) without further consent or action by the investors, as well as a host of other ancillary acknowledgments and consents for the benefit of such lenders (often as express third-party beneficiaries), can provide additional comfort to lenders when analysing the capacity of the fund to incur indebtedness and the contractual relationship between fund and investors.

As the sophistication of market participants grows, much more attention is paid to subtle nuances and technical drafting of the relevant provisions, and in particular certain of those that have come to be increasingly negotiated between the funds and investors, such as investment "excuse" provisions (allowing an investor not to participate in a particular investment due to regulatory, tax or other considerations specifically applicable to it).

As a result of these developments "investor letters" (i.e. separate bilateral arrangements between the lenders on the one hand, and the investors on the other hand, which would establish contractual privity), are only used in exceptional circumstances. We will address certain situations in which obtaining such letters may be beneficial for structuring the subscription facility from both the borrower and lender perspective in more detail below.

Kitten or lion? Could it be both?

The variations of fund structures and underlying investor pools can result in differing considerations, and typically require custom and complex loan documentation in each specific case. Below, we illustrate the need for bespoke facility structuring in the context of: (i) separately managed accounts (so-called SMAs, which may have only a single investor); (ii) complex commingled vehicles (which may have hundreds or more investors and utilise numerous entities that are part of one fund family); and (iii) by comparison, funds in the UK market.

Separately Managed Account – The lone tiger

As discussed above, the investor composition of a fund is a key factor for lenders in establishing the borrowing base for a subscription facility. When there is only one investor, as is the case for SMAs, unique considerations for the related subscription facility arise, including those stemming from an increased concentration risk. In our experience, SMAs continue to be popular for a number of reasons, in particular among large institutional investors such as state and private pension funds, educational endowment funds, insurance companies and sovereign wealth funds.

While from a financing perspective SMAs present some specific challenges, there are also advantages and, indeed, it appears that as the number of SMAs in the marketplace has increased, so too have subscription facilities for these investment products. Like any other fund, the terms of the organisational documents of an SMA must satisfy the general requirements of the subscription facility lender. To the extent, however, that some or all of those provisions are not addressed in a manner satisfactory to a lender, it may be easier for a sponsor and investor of an SMA to revise the provision than it would be for those in a multi-investor fund, because the revision process for the latter requires a consent solicitation from multiple investors.

As an alternative (or an addition) to incorporating such provisions in the organisational documents, it is fairly common for lenders to request that the investor in the SMA enter into an investor consent letter to address any other specific issues which may arise in a particular context (for example, as many investors in SMAs are government pension plans, there may be sovereign immunity issues that lending against such investors might potentially present to banks). Understandably, the treatment of such issues requires a highly individualised analysis that needs to be performed on a case-by-case basis.

As compared to subscription facilities for multiple-investor funds, advance rates for the single-investor SMAs tend to be more customised and negotiable. While banks generally lend based on the creditworthiness of each investor, and thus would be expected to assign an advance rate for an investor in an SMA that is substantially equivalent to the advance rate such investor would receive if it were investing in a commingled fund, other factors may necessitate a different approach. For example, in an SMA scenario, lenders cannot rely upon a diversified investor base that, in the aggregate, reduces the exposure to an individual investor's funding failure. Further, as noted above in many commingled fund facilities, there are investors who do not qualify for inclusion in the borrowing base, but their uncalled capital commitments are still pledged as collateral and so effectively provide for "over-collateralisation".

There may be other terms in SMA subscription facilities for which lenders may seek a stricter regime, as compared to commingled fund subscription facilities. For example, certain exclusion events (i.e., events that, if they were to occur with respect to an investor, would trigger removal of such investor from the borrowing base) under a commingled fund subscription facility may be characterised as events of defaults (i.e. events that give the lender a right to accelerate the amounts outstanding under the facility and pursue remedies) under an SMA subscription facility.

There is sound rationale for this approach for a number of exclusion events: for instance, if the only investor in an SMA defaults on its obligation to fund a capital call, the lack of any other investor commitments to fall back on makes it reasonable to characterise such an occurrence as an event of default. However, if the same failure to fund capital were to occur in a commingled fund, the typical subscription facility would simply no longer give credit for such investor's commitment in the borrowing base. Only if investors with material capital commitments (above agreed-upon thresholds) defaulted, would an event of default be triggered under a commingled fund's facility.

Focusing on potential advantages, sponsors with multiple SMAs may be able to utilise the straightforward nature of the single-investor vehicle in order to achieve greater efficiency with respect to the facility documentation. Indeed, some sponsors have found that SMAs are generally well-suited for employing the so-called "umbrella" technology, pursuant to which the same lender provides individual and separate loan commitments to multiple borrowers under one credit agreement.

Under these instruments, many of the terms are shared by all of the SMAs party to the loan document, but investor-specific terms, such as the advance rate and the loan amount, can be different for each SMA, and each SMA remains severally (and not jointly) liable for its own borrowings. Additionally, the distinct facilities are not cross-defaulted or cross-collateralised, meaning potential issues under one SMA's facility will not impact another SMA's facility, even if both are party to the same credit agreement. Umbrella facilities allow sponsors to negotiate a single set of documentation while putting multiple facilities in place.

Commingled funds – Hunting in packs

At the other end of the fund spectrum, there are pooled investment fund vehicles with diverse investor bases, which may include a variety of institutional investors, as well as private wealth management clients (such as high-net-worth individuals and their family offices) and, at times, the sponsor's management and employees. Depending on the composition of the investor base, such funds often require, due to various tax, regulatory and other considerations, multiple entities through which the investors can access the underlying investments, resulting in structures that can be quite complex.

A frequently used technology is a multi-tiered structure, sometimes referred to as the "master-feeder" structure. This arrangement utilises two or more separate entities on top of each other; investors contribute capital through a "feeder" fund, which then passes on (feeds) the capital to a "master" fund, which in turn makes investments, either directly or indirectly through subsidiaries. In certain circumstances, there may be some investors who invest through the feeder fund, and other investors who invest directly into the master fund. In other situations, a separate fund structure may be formed for different types of investors without there being an aggregating master fund, sometimes referred to as a "parallel fund" structure.

For US-based sponsors, an initial fund is often formed as a Delaware or Cayman Islands limited partnership that is treated as a pass-through entity for US federal income tax purposes and typically includes taxable US investors. When the investor pool includes non-US investors and/or certain tax-exempt US investors, one or more separate "offshore" funds, which are treated as non-US corporations (or non-US limited partnerships) for US federal income tax purposes, are often formed in various jurisdictions (frequently Cayman Islands, British Virgin Islands or Bermuda and increasingly also European domiciles such as Luxembourg, Ireland and Scotland).

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

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

A "cascading pledge" structure is one potential method utilised to assure that lenders have an appropriate "path" to the ultimate source of capital commitments. In this scenario, the upper-tier feeder fund pledges the capital commitments of its investors to the lower-tier master fund, in order to secure such feeder fund's obligations to make capital contributions into the master fund. The lower-tier master fund then, in turn, pledges the capital commitments of its "investors" (i.e., the upper-tier feeder fund(s)), and any rights it may have under the pledge granted to it by the upper-tier feeder fund, to the lenders to secure such master fund's obligations as a borrower under the subscription facility.

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

There are situations where it may not be possible to have multiple parallel entities within a fund structure jointly and severally liable for repayment of the loans and, in some instances, the "onshore" and "offshore" entities may be required to enter into separate credit agreements. Such separate credit agreements may or may not be permitted to be cross-collateralised, whether for tax and/or regulatory reasons or because of an understanding with the investors in the separate vehicles. This effectively means that each of the parallel vehicles must rely on a borrowing base comprising only capital commitments of its own investors.

Because banks will typically provide different advance rates and concentration limits for different investors based on their underwriting criteria, the borrowing capacity of one silo may be different from the borrowing capacity of the other silo(s). Since sponsors ordinarily aim to manage borrowings on a consistent level across the various vehicles in a fund family, the ability to borrow might then be dictated by the vehicle with the lowest borrowing capacity.

One potential solution may be to provide for a cross-guarantee and/or cross-default between the individual credit agreements, which might allow the borrowing base to be calculated on an aggregate basis. Another approach may be to utilise "investor letters" which may give an increased level of comfort to the lenders, which may result higher advance rates and/or concentration limits.

European perspective

The internationalisation of the subscription finance market has influenced the documentation and transaction terms of subscription facilities in the European market. US-based sponsors have been expanding their investment activities across the Atlantic and continue to seek subscription facilities similar to what they have been accustomed to in the US. European and US-based lenders have increasingly offered subscription facility terms similar to those seen in the US market. Nevertheless, despite a trend for convergence of the terms, certain differences persist due to differing approaches to credit evaluation and local law requirements with respect to the creation and perfection of security interests in collateral.

Subscription facilities in the UK market were historically almost exclusively the product of "relationship" deals, with lenders primarily focusing on the success record of the larger sponsor group when determining whether to offer a subscription facility to an individual fund. This difference in approach used to be reflected in some of the terms typical of subscription facilities in the UK market. For example, traditionally subscription facilities in the UK market frequently used the "coverage ratio" to limit the amount that may be drawn under the facility at any given time.

The coverage ratio is the ratio of the uncalled capital commitments of the included investors to the aggregate indebtedness of the fund, and is typically set at no less than 1:1. Notably, the coverage ratio approach does not typically involve applying advance rates to the uncalled capital commitments of included investors, meaning that once an investor is deemed an "included investor", the borrower receives credit for 100% of that investor's uncalled capital commitment. In recent years, the coverage ratio approach has become less common in the UK market and is frequently substituted by a US-style borrowing base model.

Parallel to the development of the borrowing base methodology, investor exclusion events have also been refined. These events are typically narrower in scope for facilities that apply a borrowing base methodology, but are often tailored to particular investors and address a greater in the number of specific events which would result in a reduction of the borrowing base. More recently, lenders have increasingly been focused on the exclusion event definitions – a trend that goes hand in hand with the increased focus on and diligence of organisational and fund-related documents.

Irrespective of the internationalisation of the subscription finance market and the convergence of certain terms of subscription facilities in US and European markets, the granting of security interests in respect of a borrower's obligations under a subscription facility remains specific to the jurisdiction applicable to the relevant fund entity. Granting and perfecting security interests over the uncalled capital commitments of the funds' investors, the rights of the general partner to call capital commitments, and the bank accounts into which any capital commitments called from investors are funded represent, for the lenders, the building blocks of the principal collateral base of the subscription facilities it provides.

By way of example, to perfect the security interest and enforce the lender's rights against third parties in the US, a UCC-1 financing statement should be filed, typically on or shortly after entering into the transaction. It is customary for the security agreement to contain an authorisation by the borrower to the lender for such filings. By comparison, under English law, the security interest of lenders in the rights of the general partner to call capital is typically created pursuant to an assignment by way of security. The perfection thereof occurs upon notification to the investors in the fund. To manage and protect the relationship with their investors, borrowers often seek to negotiate the timing for the delivery of the notices to investors, and are also highly sensitive to the form of any such notifications. This process needs to be balanced against the lenders' need to obtain a perfected security interest promptly after the facility is made available.

The conclusion – Hakuna Matata?

We continue to see a sustained and steady increase in the volume and size of subscription facilities, and more broadly, of fund financing transactions overall. As noted, the number of users and providers in this market has increased exponentially. A key shift is the willingness of sponsors and investors to work with lenders, on devising and implementing customised solutions addressing all parties' needs and requirements, and thus developing products flexible enough to adapt to evolving fund structures as well as liquidity solutions for the "long run" that can adopt to the different stages of the life of a fund.

This is evidenced by a growing number of combinations of subscription facilities and so-called asset-based facilities (collateralised by the underlying fund investments), whether in the form of hybrids (with a collateral package that consists of both uncalled capital commitments and underlying investment assets) or other bespoke instruments (for example, where a traditional subscription-based borrowing base is enhanced by a component based on value of the underlying investment assets, but without a corresponding pledge). Moreover, there has been a convergence of the larger fund financing market where we are observing an increasing appetite for syndicated facilities globally (as has been common in the US for some time).

We believe that the popularity of this product is driven in part by the strong performance these loans have demonstrated over extended periods of time, and the strength of the alternative asset sector, as well as the continued ability of sponsors and lenders to craft solutions that meet the growing needs and complexities of today's investment fund structures.

We are pleased to note that this segment of the market appears to remain very active even as it has absorbed recent geopolitical and other developments. Indeed, even during the current period of macro-economic uncertainty in the US, fuelled by trade negotiations and interest rate policy, as well as the upcoming election year, the fund financing space there has largely remained stable.

Likewise, in Europe there remains some uncertainty surrounding the future of UK–EU relations. However, it appears that, whilst Brexit has affected structuring considerations of funds to future-proof a departure from the European Union, this has not resulted in material changes to the terms of the underlying financing documents, and the loan market remains relatively unaffected.

Also, in relation to the replacement of LIBOR with successor reference rate(s) by the end of 2021, the insecurity surrounding the upcoming changes has similarly not stifled the market, and substantial progress has been made in the past year on this front to bring clarity. Whilst an ever-changing regulatory environment can be expected to continue influencing the legal landscape with increased focus on globally relevant issues such as cybersecurity, data privacy and international sanctions, we remain optimistic about the outlook for the industry, which due to the versatility and adaptability of its product, has weathered many challenges to date.

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Financing funds of one: A borrower's field guide

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Introduction

Subscription facilities for funds of one are trending, as fund sponsors, and investors alike, realise the operational efficiencies and competitive advantages they can provide. In addition, as the subscription facility market evolves, a larger number of lenders are willing and able to meet the demand. Historically, lenders have not shown much enthusiasm for funds of one, given their concentrated risk and lack of overcall rights compared to larger, more diversified funds. More recently, however, lenders are increasingly amenable to these types of products as a means to expand their Rolodex and broaden ties to existing clients. Still, even seasoned fund sponsors might be wary of what to expect when arranging financing for a fund of one. This chapter aims to demystify that process.

As a threshold matter, in order for a fund sponsor to successfully finance a fund of one, it is imperative that the fund has the support of its investor. From the lender's perspective, it is effectively underwriting a single investor's capital commitment, and is relying entirely on the creditworthiness of such investor and the strength of its obligation to fund capital contributions pursuant to the terms of the fund's constituent documents. A lender will often require some level of involvement from the investor, whether in the form of an investor consent letter or delivery of KYC information. Therefore, cooperation from the investor is key to securing a facility on the best possible terms.

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Diligence and KYC process

The financing process inevitably requires the sharing of fund documentation and potentially sensitive investor information with the lender. At a minimum, the fund will be required to deliver the following as part of the lender's diligence and KYC process: (i) the certificate of limited partnership or other certificate of organisation of the fund, its general partner (or similar managing fiduciary) and any other relevant credit parties; (ii) the limited partnership agreement or other governing agreement of such parties; (iii) the investor's subscription agreement; and (iv) the investor's side letter, if any.

None of the foregoing requirements is unique to a fund of one, but they will be subject to closer scrutiny than they would otherwise be in a commingled fund. The fund's limited partnership agreement and the investor's subscription agreement provide the foundation for the facility, as they constitute the source of the lender's collateral. Recall that the collateral security for any subscription facility is comprised of the investor's uncalled capital commitment, the right of the fund and/or its general partner to call capital from the investor, and the fund's right to receive capital contributions.

A separate chapter could be dedicated to lenders' review of fund documents but, in short, the lender will want comfort that the fund documents permit: (i) the performance by the fund of its obligations under the facility; and (ii) the pledge by the fund and its general partner of the collateral thereunder. Further, the lender will diligence the fund documents to confirm that none of the provisions therein compromise the lender's foreclosure rights. However, it should be noted that any shortcomings in the fund documents may be addressed in an investor consent letter.

At this stage in the process, confidentiality is likely to be of utmost concern to the investor. Fund sponsors should be mindful of any confidentiality restrictions contained in the investor's subscription agreement or side letter, as they may need to obtain the investor's waiver or consent prior to sharing such information and documentation with the lender. While a redacted subscription agreement or side letter may be acceptable to a lender under certain circumstances when financing a diversified fund, a lender to a fund of one will expect such documents to be delivered without redaction.

At a minimum, the lender will need to ascertain the identity of the investor, the amount of its capital commitment and the investor's contact information. In addition, if the investor has no credit rating or its financial information is not publicly available, the lender may require additional information in order to obtain credit approval. In such case, the fund sponsor should confirm whether the investor is willing to provide financials, which will ultimately be shared with the lender (both at the initial closing of the facility and on an annual basis thereafter). If the direct investor in the fund is a special purpose vehicle or a shell entity, or if the lender is otherwise unable to obtain financial information sufficient to determine the investor's creditworthiness, it is likely that the lender will request information regarding the investor's parent or beneficial owner(s).

Comfort letters

If a lender is ultimately relying on the creditworthiness of an investor's parent, such entity may be required to execute a comfort letter. The content of the comfort letter may vary, but usually it is a short form document whereby the signatory: (i) confirms that it has an equity interest in the investor; (ii) acknowledges that the investor has subscribed to the fund; and (iii) agrees that it will cause the investor to meet its payment obligations under the fund's governing agreement and the investor's subscription agreement as and when they become due. This final clause may take various forms depending on the relationship of the parent to the investor and the lender's requirements. For example, the investor's parent may agree that it will cause the investor to have sufficient liquid assets, that it will keep the investor adequately capitalised or, simply, that it will influence the investor to the best of its ability. This document is executed by the investor's parent and delivered to the lender, but the lender need not be a party.

To clarify, a comfort letter is not a guarantee of the investor's obligations under the fund documents (which a fund sponsor may wish to avoid from an investor relations perspective, and which should not be necessary). Rather, such a letter should be sufficient to establish a credit linkage between the investor and its parent and bolster the lender's confidence in the investor's ability to fulfil its capital commitment.

Investor consent letters

While investor consent letters might be considered a relic of the past, they are often a prerequisite to financing a fund of one. In such cases, the investor executes a consent letter directly in favour of the lender, thereby establishing privity between the lender and the investor. The consent letter will contain a number of reps and warranties and acknowledgments, but perhaps most importantly from the lender's perspective, the investor acknowledges its obligation to fund capital contributions pursuant to capital calls duly made in accordance with the fund documents, without counterclaim, offset or defence of any kind, including Section 365 of the U.S. Bankruptcy Code.

This provision is often met with resistance by investors for several reasons. Investors are often (understandably) hesitant to waive any counterclaim, offset or defence they may have; however, it is helpful to clarify that such waiver only applies in the event that the lender makes a capital call and, in such event, the investor retains any counterclaim, offset or defence that it may have *vis-à-vis* the fund and the fund's general partner. In any case, the capital call by the lender must be duly made in accordance with the fund's constituent documents and the investor's subscription agreement and side letter. In no event should such a letter compel the investor to fund capital contributions in excess of its unfunded capital commitment or to repay indebtedness incurred for a purpose for which the investor would otherwise not be obligated to fund. Further, the letter will provide that any capital contributions made by the investor in response to a capital call must be deposited into an account of the fund that has been pledged to such lender; under no circumstances should the letter require capital contributions to be made directly to a lender.

It is important to remember that the lender's authority ultimately stems from that of the general partner. As a result, the lender cannot exercise any rights that the general partner would not otherwise be permitted to exercise. In addition, there is often a misperception that the investor's execution of the letter will cause it to be personally liable for the fund's indebtedness. Although the investor has entered into a contractual undertaking with the lender, the investor's obligations are limited to those set forth under the fund's constituent documents – namely, to fund capital contributions with respect to its unfunded capital commitments into an account of the fund as and when due. Ultimately, the obligations imposed on the investor by virtue of the consent letter should not be more onerous than those imposed under the fund's limited partnership agreement or the investor's subscription agreement and any side letter.

A lender may also require that the investor make certain representations and warranties in the investor consent letter. For example, the investor consent letter may include representations that: (i) the subscription agreement and the investor consent letter have been duly authorised, executed and delivered by the investor; and (ii) the subscription agreement, the partnership agreement and the investor consent letter constitute valid and binding obligations of the investor that are enforceable against the investor in accordance with their terms.

A lender may also want to ensure that the investor comes into the deal "clean", i.e., that as of the date it executes the investor consent letter, the investor does not have any knowledge of a default under the fund's partnership agreement or subscription agreement, or any claim, right of offset or defence that would adversely impact its obligation to fund. These provisions are not usually controversial. However, negotiations may hit a stumbling block when addressing sovereign immunity.

Sovereign immunity rights, a frequent point of contention between lenders and investors, limit the circumstances under which certain state and governmental actors can be subject to suit. This immunity is particularly problematic if the partnership agreement or side letter contains a provision whereby the investor expressly reserves its rights to sovereign immunity. Consequently, the lender may propose including a waiver of sovereign immunity in the investor consent letter. The investor may be reluctant to waive sovereign immunity as a matter of internal policy, or it may be prohibited from doing so as a matter of law.

Commonly, the lender and the investor agree to a middle-of-the-road approach relying on an exemption for commercial activities. In those cases, the investor does not explicitly waive its sovereign immunity but, instead, acknowledges its contractual liability with respect to its obligations under the partnership agreement and the subscription agreement, and/or that the performance of its obligations thereunder constitutes a commercial act. Otherwise, to the extent an investor reserves its rights with respect to sovereign immunity, and the investor is unwilling to make any acknowledgment with respect to its commercial obligations in its investor consent letter, the lender will have to reevaluate the business risk associated with lending against such investor's commitment.

In some cases, the lender might be willing to proceed on the basis of the investor's track record of funding. In other cases, the lender may agree to move forward, subject to increased fees or pricing or tighter covenants. To the extent the fund sponsor is aware of the investor's sensitivities related to sovereign immunity, the fund should make every effort to address those concerns in advance of negotiating the definitive documentation for the fund's credit facility.

Given the fact that the investor consent letter may be a gating item to closing, it is recommended that the fund sponsor involve the investor early in the financing process, so that any threshold issues can be identified and hopefully resolved. Fund sponsors should anticipate a longer lead time for negotiating and finalising the investor consent letter, which is often dependent on the responsiveness of the investor (and its appetite for the financing). Ideally, the investor consent letter is prepared concurrently with the term sheet for the facility (or even at the time of the investor's subscription to the fund), and socialised with the investor before the commencement of negotiations for the credit facility. As the investor reviews the letter, the fund might consider sharing the term sheet, or a summary of key terms, as a means of providing context and stemming any concerns.

Structuring considerations

Various factors influence the structuring of a facility for a fund of one, including the flexibility afforded under the fund's governing agreement and the expectations of the investor. A fund of one may obtain its own facility on a standalone basis, assuming it has procured a lender. Alternatively, a fund of one may be added to an existing facility as a parallel fund borrower.

There are, of course, several benefits to joining the fund of one to an existing facility: (i) both the existing borrowers and the fund of one enjoy the benefits of a larger borrowing base; (ii) such approach is likely to be more palatable to the lenders, given the additional collateral; (iii) the fund of one may receive better pricing terms than it would otherwise; and (iv) the fund of one (and, in turn, its investor) save on documentation and execution costs related to a separate facility.

Although there may be synergies to adding a fund of one, there are also some caveats to consider when joining a fund of one to another facility. Due consideration should be given to the potential impact on the liability of the funds at issue. Each borrower is ordinarily severally liable for its obligations under a subscription facility, subject to the cross-collateralisation of each of the other members of such borrower's borrowing group. If an event of default occurs under the facility with respect to any particular fund borrower (including the fund of one), each borrower is deemed to be in default and the lender can ultimately exercise remedies against any of the members of such defaulting borrower's borrowing group.

As a threshold matter, the fund sponsor should confirm whether the constituent documents of the fund of one and the other relevant funds permit such funds to cross-collateralise each other's obligations. Assuming cross-collateralisation is permitted under the applicable constituent documents, the fund sponsor should also confirm that adequate disclosure has been made to the investors, and that such cross-collateralisation is in alignment with investors' expectations. If the fund of one cannot cross-collateralise the main fund or vice versa, the fund of one may still be joined to the existing facility. However, the credit agreement would likely have to be amended to provide for two separate borrowing bases. Further, the lender may request an amendment to accommodate the joinder, which may call into question the efficiencies of joining the fund of one to an existing facility in the first place.

Given the structural complexities discussed above, a separate facility may offer the best path forward for a fund of one. That said, not all lenders are willing to lend to funds of one and, as a consequence, the fund will necessarily be working with a smaller universe of lenders. Lender appetite may be reduced if the investor has opt-in or opt-out rights with respect to any investment. These are ultimately relationship-based transactions, so the fund sponsor might reach out to its existing subscription facility lender(s) who are already familiar with the fund structure, management and investment strategy.

If the fund sponsor chooses to move forward with its existing subscription facility lender, the parties can leverage off the existing precedent, thereby reducing documentation costs and streamlining execution. In any event, it is most efficient to base the definitive documentation on the existing loan documents for the related main fund, subject to any changes that are required in light of the fund's organisational documents or as otherwise agreed.

Documentation

When negotiating a standalone credit agreement for a fund of one, the fund sponsor should be mindful of certain sticking points which are unique to funds of one.

- ***Investor transfers***: Customarily, subscription facilities will not impose restrictions on an investor's ability to transfer its interest in the fund; rather, an investor transfer is permitted, subject to: (i) compliance with sanctions; (ii) notice to the administrative agent and delivery of related transfer documentation; and (iii) payment of any mandatory prepayment to the extent the transfer results in a borrowing base deficiency.

  This mechanism is the right result for a commingled fund, as investors should be able to freely transfer their interests in compliance with the fund's organisational documents, without obtaining lender consents. However, for a fund of one, it is not unusual for a subscription facility lender to prohibit any investor transfers without lender consent. Such a prohibition may be viewed as reasonable in this limited circumstance, given the lender is relying entirely on the investor's capital commitment as its primary source of repayment. Still, any lender consent requirement should be circumscribed such that consent may not be unreasonably withheld, delayed or conditioned. A fund sponsor might also consider pre-clearing transfers to affiliates, subject to delivery of a new or updated investor consent letter, if requested.

- ***Exclusion events***: A fund sponsor should expect exclusion events to be tighter for a fund of one than they may otherwise expect for a commingled fund. For example, if an investor is subject to an involuntary bankruptcy proceeding, ordinarily the investor is not excluded from the borrowing base, unless such proceeding is not dismissed or stayed for a period of 60 days. A lender may not be willing to sit on the sidelines for quite as long when lending to a fund of one and may push for this grace period to be shortened. Similarly, if an investor in a fund of one fails to fund any capital contributions beyond the due date therefor, such failure to fund is subject to closer scrutiny and, consequently, a shorter grace period.

  A lender might also demand a broader exclusion event for any circumstance or event having a material adverse effect on the investor's ability to perform its funding obligations under the fund documents. For a commingled fund, such an exclusion event would ordinarily apply solely to unrated investors, on the basis that a lender could rely on the credit rating of a rated investor (which would be subject to a downgrade upon the occurrence of a material adverse event). Although such an exclusion event affords the lender more discretion, it's not uncommon in the context of a fund of one.

  Also, to the extent an investor consent letter is executed, several of the exclusion events will likely be expanded to include references thereto. For example, the investor will likely be excluded from the borrowing base if it breaches a material provision of its investor consent letter or makes a representation or warranty therein that proves to be materially inaccurate when made.

  Of course, if an exclusion event occurs with respect to the fund's sole investor, the fund will have no borrowing base. In a diversified fund, the occurrence of an exclusion event might give rise to a borrowing base deficiency, and consequently, a mandatory prepayment obligation. In a fund of one, the occurrence of an exclusion event which is not remedied within a short period of time may be fatal to the facility.

- ***Events of default***: With a few limited exceptions, events of default under a subscription facility should not be triggered by the actions of a single investor. However, when negotiating a subscription facility for a fund of one, it is unavoidable that certain events affecting the investor will also impact the facility. For example, if an exclusion event with respect to the sole investor in a fund of one continues uncured for a specified period of time, it may result in an event of default or an early termination of the facility.

If the fund sponsor is concerned about the implications of a default (for example, a cross-default to another facility or agreement), the fund sponsor may opt for the uncured exclusion event to trigger an early maturity rather than an event of default. Likewise, a lender may push for an event of default if the sole investor fails to fund a capital contribution when due, subject to a grace period. In contrast, a failure to fund by investors in a commingled fund would generally have to be significant to trigger a default under the facility.

Finally, some lenders may insist upon an event of default in the case of a bankruptcy event with respect to the sole investor in a fund of one. As a bankruptcy proceeding involving the investor would already result in an exclusion event, which would, in turn, result in an event of default, fund sponsors should be mindful as to how these two provisions might interact. While it is inevitable that the viability of the facility is dependent on the creditworthiness of the investor, it is important to strike the right balance, and circumscribe the events of default accordingly.

Separately, while some standard terms in a form credit agreement may make sense for a large commingled fund, they may not work when applied to a fund of one. Fund sponsors should carefully review their precedent credit agreement for any updates that should be made in light of the fund's structure and operating agreement. Below are a few examples.

- ***Opt-in and opt-out rights***: As a condition to borrowing, oftentimes the fund must confirm that no investor is entitled to exercise an excuse or exemption right in respect of such borrowing, except as otherwise disclosed to the administrative agent. This can be challenging for funds of one where the investor has opt-in or out-out rights with respect to any investment. For example, a side-car vehicle might be formed alongside a main fund to allow an investor participating in the main fund to effectively increase its commitment with respect to any investment, at such investor's option.

  In such case, as a condition to any borrowing, a lender may require delivery by the fund of evidence that such investor has waived its opt-out right or exercised its opt-in right, or a certification by the fund with respect thereto. Alternatively, to the extent the opt-out right expires by a certain date, the borrower could time the delivery of the borrowing request to follow such date, and be able to make the requisite certification. This latter option requires diligence on the fund's part, but avoids the need for any cooperation on the part of the investor.

- ***Borrowing conditions***: Given the bespoke nature of a credit facility for a fund of one, the lender may propose additional borrowing conditions corresponding to unique features or limitations contained in the fund's operating agreement. This is fine in principle, but such conditions should not be any more onerous than those contained in the fund's operating agreement. In any case, such conditions are arguably unnecessary if there is a covenant that the borrower will only use loan proceeds in accordance with its partnership agreement.

- ***Ratings requirement***: Fund sponsors should pay special attention to any ratings requirement, with the understanding that there will be no borrowing base to support the facility if the investor fails to meet such requirement. If the investor is unrated, the lender may instead look to the rating of the parent or credit support provider.

- ***Investor reporting***: Pursuant to the terms of the credit facility, a fund may be obligated to share with lenders any notices, reports, documents or other communications delivered to its investors generally. In the case of a fund of one, it is important that this covenant be limited to material documents and communications, and/or expressly exclude any such documents or communications that would not be shared with substantially all investors in a traditional commingled fund.

As the credit documentation for a fund of one is largely driven by the structure of the fund and its organisational documents, there is no one-size-fits-all approach. These facilities are bespoke by nature and require cooperation among all interested parties to achieve a successful outcome.

Conclusion

While the investor may not be a party to the facility, its influence is felt throughout the financing process. Collaboration among the fund's credit counsel and fund formation counsel is therefore key to managing the investor relationship and ensuring smooth negotiations. At the very least, the investor consent letter (or comfort letter) will require the investor's buy-in, which might be challenging. The fund sponsor and legal counsel should carefully steer investor communications and manage lender expectations accordingly.

The terms of the credit agreement are also directly impacted by the creditworthiness of the investor and the terms of its capital commitment. As the fund's partnership agreement is ultimately the governing document of the lender's collateral, it is recommended that credit counsel coordinate with fund formation counsel to tailor the credit documentation accordingly. Given the complex mechanics described above, it is paramount that fund sponsors engage experienced legal counsel to traverse the financing process and circumnavigate any issues before they arise.

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Investor views of fund subscription lines

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Introduction

In recent years, the use by private investment funds of capital call subscription facilities has increased dramatically. Fund managers who previously did not use subscription facilities have begun setting them up for their newer funds, and managers who were already using such facilities have been relying on them more extensively, leaving advances outstanding for increasingly longer periods.

As the use of such facilities has increased, so has their scrutiny by fund investors and the financial press. In recent years, a number of articles have appeared in the press questioning whether the use of subscription facilities truly benefits fund investors, or whether managers rely on them in ways that distort reported investment returns and increase risks to investors. The more pessimistic view gained significant traction in 2017, when the Institutional Limited Partners Association (the **ILPA**) published guidelines on fund subscription facilities that expressed concerns as to their widespread use, and recommended that investors negotiate limitations on their use where possible.

This chapter explores how the market has responded to such recommendations, the practical ways in which such recommendations have influenced the use of capital call subscription facilities and some of their terms, and their likely impact on the ways that subscription facilities will be used in the future.

Recent discussions on the pros and cons of subscription facilities

The practical benefits to fund managers and investors of the use of capital call facilities are well established. First, subscription facilities give funds the flexibility to close investments on short notice, because a fund with a subscription facility can fund an investment by borrowing the money (typically on no more than three business days' notice) instead of waiting weeks to receive the proceeds of a capital call to its investors.

The ability to close investments more quickly reduces execution risk, and puts the relevant fund in a competitive position relative to potential buyers that need more time to obtain the cash necessary to pay the purchase price. Second, the ability of a fund to use a credit facility to pay the purchase price of an investment, to fund direct lending activities (in the case of credit funds), or to make an unexpected expense reduces the need to make frequent capital calls. Rather than calling capital from investors every time that a fund needs additional cash flow, a fund manager can limit capital calls to once every one or two quarters. Fewer capital calls increases predictability for investors, and reduces the need for them to keep significant levels of liquid assets on hand in case of an unexpected capital call.

Counterbalancing the benefits of subscription facilities, a number of potential drawbacks for investors have been highlighted (most notably in an April 2017 memo by Howard Marks, the founder and co-chairman of Oaktree Capital, titled "Lines in the Sand"). These potential drawbacks have been the topic of negotiation between investors and fund managers for several years. They fall into four general categories:

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

(which would be increasingly likely during a financial crisis). In such cases, funds might have to liquidate assets at fire sale prices in order to repay their subscription debt, further exacerbating the systemic crisis.

The 2017 ILPA recommendations

In light of investor concerns in the face of increased capital call activity, the ILPA issued in June 2017 a set of guidelines for the use of subscription facilities, titled "Subscription Lines of Credit and Alignment of Interests: Considerations and Best Practices for Limited and General Partners". The ILPA's guidelines included the following recommendations for funds that use subscription facilities:

- *Calculation of IRR*

  For purposes of determining when the preferred return hurdle has been met for a fund manager's incentive compensation, a fund's IRR should be calculated starting on the date that the subscription facility is drawn, rather than on the date when capital is called from the investors.
- *Disclosure to investors*

  When a new fund is being formed, the manager should disclose to all potential investors:
  - The IRR of its previous funds, calculated with and without giving effect to the use of any subscription facilities.
  - Its policy on the use of subscription facilities.

  During the lifetime of the fund, the manager should disclose:
  - Its IRR with and without giving effect to the use of its subscription facility.
  - The cost of the facility (e.g., rates of interest and fees).
  - The purpose of each advance made under the facility and the making of any investment (even if capital has not yet been called).
  - The number of days that each advance is outstanding.
- *Terms of the fund's limited partnership agreement*

  The fund's limited partner advisory committee should consider discussing the fund's use of credit lines at its meetings, including whether the terms of any subscription facility then in effect are "market".

  The fund's ability to borrow under its subscription facility should be subject to a cap (e.g., 15–25% of uncalled capital).[1] The ILPA also suggested placing a cap on total interest expense.

  Any advances made under the facility should be repaid within 180 days.

  Advances should not be used to fund distributions prior to the fund's sale of the relevant portfolio company investment.

  The limited partnership agreement should permit investors that don't want to participate in a financing to fund their capital calls in advance of other investors, or otherwise contain mechanisms to enable investors to opt out of subscription financing.
- *Terms of subscription facilities*

  A fund's borrowing base (i.e., the calculation of the amount that the fund is permitted to borrow at any given time) should be based on its uncalled capital, rather than the net asset value of its portfolio assets.

The only collateral granted to the lenders should be the fund's right to call capital from its limited partners. The fund should not pledge its portfolio assets or any assets belonging to its limited partners.

The loan documents should specify a fixed maturity date for the advances, rather than enabling the lender to call for them to be repaid upon demand.

The fund's limited partners should not be required to enter into any agreements relating to the facility other than an acknowledgement of the lender's security interest in their capital commitments, and lender diligence on the limited partners should be limited to publicly available information.

Market response

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

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

Several of the ILPA's other recommendations seem equally misplaced. The concern, for example, that a fund might pledge the assets of its limited partners as collateral for its subscription facility, is unfounded. This pledge is almost never required by lenders and would not be obtained unless the relevant limited partner expressly agrees in the loan documentation to pledge its assets. Pledging the fund's asset portfolio, as opposed to its right to call capital from its limited partners, is also rare except in the context of extremely small funds or mature funds that have called virtually all of their committed capital already. The ILPA's proposal, meanwhile, to limit investors' involvement in subscription facilities to the execution of acknowledgments that the relevant fund has pledged its right to call capital, is merely a reflection of a market practice that exists already. For large funds with a diversified investor base, most lenders do not require investor acknowledgments beyond what is already customarily included in the fund's limited partnership agreement.

The second major reason for the limited response to the ILPA guidelines is that, although the financial press has at times suggested that the interests of fund managers and fund investors are inevitably opposed on the use of subscription facilities, the real situation is more complicated. Although some investors dislike subscription facilities, either because they want to put their cash to work as soon as possible or because they are concerned that the excessive use of fund-level debt distorts the calculation of IRR, other investors actually prefer to invest in funds that use subscription lines, because this enables capital calls to occur on a more predictable schedule.

In addition, the boost to IRR that use of a subscription facility can provide may actually benefit certain investors; for instance, funds of funds that report the returns on their investments to their own constituents. On the other side of the table, not all fund managers insist on the unfettered right to use their funds' subscription facilities. Some are happy to agree to constraints in the hopes that the evolution of a more consistent set of market standards on the use of subscription facilities will prevent competitors from using fund-level debt to boost their IRR calculations artificially.

Against this background, we have seen two major trends in negotiations between fund managers and investors on the use of subscription facilities. The first is greater disclosure. In response to requests from investors, many of which pre-dated the release of the ILPA guidelines, fund managers have increasingly been providing investors with two IRR calculations: one reflecting usage of the relevant fund's subscription facility; and the other backing this usage out. (It should be noted, though, that there is still variation in how unlevered IRR is calculated on a *pro forma* basis. While certain managers calculate it assuming all the capital was called on the date that the relevant deal closed, other calculations assume that capital was funded at the end of the quarter in which the particular deal was done.)

There is also more disclosure of the costs associated with a fund's subscription line, in particular interest and fee rates, and of mandatory prepayment triggers and events of default, especially any events outside a fund's control that could trigger early repayment. It is worth noting, however, that notwithstanding the ILPA's recommendation that managers disclose the use of each advance made under a fund's subscription facility, in general, investors seem uninterested in this level of detail.

The other major trend in investor demands relates to the length of time that advances under subscription facilities remain outstanding. Some fund managers are agreeing to strict time limits on borrowings, while others have agreed that in calculating a fund's IRR, they will start the clock on the earlier of the date that capital is called, and a specified number of days after the loan was made to fund the relevant investment (thus preventing the manager from boosting IRR artificially by keeping the loan outstanding for a longer period). ILPA goes one step further and, consistent with its 2017 guidelines, recommends in its recently published model limited partnership agreement for buyout funds that if the fund utilises a subscription line of credit, the preferred return should be calculated from the date on which the subscription line of credit was drawn. It remains to be seen if funds will adhere to such recommendation. A recent survey conducted by our firm, covering over 100 buyout funds, showed that less than 8% of those funds started the preferred return clock earlier than upon calling capital. The managers of funds without actual or implicit time limits on borrowings would argue that they are already required under the funds' limited partnership agreements to keep borrowings short-term in order to avoid unrelated business taxable income (UBTI) for tax-exempt investors, but that a strict deadline for repayments could limit their flexibility in ways that could be detrimental to investors – especially if it meant increasing the frequency of capital calls. Where time restrictions on borrowings do exist, the prevailing market trend seems to be for an actual or implicit limit of 180 days.

Outlook

While it is always difficult to anticipate how market terms will evolve, it has been clear to date that the ILPA guidelines have not been adopted wholesale. Nor have the guidelines limited the extent to which subscription facilities are used. One could argue, in fact, that by encouraging the development of market standards and expectations among fund managers and investors as to how these facilities will operate, the guidelines have, if anything, facilitated the growth of subscription facilities.

We would expect the trends in market standards identified above to continue. In particular, fund managers are likely to continue to provide investors with greater disclosure about the terms and use of these facilities, including, increasingly, by providing calculations of both a levered and an unlevered IRR. It is also possible that as new funds are formed, more (though not all) limited partnership agreements will contain caps on fund-level debt and/or actual or implicit limits on the duration of fund borrowings, the latter probably averaging around 180 days.

Another possible development may be the evolution of mechanisms in limited partnership agreements to enable investors to opt out of participating in subscription facilities by funding their capital calls in advance of other investors.[2] We have not seen many investor requests for such a mechanism so far, but this could become more prevalent in the future if interest rates increase. We note that ILPA published in September 2019 its "ILPA Principles 3.0: Fostering Transparency, Governance and Alignment of Interests for General and Limited Partners", in which it recommends that limited partners be offered the option to opt out of a facility at the onset of the fund.

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

* * *

Endnotes

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

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

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Introduction

Lenders must have a sound understanding of their legal rights regarding the process of enforcing remedies against a borrower and its limited partners[1] under a subscription-secured credit facility in order to assess risk, price the risk, and properly document the facility. Lenders who adequately plan for an event of default and exercise of remedies are more likely to prevail against the borrower and its investors when enforcing rights. Lenders must be prepared to execute every step of their enforcement strategy, beginning with the occurrence of an event of default, through the decision to accelerate the obligations, to the exercise of remedies and, finally, to recovery of payment.

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

Before a lender can exercise its remedies, there must first be an event of default under the facility documents. In many cases, the occurrence and continuation of an event of default will be clear (*e.g.*, failure to make payment or failure to timely act under the terms of the facility documents). However, if a borrower contests the existence of a default, the lender should consider immediately filing a declaratory judgment action in an appropriate court to establish that an event of default has occurred.[2] A declaratory judgment filing does not set forth a cause of action for damages, but instead seeks a declaration from the court establishing existing rights, status or other legal relationships under the terms of a contract. It provides a remedy to a party that is uncertain of its rights and wants an early adjudication without having to wait for its adversary to file suit.[3]

The court must have jurisdiction over the parties and the subject matter to issue a declaratory judgment. Typically, the borrower agrees to submit to jurisdiction in a particular forum in the facility documents, which establishes personal jurisdiction over the borrower.[4] Subject-matter jurisdiction is the court's jurisdiction over the nature of the case and the type of relief sought. A U.S. federal court has the power to hear a declaratory judgment action under 28 U.S.C. § 2201(a)[5] if the case is within its subject-matter jurisdiction and involves an actual controversy.[6] A lender seeking a declaratory judgment has the burden of establishing, by a preponderance of the evidence, that there is an actual controversy.[7] Similarly, under most state laws, a declaratory judgment is only proper when there is an actual controversy and the existence of the controversy is not "contingent upon the happening of future events which may never occur".[8]

In federal court, service of process on domestic entities is governed by the Federal Rules of Civil Procedure. *Rule 4* provides that a corporation, partnership, or other type of business association may be served by delivering the summons and complaint to an officer, managing or general agent, or an agent authorised by appointment or law to receive service.[9] New York and Delaware courts have similar service of process rules.[10] If the borrower agrees in the facility documents that service of process may be effected by registered or certified mail sent to a specific address, the state or federal court will recognize such service as effective.[11]

Several additional issues must be considered when the defaulting borrower is a non-U.S. ("***foreign***") entity. First, lenders must decide whether to pursue the foreign entity in the United States or in its home country.[12] Several factors favour suit in the United States. First, a judgment from any American court, state or federal, is relatively easy to register and enforce throughout the United States. Second, a U.S. court will be more familiar with the contractual obligations at issue. Finally, depending upon the applicable foreign jurisdiction, there may be considerable local bias in the foreign jurisdiction in favour of the foreign defendant that must be overcome.

Establishing personal and subject-matter jurisdiction over a foreign entity requires the same analysis.[13] Once jurisdiction has been established, the lender must effectively serve process on the foreign entity. If a foreign borrower has agreed in the facility documents to accept service of process by certified or registered mail, this manner of service will be enforceable unless the borrower demonstrates that such service is precluded by foreign laws.[14]

If the manner of service in the facility documents fails, is impractical, or is deemed unenforceable, the Hague Convention on the Service Abroad of Judicial and Extra-Judicial Documents (the "***Hague Convention***") provides an additional method of service on a defendant residing in any nation that is a signatory to the Hague Convention,[15] such as the United States,[16] the United Kingdom, or the Cayman Islands.[17] Therefore, knowledge of the Hague Convention procedure for service of process is useful as it provides the most fool-proof manner of service in applicable jurisdictions.

The Hague Convention provides for formal service through the foreign defendant's government's designated "*Central Authority*", where the process is sent to the Central Authority with instructions to forward it to the defendant.[18] Alternatively, in *Article 10(a)*, the Hague Convention states that, unless the foreign government has lodged an official objection, service by international registered mail directly to the defendant in the foreign nation is adequate.[19]

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

Once jurisdiction has been established and the foreign entity has been properly served, the lawsuit may proceed just as any other, and a declaratory judgment may be obtained. Under U.S. law, a declaratory judgment issued by a court has the force and effect of a final judgment or decree.[20]

Recovery from borrower and investors

Once an event of default is established, lenders may either direct the borrower to make a capital call on the investors for repayment of the obligations or issue a capital call directly on the investors.[21] If the borrower files for bankruptcy, a motion to lift the stay will be required before the lender can proceed. In well-documented, subscription-secured facilities, the obligations of the borrower and the rights of lenders *vis-à-vis* the investors should be so well-defined that even if the borrower challenges the lender's right to call capital, the fundamental obligation of the borrower to repay the obligations, and the lender's rights to call capital, are likely to be resolved by summary judgment.

By contrast, more complicated issues regarding recovery arise with respect to enforcement against the investors. Under most subscription-secured facilities, each investor enters into agreements or makes acknowledgments that run to the lender, either in an "***Investor Letter***" or in the partnership agreement, wherein the investor expressly acknowledges and confirms, *inter alia*, its obligation to make capital contributions without defence, set-off or counterclaim when called to repay the facility.[22] These agreements, together with the nature of the collateral securing subscription-secured facilities, constitute the foundation for recovery from the investors.

Legal theories of recovery against investors

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

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

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

Breach of contract claims may be based on:

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

If there is no express contract between the lender and the investors,[23] or if a contract between them is unenforceable or unproven,[24] the lender may be able to assert a claim for unjust enrichment on the equitable principle that the investors should not be permitted to enjoy the benefit of the lender's extension of credit if the lender is provided no remedy for an investor's subsequent default. The lender may also be able to assert a promissory estoppel claim based on the investors' capital commitment promise.[25,26]

Creditor enforcement under limited partnership law based on reliance

(a) *Rights of lenders*

In Delaware, the Revised Uniform Limited Partnership Act ("***DRULPA***") provides a statutory basis for asserting a reliance claim for the benefit of a lender.[27] Under DRULPA, unless otherwise provided in the partnership agreement, the obligation of investors to make contributions may be "compromised" only by the consent of all investors.[28]

The practical effect of DRULPA is to confer the benefit of the obligations of investors to a borrower on a lender who reasonably relied upon the capital call rights contained in the partnership agreement (*i.e.*, the lender would not have extended credit to the fund but for the fund's right to call capital from its investors). There is limited guidance as to what constitutes reasonable reliance; however, some courts have found reliance simply because the capital contribution obligations were contained in a publicly-filed certificate of limited partnership.[29] It has also been suggested that evidence of reliance may include:

- references in the lenders' credit files to the capital contribution obligations as a source of repayment of the loan;
- references to the capital contribution obligations in the facility documents or solicitation materials;
- communications with the general partner and limited partners regarding the basis on which the loan will be repaid;
- review of the partnership's books and records, such as capital accounts and financial statements; and
- execution of an undertaking pursuant to which the general partner agrees to issue, and/or the limited partners agree to make, capital contributions to repay the debt.[30]

In re LJM2 Co-Investment, L.P. Ltd. Partners Litig., 866 A.2d 762 (Del. Ch. 2004), the Delaware Court of Chancery held that the bankruptcy trustee of the limited partnership adequately demonstrated that the bank creditors reasonably relied, for the purposes of DRULPA, on the limited partners' representations that they would honour their capital commitments, which allowed the creditors to enforce the capital commitments.[31]

Specifically, the trustee alleged that the bank creditors reasonably relied on *Section 3.1* of the partnership agreement to extend credit to LJM2 because: (i) under that section, the limited partners were obligated to contribute their commitments only when called for by the general partner; and (ii) the bank creditors removed this solitary condition by creating interrelated agreements compelling the general partner to make capital calls if LJM2 defaulted (through the combination of the Credit Agreement and the General Partner Undertaking to the effect that, if LJM2 defaulted on the Credit Agreement, the [general partner] would be bound to issue Drawdown Notices to the limited partners to the extent necessary to cure such payment default).[32]

(b) *Defences*

Generally, if a limited partner's obligation to make capital contributions is not subject to conditions in the certificate of limited partnership (or in Delaware, the partnership agreement),[33] the circumstances in which payment will be excused are few and narrow because third parties and other limited partners have a right to rely on receipt of such capital contributions.[34] However, limited partners *may* be able to raise one or more of the following defences.

First, under Delaware law, a limited partner's obligation to make capital contributions to a limited partnership may not be enforced unless the conditions to funding obligations have been satisfied or waived.[35]

Second, one court applying a state analogue of *Section 502* of DRULPA has suggested that contribution obligations may be excused – even as to partnership creditors – where there has been a "profound failure of consideration such as repudiation of, or fraud incident to, the essentials of the venture to which the [partnership] was made."[36] The court provided two examples: (i) the general partner had absconded with the limited partners' initial contributions, without putting any money into the construction of a proposed apartment project; and (ii) a failure by the general partner to take any steps at all in furtherance of the apartment complex venture.[37]

However, a "material breach of the limited partnership agreement – including mismanagement, negligence, diversion of some assets, or unauthorized acts of the general partners, or disappointed expectations, or failure to perform certain elements of the agreement – would not excuse a limited partner's commitment to contribute additional capital," and thus would not constitute a valid defence to a *Section 502* claim.[38] One court held that proof of the general partner's fraudulent activities did not excuse the limited partners' capital contribution obligations and did not provide adequate defence to a creditor's claim under *Section 502* because the fraud had not resulted in a total failure of consideration.[39]

Third, another court has suggested that when loan proceeds are not used for partnership purposes, lenders may not be able to recover from those limited partners that lacked knowledge of such use.[40]

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

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

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

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

Because the investors are obligated to make capital contributions under the partnership agreement, and the collateral pledged to the lenders constitutes general intangibles, investors are considered "*account debtors*" under the UCC.[41] Under UCC § 9-406, after a lender delivers notice to investors that the amount due or to become due has been assigned ***and*** that payment is to be made to the assignee,[42] the investors may discharge their obligations to make capital contributions only by paying the lender. If the investors fail to fund their capital contributions, the lender may assert a breach of contract claim against the investors as an assignee under the security agreement.[43]

While no particular form of notice is mandated under UCC § 9-406, other than that the notice must be authenticated,[44] notice will be effective so long as the lender's chosen method of notifying the investor is sufficiently specific and direct.[45] Conversely, if the notice of the assignment does not reasonably identify the rights assigned, then it will be deemed ineffective.[46]

The courts uniformly hold that, if the notice simply informed the investors that the right to payment has been assigned to the lender – without also informing the investors that future payments are to be made to the lender – then the investors, by paying the borrower, are discharged and need not pay the lender as well.[47] It is not clear whether the notice requirement is satisfied by delivery of notice to investors at the closing of a facility, which notice would presumably disclose that payments would be required to be made to the lender upon an event of default and issuance of a capital call notice by the lender, both of which are conditions subsequent that may never occur. Thus, the prudent lender will deliver a notice, upon an event of default, that the right to payment has been assigned and that future payments must be made to the lender, so that any payment by the investors to the borrower will not discharge any liability to the lender – investors must pay the lender directly.[48]

After sending notice, the lender may exercise remedies under the partnership agreement *in lieu* of the general partner.[49] Under UCC § 9-404(a) this means that, unless the investors have agreed to fund capital contributions without defence, the lender's rights are subject to any claims or defences the investors have against the borrower. This principle is an "application of the 'elementary ancient law that an assignee never stands in any better position than his assignor. An assignee is subject to all the equities and burdens which attach to the property assigned because he receives no more . . . than his assignor.'"[50]

(b) *"Waiver" of defences*

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

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

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

In its Investor Letter, each investor will acknowledge and confirm that the lender, by extending the credit facility to the partnership, is relying on the obligation of the investor to make capital contributions to the partnership. Facility documents typically permit the lender to issue capital calls directly to the investors, and the investors will have agreed to fund capital contributions without defence, set-off or counterclaim. If any investor fails to fund its capital contribution when called by the lender, it will have breached the terms of its Investor Letter, and the lender may bring a breach of contract claim.

After discovery, the lender may be able to move for summary judgment, since proof of the executed Investor Letter and its terms and provisions will likely eliminate many issues of fact that may otherwise prevent the lender from obtaining summary judgment against such investor. Even short of an actual agreement, if an investor, by execution of an Investor Letter, *acknowledges and confirms* its obligations under the partnership agreement, such acknowledgment and confirmation may constitute an enforceable contract.[51]

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

If the partnership agreement expressly grants the lender the right to directly demand payment of capital contributions from the investors, the lender will be an intended third-party beneficiary of the agreement; often, partnership agreements make the third-party beneficiary status of the lenders explicit. The lender should then be able to enforce the investors' capital call obligations for its benefit. In *Chase Manhattan Bank v. Iridium Africa*, 307 F. Supp. 2d 608, 612 (D. Del. 2004), the limited liability company agreement at issue gave the lender the right to directly demand payment of the members' capital call obligations.[52] In that case, the court granted the lender's summary judgment request on its breach of contract claim (as a third-party beneficiary of the LLC agreement) based on the members' refusal to comply with the lender's demand for payment under the limited liability company agreement.[53] However, it appears the court granted summary judgment based solely on the relevant provisions of the limited liability company agreement (which gave the lenders the right to directly demand capital contributions from the members), without reviewing the lender's rights under the security agreement.[54]

Relevance of "waiver of defences"

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

Although lenders may have the right to require investors to make capital contributions through the security agreement, partnership agreement or *Section 502* of DRULPA (as enacted in Delaware and many other states), the limited partners may have defences at their disposal.[55] However, if the partnership agreement, the subscription agreements or the Investor Letter contain the customary waiver of defences language,[56] the investors should be estopped from raising those defences and the lenders may be able to obtain summary judgment against the investors.[57]

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

Parties to a contract may contractually agree to waive certain rights. A party may waive a defence to a contract,[58] and courts have enforced such waivers if the waiver language is manifested in some unequivocal manner.[59]

For example, in *Relational Funding Corp. v. TCIM Services, Inc.*, No. Civ. A. 01-821-SLR, 2003 WL 360255, at *2-3 (D. Del. Feb. 14, 2003), the Delaware District Court dismissed a lessee's counterclaims due to the following waiver in the lease agreement: "Lessee's obligation under the Lease with respect to Assignee shall be absolute and unconditional and not subject to any abatement, reduction, recoupment, defence, offset or counterclaim[.]"[60] The court held that this provision was enforceable based on the degree and specificity to which it explicitly waived the defendant's rights.[61]

As to whether fraud (especially, fraud in the inducement) as a defence is waivable, the Third Circuit in *MBIA Ins. Corp. v. Royal Indemnity Co.,* 426 F.3d 204, 210 (3d Cir. 2005), noted that "[W]e predict that when sophisticated parties have inserted clear anti-reliance language[62] in their negotiated agreement, and when that language, though broad, *unambiguously* covers the fraud that actually occurs, Delaware's highest court will enforce it to bar a subsequent fraud claim."[63] However, the same court also pointed out that the standards for effective waiver would be stricter, if waiver is possible at all, if fraud in the factum was raised as a defence.[64]

In 2007, the Sixth Circuit endorsed and adopted the *MBIA* court's analysis regarding waivers of defences.[65] In *Commercial Money Center, Inc. v. Illinois Union Insurance Co.*, 508 F.3d 327 (6th Cir. 2007), the Court of Appeals for the Sixth Circuit, applying California law, enforced a contractual provision waiving an insurance company's right to assert the defence of fraud.[66] In doing so, the court noted that the parties had negotiated for and "sculpted" provisions containing anti-reliance language and explicitly waiving the right to assert defences relating to "all issues of fraud".[67]

An exception to the enforceability of a waiver of defences may exist when public policy concerns arise. Principally, some courts have refused to enforce a waiver of defences provision when the defendant was fraudulently induced to enter into the agreement.[68] Other courts have permitted waiver when sophisticated parties agree to clear any unambiguous waiver language covering the fraud that occurred.[69] Generally, courts will not permit waiver under any circumstances when a contract is procured by fraud in the factum, such that the waiving party does not even know the "true nature" of what it is signing.[70] If investors have not agreed to an enforceable waiver of defences, then the lender's breach of contract claim will be subject to any valid affirmative defences the investors can assert.

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

If a lender is enforcing its rights under a security agreement, UCC § 9-403 provides guidance as to: (i) the enforceability of the investor's waiver of defences; and (ii) what types of defences may be waived, and what types of defences may not be waived.[71]

Under UCC § 9-403, a waiver by an account party, in favour of an assignee, of defences that such account party may otherwise have against the assignor, is enforceable.[72] If a waiver of defence clause in favour of an assignee is recognized as enforceable under UCC § 9-403, the assignee will be subject to only those defences that could be asserted against a holder in due course (which are not waivable under the UCC),[73] which may include defences (among others less relevant) based on:

- duress, lack of legal capacity, or illegality of the transaction which, under other law, nullifies the obligation of the obligor;
- fraud in the factum (*i.e.*, fraud that induced the obligor to sign the instrument[74] with neither knowledge nor reasonable opportunity to learn of its character or its essential terms);[75] or
- discharge of the obligor in insolvency proceedings.[76]

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

- failure of consideration;[77]
- non-delivery of goods;
- fraud in the inducement;[78]
- breach of warranty; or
- the lack of a meeting of the minds between the parties and, accordingly, no valid contract.[79]

(c) *Lack of waiver of defences*

In the event that no waiver of defences has been entered into, the circumstances under which an investor's capital call obligation will be excused should still be few and narrow. Courts are reluctant to excuse capital call obligations, because third parties and other investors generally rely upon them.[80]

(d) *Enforcing judgments*

The last step in the litigation process, after a judgment is obtained, is to enforce the judgment against the investors' assets.[81] This process can be time-consuming and difficult; however, Federal Rule of Civil Procedure 69 provides for very broad post-judgment discovery of a judgment debtor's assets. All of the discovery tools under the Federal Rules of Civil Procedure are available to locate a debtor's assets, including requests for documents, interrogatories, and depositions.[82] Federal courts have broad authority to sanction judgment debtors that refuse to comply with post-judgment discovery.[83] Once a judgment debtor's assets have been located, Federal Rule of Civil Procedure 69 provides that execution of those assets proceeds in the manner of the state where the federal court is located. Depending on the jurisdiction, common judgment enforcement mechanisms include garnishments,[84] attachments, turnovers, and execution on property.[85]

Moreover, transferring an American judgment from one U.S. jurisdiction to another so that it may be locally enforced is a relatively simple matter. Federal law provides for the registering of a federal judgment in a different federal district simply by filing a certified copy of the judgment.[86] In state courts, the Uniform Enforcement of Foreign Judgments Act ("***UEFJA***") has been adopted by every state except California (which has adopted a similar procedure).[87] The UEFJA allows enforcement of a judgment from another state upon the simple filing of the judgment with the clerk of court.[88]

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

Unlike many countries, the United States has no treaty or agreement with any other country respecting the enforcement of judgments.[89] Therefore, a country-by-country analysis is required to determine how to enforce a U.S. judgment against assets of an investor outside of the U.S., or against a non-U.S. investor. Common criteria to consider include the following:

- whether the court of origin had jurisdiction over the judgment debtor;
- whether the judgment debtor was properly served in the original action;
- whether enforcement of the judgment would violate local public policy; and
- whether the judgment is "final".[90]

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

Conclusion

Although material borrower defaults in the subscription lending universe have been rare, the few that have occurred are instructive. In each known case, a facility default has resulted in the borrower's full repayment of the facility, usually from proceeds of a capital call on the investors. In the *Chase Manhattan Bank v. Iridium Africa* case,[91] the lenders recovered from investors as well. However, the rarity of defaults means that there is little guidance from case law that confirms the legal analysis relating to enforcement and recovery. Thus, it is critical to a lender's adequate risk-management strategy and credit analysis to understand the issues and anticipate a strategy for enforcement of remedies against a borrower and its investors, should the need arise.

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Endnotes

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

directed to the corporations for which it serves as registered agent and forward same to the corporation to which the service or communication is directed . . . ."). Note, however, that the lender may also obtain a waiver of formal service requirements from the defendant under the federal rules. Fed. R. Civ. P. 4(d). The federal rules provide an incentive for a defendant to waive formal service in the form of 60 days to answer the complaint as opposed to 20. Fed. R. Civ. P. 12(a)(1). The option to seek a waiver is in the lender's discretion, however, and the lender may not wish to give the defendant more time to answer.

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

defendant can be found in New York, service under New York law may be effective against the defendant itself, with no need to resort to the Hague Convention. *See Volkswagenwerk Aktiengesellschaft v. Schlunk*, 486 U.S. 694, 707 (1988) ("Where service on a domestic agent is valid and complete under both state law and the Due Process Clause, our inquiry ends and the Convention has no further implications.").

17. The Cayman Islands are a British Overseas Possession, and as such are not an independent nation. However, they will be considered separately because certain financial privacy legislation presents special difficulties with enforcing a judgment there. *See* Cayman to Welcome Third Party Rights Rules, Appleby (July 2014), http://www.mondaq.com/caymanislands/x/309882/offshore+financial+centres/Cayman+to+Welcome+Third+Party+Rights+Rules; *see also* Changes to the Cayman Islands Exempted Limited Partnership Law, Appleby (April 2014), http://www.mondaq.com/caymanislands/x/308408/offshore+financial+centres/CHANGES+TO+THE+CAYMAN+ISLANDS+EXEMPTED+LIMITED+PARTNERSHIP+LAW; *see also* Changes to the Cayman Islands Exempted Limited Partnership Law, Appleby (May 2009), https://www.internationallawoffice.com/Newsletters/Offshore-Services/Cayman-Islands/Appleby/Changes-to-the-Exempted-Limited-Partnership-Law.
18. *See* 1965 Convention Outline, http://www.hcch.net/index_en.php?act=publications.details&pid=2765&dtid=28 (last visited November 29, 2017) for a practical outline of service of process under the Hague Convention. Each participating government designates its own "Central Authority". For example, the United States' Central Authority is the Office of International Judicial Assistance, a part of the Justice Department. *See* U.S. Dep't of State, http://travel.state.gov/content/travel/en/legal-considerations/judicial/service-of-process.html (last visited November 29, 2017). The United Kingdom's Central Authority is the Senior Master of the Royal Courts of Justice, in London. *See* Central Authority, https://www.hcch.net/en/states/authorities/details3/?aid=278 (last visited November 29, 2017).
19. Hague Convention art. 10(a), Nov. 15, 1965, 20 U.S.T 361, 658 U.N.T.S 163. Note that the United Kingdom and the Cayman Islands have made no objection to service by mail. *See McCarron v. British Telecom*, No. CIV A. 00-CV-6123, 2001 WL 632927, at *1-2 (E.D. Pa. June 6, 2001) (holding that mailing documents via certified mail to the defendant's business address in London, England was sufficient under the Hague Convention).
20. *See* 28 U.S.C. § 2201(a) (2010).
21. In some facilities, borrowers negotiate a short standstill period to permit time for the borrower to make a capital call before the lender may act. Lenders sometimes agree to this provision under the theory that the investors may be more inclined, as a practical matter, to respond to an "ordinary course of business" capital call than one issued by a lender. However, in most subscription-secured facilities, lenders have an immediate right to make capital calls upon a payment default or acceleration of the debt following an event of default.
22. Note that investors typically agree to fund capital contributions for the repayment of the facility without defence, setoff or counterclaim, whether called by the borrower or lender. Strictly speaking, they do not waive defences against the fund, but this mechanism keeps the risk of mistake, fraud or bad investments between the investors and the fund.
23. Many states and the District of Columbia preclude recovery for unjust enrichment if

there is an express contract between the parties. *See, e.g., Nemec v. Shrader*, Nos. 3878-CC, 3934-CC, 2009 WL 1204346, at *6 (Del C. Apr. 30, 2009) ("Delaware courts, however, have consistently refused to permit a claim for unjust enrichment when the alleged wrong arises from a relationship governed by contract."); *Schiff v. American Ass'n of Retired Persons*, 697 A.2d 1193 (D.C. 1997) (no claim for unjust enrichment when an express contract exists between the parties); *Marshall Contractors, Inc. v. Brown University*, 692 A.2d 665 (R.I. 1997) (same); *W&W Oil Co. v. Capps*, 784 S.W.2d 536 (Tex. App.–Tyler 1990) (same). Note that if there is only an express contract between the investors and the fund (such as the partnership agreement), this may not bar a claim for unjust enrichment between the investors and the lender. *See Leasepartners Corp. v. Robert L. Brooks Trust Dated November 12, 1975*, 942 P.2d 182 (Nev. 1997) (permitting claim for unjust enrichment by leaseholder against owner because the only express written contract was between the owner and tenant).

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

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

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

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

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

28. 6 Del. C. § 17-502(b)(1) (1995). The same holds true for creditors of limited liability companies. *See also* Ribstein and Keatinge, *supra* note 27 at § 5:8 ("The [LLC] statutes also generally provide that creditors who rely on the original contribution may enforce original contribution obligations notwithstanding an intervening compromise." (citing, *inter alia*, 6 Del. C. § 18-502(b) (1995), which says: "Notwithstanding the compromise, a creditor of a limited liability company who extends credit, after the entering into of a limited liability company agreement or an amendment thereto which, in either case, reflects the obligation, and before the amendment thereof to reflect the compromise, may enforce the original obligation to the extent that, in extending credit, the creditor reasonably relied on the obligation of a member to make a contribution or return.")).
29. Hall & Payne, *supra* note 26 (citing *Partnership Equities, Inc. v. Marten*, 443 N.E.2d 134, 136 (Mass. App. Ct. 1982)). To the extent that there is an Investor Letter, the acknowledgment/agreement contained therein should substantiate the lender's reasonable reliance claim against the investors under 6. Del. C. § 17-502 (1995).
30. Hall & Payne, *supra* note 26.
31. 866 A.2d 762.
32. *Id*. at 781. Section 3.1, as part of the Partnership Agreement, was attached to the Confidential Information Memorandum given to the bank creditors. *Id*. It provided, *inter alia*:
    - that each limited partner made an initial capital contribution of 15% of its overall Commitment;
    - that the Commitment means "the aggregate amount of cash agreed to be contributed as capital to the Partnership by such limited partner as specified in such limited partner's Subscription Agreement...";
    - that the limited partners need to make additional capital contributions to the Partnership "at such times as the General Partner shall specify in written notices (each, a 'Drawdown Notice')";
    - that each partner's funding obligation would expire upon the "termination of the Commitment Period" but, nevertheless, required contributions thereafter "to pay or provide for payment of Partnership Expenses, including Partnership funded indebtedness"; and
    - that there is no obligation by the limited partners directly to creditors, as follows:

(the provisions of this Agreement (including this Article III) are intended solely to benefit the Partners and, to the fullest extent permitted by applicable law, shall not be construed as conferring any benefit upon any creditor of the Partnership (and no such creditor shall be a third party beneficiary of this Agreement), and no limited partner shall have any duty or obligation to any creditor of the Partnership to make any Capital Contributions or to cause the General Partner to make a call for Capital Contributions.

- *Id*.

33. *Id.* at 762 ("To the extent a partnership agreement requires a partner to make a contribution, the partner is obligated, except to the extent such obligation is modified by the terms of the partnership agreement, to make such contribution to a limited partnership"); *see also* 6 Del. C. § 17-502(b)(1)(1995).
34. *Partnership Equities, Inc. v. Marten*, 443 N.E.2d 134, 136 (Mass. App. Ct. 1982); *see also* 59A Am. Jur. 2d Partnership § 871 (2003).
35. Conditional obligations include contributions payable upon a discretionary call of a limited partnership or general partner prior to the time such call occurs. *See* 6 Del. C. § 17-502(b)(2) (1995). *See also supra* notes 31-32 and accompanying text.
36. *Partnership Equities, Inc.*, 443 N.E.2d at 136.
37. *Id*. at 138-139.
38. *Id*. See also *Stobaugh v. Twin City Bank*, 771 S.W.2d 282 (Ark. 1989); 59A Am. Jur. 2d Partnership § 871 (2003).
39. *In re Securities Group 1980*, 74 F.3d at 1108-09 (11th Cir. 1996) (holding that any fraud on part of Chapter 11 debtor-limited partnerships and their general partners based upon general partners' convictions for income tax fraud arising out of activities related to limited partnerships, including use of "rigged straddles" and "rigged repurchase agreements" to create fraudulent income tax losses, which were then passed through to investors such as limited partners and subsequently disallowed by IRS, was not sufficient to permit limited partners to avoid their liability, under New York partnership law, to make additional capital contributions to partnerships upon capital call by Chapter 11 trustee, given strong statutory purpose of New York partnership law to favour creditors over limited partners).
40. Liability for contribution obligations – Liability to partnership creditors for unpaid contributions, *See* J. William Callison and Maureen Sullivan, Partnership Law & Practice § 24:4 (2006) (citing *Northwestern Nat. Bank of Minneapolis v. Swenson*, 414 N.W.2d 543 (Minn. Ct. App. 1987) (holding that evidence supported trial court's finding that limited partner had no knowledge that his notes, which were given for his investment in limited partnership, would be used as collateral for loans to general partner, which were then used by general partner for non-partnership purposes, and, therefore, limited partner was not estopped from asserting defence that proceeds of loans were used for non-partnership purposes)).
41. *See* UCC § 9-102(a)(3) (AM. LAW INST. & UNIF. LAW COMM'N 2010) ("account debtor" means a person obligated on an account, chattel paper, or general intangible).
42. Because the notice must recite that payment is to be made to the assignee, it is prudent to provide notice upon an event of default, which is the time after which a lender has the right to receive payment of the capital contributions, even if prior notice has been delivered or if Investors Letters are in the transaction.
43. *See, e.g., IIG Capital LLC v. Archipelago, L.L.C.*, 36 A.D.3d 401, 404-05 (N.Y. Sup.

Ct. 2007) (holding assignee properly asserted a breach of contract cause of action against account debtors under New York's version of UCC§ 9-406).

44. This requirement normally can be satisfied by the lender sending notification on its letterhead or on a form on which its name appears. *See also* UCC § 9-102(a)(7) (AM. LAW INST. & UNIF. LAW COMM'N 2010) (defining "authenticate" to mean "with present intent to adopt or accept a record, to attach to or logically associate with the record an electronic sound, symbol, or process").
45. *See e.g., Banque Arabe et Internationale D'Investissement v. Bulk Oil (USA) Inc.*, 726 F. Supp. 1411 (S.D.N.Y. 1989) (holding notice of an assignment is effective when the debtor receives notice that the funds have been assigned and that payment is to be made to the assignee); *General Motors Acceptance Corp. v. Albany Water Bd.*, 187 A.D.2d 894 (N.Y. 1992) (no particular form of notice is necessary in order to require payment to the assignee; it is sufficient if information known to the debtor either apprises it of the assignment or serves to put it on inquiry).
46. *See* UCC. § 9-406(b)(1) (AM. LAW INST. & UNIF. LAW COMM'N 2010); *Warrington v. Dawson*, 798 F.2d 1533, 1536 (5th Cir. 1986).
47. *See 29 Williston on Contracts* § 74:56 at n.43 (4th ed. 2008). In this scenario, the lender would likely have alternative cause of action against the fund for unjust enrichment and/or *quantum meruit*. The existence of a valid and enforceable contract typically precludes recovery in quasi-contract for events arising out of the same subject matter, but if there is a *bona fide* dispute as to the existence of a contract or if the contract does not cover the dispute in issue, then the plaintiff may be able to proceed on an alternative theory such as unjust enrichment or *quantum meruit*. *See IIG Capital*, 36 A.D.3d at 404-05 (citations omitted).
48. *See IIG Capital*, 36 A.D.3d at 402-03.
49. It is important to note that "[n]otification is for the benefit of the assignee, who would otherwise have no recourse against the account debtor if the assignor failed to forward payment that the account debtor made directly to the assignor." *Novartis Animal Health US, Inc. v. Earle Palmer Brown, LLC*, 424 F. Supp. 2d 1358, 1364 (N.D. Ga. 2006).
50. *GMAC Commercial Credit LLC v. Springs Industries, Inc.*, 171 F. Supp. 2d 209, 213-14 (S.D.N.Y. 2001) (quoting *Septembertide Publishing, B.V. v. Stein and Day, Inc.*, 884 F.2d 675, 682 (2nd Cir. 1989)).
51. *See, e.g., C.H.I. Inc. v. Marcus Bros. Textile, Inc.*, 930 F.2d 762, 763 (9th Cir. 1991) (enforcing terms of contract confirmation form that was sufficiently specific and provided for mutuality of remedy).
52. (*Iridium I*), 307 F. Supp. 2d 608, 612 (D. Del. 2004); *see also Blair v. Anderson*, 325 A.2d 94, 96-97 (Del. 1974) (holding that a federal prisoner could enforce a contract between the United States and Delaware involving care for prisoners, and stating: "It is established Delaware law that a third-party beneficiary of a contract may sue on it."); *John Julian Constr. Co. v. Monarch Builders*, 306 A.2d 29 (Del. Super. Ct. 1973) (creditor of liquidated corporation could enforce the assumption of liabilities contract against the defendants as a third-party beneficiary). Note that the analysis provided in these cases should apply equally to the investors in a limited partnership.
53. *Iridium I* at 612.
54. "Accordingly, the Court will grant Chase summary judgment on its first claim for relief, breach of contract." *Id*. "It is undisputed that Iridium LLC defaulted on the Chase Loan

and that Chase called the Members' RCC obligations pursuant to Section 4.02 of the amended LLC Agreement. The Members refused to comply with Chase's demand for payment in contravention of the amended LLC Agreement, thus compelling the Court to grant Chase summary judgment on its breach of contract claim." *Id.* at 612 n.1. *See also Chase Manhattan Bank v. Iridium Africa* (*Iridium II*), 474 F. Supp. 2d 613 (D. Del. 2007).

"Based on the Court's conclusion that the Members may not deny the validity of the Certificate's representation that the amended LLC Agreement is "true and correct," the Court will not discuss the Magistrate Judge's Report and Recommendation on the issues of … 2) whether Chase is entitled to summary judgment on its first claim for relief due to the Security Agreement." *Iridium I* at 612 n.2.

55. For a highly publicised example, *see Wibbert Investment Co. v. New Silk Route PE Asia Fund LP*, case number 650437/2013, in the Supreme Court of the State of New York. Wibbert Investment Co., the investor, declined to fund a capital call after allegations of the general partner's gross negligence and/or willful malfeasance and the conviction of a related person for insider trading. Wibbert alleges that the Fund has threatened to implement default remedies, and he was granted a preliminary injunction preventing the fund from declaring default. The case is still active.
56. When the partnership agreement and subscription agreements do not contain waiver of defences, the Partner Confirmations usually contain such language.
57. *See Iridium I* at 612-13 (where the LLC Agreement provided that each Member agreed that its duty to perform under the Reserve Capital Call (RCC) obligation was "absolute and unconditional", and each Member waived "any defence it may have or acquire with respect to its obligations under the [RCC]").
58. *See* 17B C.J.S. Contracts § 637 Waiver of Defences (2008).
59. *See Wells Fargo Bank Minnesota Nat. Ass'n v. Nassau Broadcasting Partners, L.P.*, No. 01 Civ 11255(HB) 2002 WL 31050850, at *2 (S.D.N.Y. Sept. 13, 2002) ("The hell or highwater provisions at issue, especially in light of the degree in which they explicitly waive [defendant's] right to assert setoffs, defences or counterclaims, are generally enforceable.") (citations omitted).
60. No. Civ. A. 01-821-SLR, 2003 WL 360255, at *2-3 (D. Del. Feb. 14, 2003).
61. *Id*. at *3, n.1.
62. It appears by "anti-reliance language", the court refers to broad waiver of defence language that is clearly inconsistent with reasonable reliance on extracontractual representations (and therefore the defence of fraud in the inducement). In particular, the court refers as "anti-reliance language" the following language (emphasis added):

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

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

The court pointed out that, to establish fraudulent inducement, the defendant insurer must show *reasonable and detrimental reliance* on a misrepresentation intentionally or recklessly made to induce action or inaction. *Id*. at 212. The court thought it was unfathomable that an insurer that intended to rely on extracontractual representations would agree that its obligations are "absolute, continuing, irrevocable and unconditional irrespective of ... any other rights or defences that may be available to the insurer ... (all of which rights and defences are hereby expressly waived by the insurer)." *Id*. Thus, according to the court, the defendant insurer could not possibly claim that its reliance on those representations was reasonable when it waived all defences based on reasonable reliance. *Id*. Thus, an agreement may foreclose a fraud defence not only by waiving "fraud" but also by setting forth terms clearly inconsistent with reasonable reliance on extracontractual representations. *Id*. at 213.

63. *Id*. at 218 (emphasis added). The court acknowledged that a line of New York cases had referred to "*specificity*" (of the waiver language) as a test for the enforceability of waiver of defence language. However, the court then rejected such test and predicted that the Delaware Supreme Court would adopt the "*clarity*" (of the waiver language) test.
64. *Id*. at 217. Fraud in the factum is "the sort of fraud that procures a party's signature to an instrument without knowledge of its true nature or contents", and the party does not even know the "true nature" of what it is signing. *Id.*; *see also supra* note 62 and accompanying text.
65. *Commercial Money Ctr., Inc. v. Illinois Union Ins. Co.*, 508 F.3d 327 (6th Cir. 2007).
66. *Id.* Commercial Money Center, Inc. ("**CMC**") was an equipment leasing business allegedly engaged in a Ponzi-type scheme. When CMC collapsed, numerous creditors and insurance companies filed claims and counterclaims related to credit transactions to which CMC was a party. One such transaction was a surety agreement between CMC (principal), Illinois Union (surety) and JPMorgan Chase (creditor, as trustee of Citibank). Under the surety agreement, Illinois Union was obligated to "answer for the debt, default, or miscarriage" of CMC notes purchased by Citibank. When CMC filed for bankruptcy, Illinois Union sought rescission of the surety agreement, arguing, *inter alia*, that CMC fraudulently induced Illinois Union to provide surety coverage through various material misrepresentations. In discussing Illinois Union's waiver of the right to assert fraud as a defence under the surety agreement, the court explicitly followed the *MBIA* opinion, ultimately finding that the allegations against CMC did not rise to the level of fraud in the factum (which is discussed below).
67. *Id.* at 344.
68. *See Eureka Broadband Corp. v. Wentworth Leasing Corp*., 400 F.3d 62, 69-70 (1st Cir. 2005); *Computer Sales Intern., Inc. v. Lycos, Inc*., No. Civ. A. 05-10017 RWZ, 2005 WL 3307507 at *5 (D. Mass. December 6, 2005) ("[U]nder Massachusetts law, it is well settled that clauses 'attempting to protect a party against the consequences of his own fraud are against public policy and void where fraud inducing the contract is shown'." (citations omitted)); *see also F.D.I.C. v. Borne*, 599 F. Supp. 891, 894 (E.D.N.Y. 1984) ("A waiver of the right to assert a setoff or counterclaim is not against public policy and has been enforced by this court. However, such a waiver will not be enforced so as to bar a viable setoff or counterclaim sounding in fraud." (internal citations omitted)).

69. *See MBIA Ins. Corp. v. Royal Indemnity Co.*, 426 F.3d 204, 210 (3d Cir. 2005). Wells Fargo (and others) as beneficiaries under credit risk insurance policies insuring payment of principal and interest in the event of defaults on underlying student loans brought action against Royal Indemnity Company ("*Royal*"), as insurer, to recover under the policies. Royal defended on the ground that the lender of the underlying student loans fraudulently induced it to issue the policies and that this fraud in the inducement entitled it to rescission. The court held that Royal's policies unambiguously and effectively waived defences to its obligations even if induced by fraud. The court pointed out that, to establish fraudulent inducement, the defendant insurer must show *reasonable and detrimental reliance* on a misrepresentation intentionally or recklessly made to induce action or inaction. *Id*. at 212. The court thought it was unfathomable that an insurer that intended to rely on extracontractual representations would agree that its obligations are "absolute, continuing, irrevocable and unconditional irrespective of ... any other rights or defences that may be available to the insurer ... (all of which rights and defences are hereby expressly waived by the insurer)." *Id*. Thus, according to the court, the defendant insurer could not possibly claim that its reliance on those representations was reasonable when it waived all defences based on reasonable reliance. *Id*. Therefore, an agreement may foreclose a fraud defence not only by waiving "fraud" but also by setting forth terms clearly inconsistent with reasonable reliance on extracontractual representations. *Id*. at 213. *See also Manufacturers Hanover Trust Co. v. Yanakas*, 7 F.3d 310, 316-17 (2d Cir. 1993) (comparing New York state law waiver cases and concluding that "[w]here the fraud claim has been dismissed, the disclaimer has been sufficiently specific to match the alleged fraud [,]" but that "the mere general recitation that a guarantee is 'absolute and unconditional' is insufficient . . . to bar a defence of fraudulent inducement, and that the touchstone is specificity.").
70. For further analysis of the distinction between fraud in the factum and fraud in the inducement, *see infra JPMorgan Chase Bank v. Liberty Mutual Insurance Co*., in which the surety was asked to insure the delivery of a commodity when, in fact, it was guaranteeing a loan. 189 F. Supp. 2d 24, 28 (S.D.N.Y. 2002); *see also MBIA Ins. Corp.*, 426 F.3d at 217 (describing *JPMorgan Chase Bank* as an "unusual and extreme case" and questioning whether waiver would even be possible when a contract is procured through fraud in the factum).
71. In a capital commitment facility, the collateral granted by a limited partnership borrower to the lender falls under "general intangible" as defined in Article 9 of the UCC and the security agreement is governed by Article 9.
72. "Except as otherwise provided in this section, *an agreement between an account debtor and an assignor* not to assert against an assignee any *claim or defence that the account debtor may have against the assignor* is enforceable by an assignee that takes an assignment:

    (1) for value;

    (2) in good faith;

    (3) without notice of a claim of a property or possessory right to the property assigned; and

    (4) without notice of a defence or claim in recoupment of the type that may be asserted against a person entitled to enforce a negotiable instrument under UCC § 3-305(a)."

    UCC § 9-403(AM. LAW INST. & UNIF. LAW COMM'N 2010) (emphasis added); *see* *also Id.* at Comment 2 ("However, this section expands former Section 9-206 to apply to all account debtors; it is not limited to account debtors that have bought or leased goods").

73. *See* 68A Am. Jur. 2d Secured Transactions § 485 (2017).
74. Since UCC § 9-403's scope is not limited to waiver of defences in negotiable instruments, it appears that when applying UCC § 9-403, one should read the word "instrument" in UCC § 3-305 as referring to whatever agreement or document which contains the waiver of defences language in question. And presumably, it is regarding the same agreement or document the account debtor is raising a fraud in the factum defence. *See generally Chase Manhattan Bank, N. A. v. Finger Lakes Motors, Inc.*, 423 N.Y.S.2d 128 (N.Y. Sup. Ct. 1979); *MBIA Ins. Corp. v. Royal Indemnity Co.*, 426 F.3d at 217 ("Royal does not seriously question the nature of the transactions covered by its policies").
75. This defence is most frequently referred to by the courts as fraud in the factum, but is also sometimes denominated fraud in the essence or fraud in *esse contractus*, among other terms. *See* Milton Roberts, Annotation, Fraud in the Inducement and Fraud in the Factum as Defences under UCC § 3-305 Against Holder in Due Course, 78 A.L.R.3d 1020 § 2 (1977); *see also supra* at notes 69-70 and accompanying text.
76. *See* UCC §§ 9-403, 3-305(AM. LAW INST. & UNIF. LAW COMM'N 2010).
77. *Supra* note 73 (citing *Equico Lessors, Inc. v. Mines*, 148 Cal. Rptr. 554 (Cal. Ct. App. 1978) (lessees refused to pay rent to lessor's assignee; court rejected as a valid defence against the assignee lessees' defence of failure of consideration – that the equipment had not been delivered); *Stenger Industries, Inc. v. Eaton Corp.*, 298 S.E.2d 628 (Ga. Ct. App. 1983) (lessee refused to pay rent to lessor's assignee; court rejected as a valid defence against the assignee lessee's defence – that machinery was defective); *Washington Bank & Trust Co. v. Landis Corp.*, 445 N.E.2d 430 (Ill. App. Ct. 1983) (lessee refused to pay rent to lessor's assignee; court rejected as a valid defence against the assignee lessee's defence – that the machine under the lease never worked and it was taken from lessee to make room for a replacement lessee never accepted)).
78. *See F.D.I.C. v. Kassel*, 421 N.Y.S.2d 609 (N.Y. App. Div. 1979) (lessee refused to pay rent to the successor in interest of the lessor's assignee; court rejected as a valid defence against the successor in interest of the lessor's assignee lessee's defence – that the lessee was fraudulently induced to enter into the lease arrangement); 68A Am. Jur. 2d Secured Transactions § 485 (citing *Chase Manhattan Bank, N. A. v. Finger Lakes Motors, Inc.*, 423 N.Y.S.2d 128 (N.Y. Sup. Ct. 1979) (lessees refused to pay rent to lessor's assignee; court rejected as a valid defence against the assignee lessees' defence – that the lessor entered into the contract for the express purpose of fleecing the lessees, assigning the paper to the assignee, taking the money and not performing)).
79. *Supra* note 73 (citing *Compton Co. v. Minolta Business Systems, Inc.*, 319 S.E.2d 107 (Ga. Ct. App.1984) (lessees refused to pay rent to lessor's assignee; court rejected as a valid defence against the assignee lessees' defence – that there had been no meeting of the minds with respect to certain terms of the contract and thus no contract was formed between the lessor and lessee).
80. *See Partnership Equities, Inc. v. Marten*, 443 N.E.2d 134, 136 (1982). However, one court has suggested a possible defence to a capital call contribution obligation where "a profound failure of consideration such as a repudiation of, or fraud incident to, the

essentials of the venture to which subscription was made." *Id.* The example provided by the court of this possible defence was a general partner who absconded with all of the initial contributions and did nothing at all in furtherance of the partnership's goals. *Id.* Notably, a material breach of the partnership agreement, negligence, mismanagement, or disappointed expectations do not constitute defences to capital call obligations. *Id.* at 138.

81. *See British Int'l Ins. Co. Ltd. v. Seguros La Republica, S.A.*, No. 90 Civ.2370 (JFK) (FM), 2000 WL 713057, at *5 (S.D.N.Y. June 2, 2000).
82. *See Greyhound Exhibit Group, Inc. v. E.L.U.L. Realty Corp.*, No. 88 Civ.3039 (ILG), 1993 WL 50528, at *1 (E.D.N.Y. February 23, 1993).
83. *See Banco Central de Paraguay v. Paraguay Humanitarian Fund.*, No. 01 Civ.9649 (JFK), 2006 WL 3456521, at *9-10 (S.D.N.Y. Nov. 30, 2006).
84. *See, e.g.*, N.Y. C.P.L.R. § 5201 (2017).
85. *See, e.g.*, N.Y. C.P.L.R. § 5230 (2017).
86. 28 U.S.C. § 1963 (2017).
87. Uniform Law Commissioners, Uniform Enforcement of Foreign Judgments Act Legislative Fact Sheet, http://uniformlaws.org/LegislativeFactSheet.aspx?title=Enforcement%20of%20Foreign%20Judgments%20Act (last visited Nov. 29, 2017). California has a similar statute in place that accomplishes the same basic objective. Cal. Civ. Proc. Code §§ 1710.10-1710.65 (1974, 1977, 1982, 1983, 1984, 1985, 2003).
88. UEFJA § 2 (UNIF. LAW COMM'N 1964). Recall that domestic state pension plans with Eleventh Amendment immunity must be sued in the courts of their own state, and that there will be statutory requirements particular to each state that must be followed. *See supra* notes 23-24 and 26 and accompanying discussion.
89. U.S. Dep't of State, Enforcement of Judgments, http://travel.state.gov/content/travel/en/legal-considerations/ judicial/enforcement-of-judgments.html (last visited Nov. 29, 2017).
90. Philip R. Weems, *Guidelines for Enforcing Money Judgments Abroad*, https://www.adraonline.co.za/file/0ec97674ebb638f67ba20e9774d2761c/guidelines.pdf (last visited Nov. 29, 2017).
91. 307 F. Supp. 2d 608 (D. Del. 2004).

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The secondaries market: The rise of GP-led and preferred equity solutions

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In past editions of this book, we have looked at how the secondaries market has evolved and how the use of debt products by fund managers has played an important part in that growth and development. We first wrote this chapter three years ago and since that time, the secondaries market has experienced rapid growth and further evolution, showing itself to be leading with innovative solutions to private markets managers' liquidity and funding requirements.

Debt providers in the secondaries space have had to adapt and in the past 12 months, we have seen more creative structures and solutions in this market than ever before. In this edition, we take a closer look at the two biggest trends in the secondaries market, and how debt finance has played, and will continue to play, a crucial role in their evolution.

Introduction

Across all subsets of the secondaries market, it is clear that volume and size are increasing rapidly. Volume is expected to reach $90bn this year and, subject to the impact of a major market correction, it is likely that the magic $100bn figure the secondaries market has been waiting for will be hit in the next two years.

The secondaries space is awash with opportunities and the main challenge we are hearing in the market is the lack of human capital to keep up with the variety of options and deals. It's clear that debt finance is a key part of secondary GPs' strategies; some GPs which don't use leverage acknowledge they are losing deals to secondary players that do.

Like the secondaries market itself, the debt finance market supporting it is getting more creative: advancing against increasingly concentrated portfolios, LTVs are rising in some cases, and pricing is generally coming down for the "vanilla" diversified LP interest deals, which is driving financiers to look to be more innovative. So much so, that secondary houses now are hiring both bankers and lawyers with credit experience to enable them to bring this expertise in house. Although it remains a relatively small subset of the private markets, secondaries really do seem to involve some of the most creative and innovative solutions to GP/LP liquidity requirements.

By far the two most exciting developments since we first wrote this chapter have been the emergence of GP-led transactions, and the success of the preferred equity strategy. This article focuses on how these facets of the secondaries market (and beyond, in the case of preferred equity) have evolved, and how debt and alternative providers have responded over the past few years by creating bespoke and innovative liquidity solutions for these situations/products.

Preferred equity – the best of both worlds?

What is preferred equity?

Preferred equity is a tool employed by dedicated funds and traditional secondary investors to provide liquidity and funding solutions to managers with portfolios of assets, looking for a solution which allows them to retain the majority of the upside and avoid giving up control of the portfolio in a down-side scenario, either where the manager is looking to accelerate liquidity or invest more capital. Whilst preferred equity has some down-side protection, it provides significantly more flexibility to managers than traditional debt which typically comes at a lower LTV, with a repayment profile, a set maturity date, collateral over all or part of the portfolio, and covenants.

Preferred equity lacks these features, making it more akin to equity, but ranks senior to the equity in terms of cash-flow until the preferred return is achieved. After this, all of the upside accrues to the equity holders. Preferred equity bridges the gap between traditional debt and equity, and it is easy to see why vehicles dedicated to this strategy have been so successful in the last 15 years or so.

Before the emergence of preferred equity in around 2006, managers with liquidity or capital requirements had the choice of either selling assets, thereby removing any potential upside, or adding leverage to their portfolios; the closest investors came to a preferred equity product was via single asset or holdco financings.

Dedicated vehicles have now taken this model and transformed the way it is used in private equity. Investors can gain exposure to private equity through this hybrid tool, which carries the upside potential of private equity returns over a shorter investment period, with volatility reduced as a result of the downside protections… Sound like the beginnings of the secondaries market? This is still a relatively small segment of the secondaries market (albeit it is acknowledged that not all 'pref deals' are necessarily counted in the global secondary figures and if they were, the number would be significantly higher), but one which is growing rapidly, accounting for an estimated 5% of global secondary deal activity last year. The number of secondary funds exploring it as an alternative investment is increasing day by day.

Where and when is preferred equity relevant?

Although the secondaries market has evolved as an efficient and effective trading ground for the sale of private equity portfolios, a traditional sale isn't necessarily the right solution for all managers. Where a manager still sees value and upside in the underlying portfolio, it may be that holding onto those assets, to allow them to mature and generate further returns rather than embarking on a traditional sale, is in the best interests of the investors. To that extent, preferred equity is a powerful source of capital to release liquidity in the portfolio or provide additional investment capacity without leveraging the portfolio directly. We are also seeing an increasing number of acquisitions supported by a preferred equity solution.

How is debt finance used to support these transactions?

On the whole, private markets managers are very familiar with how to use subscription lines and who to approach as a provider. Finding a debt provider to lend on a non-recourse basis purely against a fund portfolio, particularly in the primary private equity space, is much more difficult and requires a financial institution to have end-to-end capabilities to diligence and analyse the credit of the underlying portfolio of investments, the underlying leverage and the impact on the potential financing.

Finding a debt provider who is able to lever a preferred equity interest is almost impossible. We were privileged to work on a ground-breaking transaction in 2019 with Investec, Palamon Capital Partners and Pomona Capital: a back-levered preferred equity financing which allowed for the creation of significant liquidity for investors, whilst avoiding creating additional leverage in the portfolio. The use of leverage as part of the structure was a key component in significantly driving down the blended cost of the preferred equity instrument, thus making the returns attractive from both Palamon and Pomona's perspective.

GP-leds

What is a GP-led?

With echoes of the secondaries market itself, 'GP-leds' have emerged, from being a last resort for struggling GPs to deal with troublesome assets, to a standalone subset of the secondaries market providing genuine optionality and liquidity to GPs and LPs looking to unlock liquidity in mature assets. It is clear this product is now being used across all types of situations, and few GPs don't now look at it as some form of a solution to their liquidity requirements. The jury is still out on how these deals will perform, but they accounted for over 40% of the market in the first half of 2019, so the growth trajectory is phenomenal – fifteen-fold in the last five years – and fund financiers are following suit to provide debt finance for these types of transactions.

However, the market expects mixed outcomes to these transactions. Key concerns centre around ensuring transparency, managing conflicts properly, giving LPs enough time to consider deals, and a feeling that LPs are becoming overwhelmed with requests to consider these transactions, with small teams not equipped to make the sorts of assessments necessary for a GP-led. LPs are leaning heavily on advisors to educate and guide them through the process.

Types of GP-led transactions

The main attraction of GP-led secondary transactions is that investors are offered an exit option whilst the value of mature investments is maximised. The four most popular types of GP-led transactions are: fund restructurings (also referred to as fund recapitalisations); direct secondaries; stapled secondaries; and tender offers. The common theme amongst all of them is that a secondary buyer purchases the existing investments and a new vehicle is established to hold those assets. The participation of the existing manager in the ongoing management of the assets, and the participation of the existing limited partners, are the key differences between the various types of transactions.

The primary characteristic of fund restructurings is that all existing investors are offered an opportunity to either sell their existing position in the fund, or an option to roll their positions into the new-formed vehicle. The GP typically remains in place to manage the underlying assets, with the added benefit of a longer investment period and added capital to assist them in maximising value. This option provides incentives to both the limited partners and the GP, while allowing them to pursue their independent investment strategies.

This can give rise to potential conflict-of-interest issues for the GP who is on both sides of the table, and continues to owe a fiduciary duty to the existing limited partners.

Direct secondaries involve the sale of all of the assets in a portfolio to a buyer along with the responsibility to manage the portfolio, thereby excluding the GP from future management of those assets. This is of interest to GPs who are looking to focus their attention on other matters or investments. Stapled secondaries are a hybrid of a fund restructuring and offer investors the opportunity to participate in the GP's new fund, thereby combining a secondaries and primary offering (which potentially creates even more of a conflict).

Tender offers are the least complex of the GP-led secondary transaction types. These involve a buyer (who could be an existing investor or an affiliate of the GP) tendering for all or a portion of the existing limited partner interests.

Pros and cons

The principle behind GP-leds, and the reason for their phenomenal growth over the past few years, centres upon:

- the creation of liquidity for limited partners and the choice of continuing (or not) with their exposure, allowing limited partners to actively manage their portfolio; and
- providing additional time and sometimes capital (depending on the structure of the deal) for the relevant assets to mature and grow which, in turn, can lead to better returns on those assets, resulting in potential additional value for either the existing GP or a new manager, depending on the type of GP-led transaction.

However, new developments in the private markets usually come with challenges, and GP-leds are no exception. The rapid growth and prevalence of these transactions has resulted in LPs, the regulators and ILPA paying a lot of attention to how they are done, and various concerns have been raised around how these transactions play out, including:

- unsettled limited partners receiving multiple requests at any one time, who feel they do not have sufficient time and/or resources to properly evaluate the transaction; and
- in respect of the GP, a material conflict-of-interest risk. As there is no standardised approach to these types of transactions, ILPA has recently publicised recommendations with a view to increasing transparency, efficiency and fairness around these processes and their structures.

How is debt finance used to support these transactions?

As with the preferred equity financing model described above, financing a GP-led solution requires a debt provider to be more creative in providing a meaningful solution, which invariably involves accepting a much more concentrated risk position than fund finance lenders have historically taken. These lenders often look at a much smaller group of investors – perhaps even one – and will need to perform more diligence and potentially create more robust recourse against that investor. Given the invariably concentrated LP position, lenders will also look to the underlying assets for their credit risk, and these underlying positions are also likely to be concentrated.

The obvious use of financing is, of course, to bridge short-term exits within the portfolio. The use of financing at SPV level is often an attractive option in GP-led processes, especially if: (i) not all the investors in the continuation vehicle have the same access to subscription lines and the GP wants to ensure equal economics for all investors; (ii) the use of equity would be dilutive from a multiple perspective given the portfolio construct (the portfolio may include debt instruments); and/or (iii) the secondary fund is unable to participate in a transaction owing to size and concentration limits.

In the recent Investec Secondary Survey (November 2019), more than half of the participants who responded, who participated in GP-led transactions, indicated that they saw debt finance in these transactions in some way shape or form. Approximately a third of them used ring-fenced finance at SPV level; a third used a hybrid solution; and a third used a traditional subscription line. Using a combination of all of these solutions is becoming more common. Whilst a specific funding solution is not necessarily applicable to every transaction, finding one that is scalable and can easily be implemented remains a key consideration for secondary firms, and often a decisive factor in determining who to partner with.

Summary

As the secondary market is continuing to evolve and innovate, so too are the financing solutions following it. Using the tools available in the secondary market, secondary funds and primary funds are increasingly relying on finance providers to partner with them to provide fire-power in competitive acquisition processes, and to unlock liquidity and value in their assets. The menu of solutions has increased significantly and we suspect this time next year, we will be discussing even more innovative and bespoke structures and processes.

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Samantha advises both financial institutions and private markets managers on the full range of fund finance products across all asset classes. She has advised on some of the largest subscription and leverage deals in the market, including a €7bn secondary financing for a leading primary PE manager, a €105m back-levered preferred equity financing, a €150m GP financing to a leading primary PA manager, as well as numerous secondary and GP-led financings. In the last 12 months she has advised on over 55 new fund financings, exceeding $23bn in value. Sam has been advising financial institutions and private markets managers for over 17 years, and her practice covers the full range of fund lending products, delivered via a number of different structures including framework and umbrella facilities.

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1940 Act issues in fund finance transactions

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Introduction

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

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

The 1940 Act

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

The definition of "investment company"

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

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

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

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

Investment company prohibitions and consequences – Private funds and other entities

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

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

Not only could an entity's noncompliance with Section 7 result in a violation of the 1940 Act for which it could be subject to SEC enforcement, it also directly affects any lender or counterparty to that entity. Section 47 of the 1940 Act deems any contract made in violation of the Act, or whose performance involves a violation of the Act, unenforceable by either party, unless a court finds that enforcement of the contract would be more equitable than non-enforcement. As a result, a lender or other counterparty to any entity in a financing transaction will, in all but the most obvious instances, typically seek representations and covenants from the entity, and a legal opinion from the entity's counsel, that provide comfort that no 1940 Act issue exists.

Investment company exemptions

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

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

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

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

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

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

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

Other exemptions from the definition of investment company are also available. Securitisation vehicles (including some CLOs) may be able to meet the exemptions provided by Section 3(c)(5)(A) or (B) of the 1940 Act and Rule 3a-7 under the Act, while REITs and other real estate issuers typically qualify for the exemption in Section 3(c)(5)(C) of the Act. Rule 3a-2 under the 1940 Act exempts temporary or "transient" investment companies that have a *bona fide* intent to return to operating company status, and a more qualitative exemption provided by Section 3(b)(1) of the Act may be available to certain holding company structures and entities with a demonstrable history of non-investment company operations, although this exemption generally has been interpreted narrowly by the SEC and its staff and presents somewhat less comfort to counterparties due to its subjective nature.

Potential Volcker Rule issues

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

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

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

Investment company prohibitions and consequences – Registered Funds

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

1940 Act capital structure/leverage restrictions

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

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

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

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

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

BDCs elect to be regulated under the 1940 Act and thus are not, as a literal matter, registered under the 1940 Act. A BDC election, however, subjects a BDC to regulation under the 1940 Act in much the same as a closed-end fund, including with respect to its capital structure, although the 1940 Act requires a BDC to have only 200% asset coverage of its debt and borrowings and permits a BDC to have 150% asset coverage of its debt and borrowings if certain conditions are met. A BDC can also issue multiple classes of debt.

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

<u>Wholly owned subsidiaries</u>

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

<u>Securities lending issues</u>

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

Registered Fund loans its portfolio securities to be a form of borrowing subject to the 1940 Act's asset coverage and other requirements. In general, a Registered Fund that engages in securities lending is subject to the following requirements:

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

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

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

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

The SEC, in a departure from its and its staff's decades-old approach to derivatives that focuses on asset segregation/offset, proposed in 2015 new Rule 18f-4 under the 1940 Act, and re-proposed the rule in November 2019. Rule 18f-4 would, if adopted, require a Registered Fund to adhere to an outer limit on fund leverage, based on a relative value-at-risk (VaR) test that compares the fund's VaR with the VaR of a "designated reference index". The fund's VaR would not be permitted to exceed 150% of the VaR of the fund's designated reference index. If the fund's derivatives risk manager is unable to identify an appropriate designated reference index, the fund would be required to comply with an absolute VaR test, under which the VaR of its portfolio would not be permitted to exceed 15% of the value of the fund's net assets.

The proposed rule would provide an exception from the program requirement and the VaR-based limit on fund leverage risk for a fund that either limits its derivatives exposure to 10% of its net assets, or uses derivatives only to hedge certain currency risks. The proposed rule would also permit a fund to enter into reverse repurchase agreements and similar financing transactions, as well as "unfunded commitments" to make certain loans or investments, subject to conditions tailored to these transactions.

Other 1940 Act considerations

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

* * *

Endnotes

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

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Marc's practice focuses on the asset management industry, where he advises clients on a broad spectrum of regulatory and transactional issues. Marc is fluent in all aspects of regulation affecting money managers, funds and fund sponsors and he focuses particularly on issues under the Investment Company Act of 1940 and the Investment Advisers Act of 1940. Marc regularly advises asset managers, sponsors and issuers in structuring, documenting, and offering funds and other investment products inside and outside the U.S., including funds registered under the 1940 Act, private funds, specialty finance products such as securitisation vehicles, CLOs, REITs and other vehicles, and advises asset managers on regulatory and transactional issues under the Investment Advisers Act, including registration with the SEC and exemptions from registration. Marc also has considerable capital markets experience, having represented issuers and underwriters in creating and structuring hundreds of products and transactions to avoid 1940 Act "status" issues.

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Considerations in providing NAV facilities to individuals

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Background

Credit facilities available to private equity funds follow one of two general forms: "Subscription Facilities" and "NAV Facilities".

Subscription Facilities – also referred to as "subscription line" or "capital call" facilities – are a common structure for many newly-formed funds with significant unfunded capital commitments. The fund's obligations under a Subscription Facility are secured by all of the fund's rights with respect to the capital commitments of its investors; most fundamentally, the ability to call capital from such investors and the proceeds of such capital calls. Availability under these facilities is subject to a borrowing base, calculated as an agreed advance rate against the unfunded capital commitments of certain highly-rated (or otherwise creditworthy) "included" investors. Subscription Facilities have become an increasingly important tool for funds early in their life-cycle, providing funds flexibility and speed in making investments by having the lender "bridge" the period between the date of an (initial) investment and the date on which the fund calls and receives capital from its investors as long-term capital.

Subscription Facilities are, however, unavailable as a source of financing to many funds, either because the fund's organisational documents do not permit (or, in certain cases, do not permit critical structural aspects of) such facilities, or the fund has already invested a significant portion of its capital (and/or its "investment period" has ended), leaving it with insufficient unfunded commitments against which to borrow (and/or significant restrictions on calling any such capital). In these cases, private equity funds have generally turned to "NAV Facilities" – also known as "asset backed" or "net asset value" facilities – to meet their ongoing financing needs.

NAV Facilities, in contrast to Subscription Facilities, are backed by the fund's investment portfolio. In the most common structures provided to "fund-of-funds", these investments are primarily equity interests in hedge funds and private equity funds, typically purchased in the secondary market. Availability under NAV Facilities is similarly subject to a borrowing base, but here calculated using the net asset value of qualifying fund interests satisfying specific eligibility and investment criteria, and adjusted for customary concentration limits. If at any time, the ratio of (x) outstanding loans to (y) the borrowing base exceeds a specified threshold, the borrower will be required to prepay loans (or take other agreed actions) to restore compliance with the agreed maximum ratio.

An interesting market development over the past few years has been the expansion of NAV Facility borrowers to include high net-worth individuals and family offices with significant hedge fund and private equity fund investment portfolios.[1] These borrowers utilise the proceeds of such NAV Facilities to either make general distributions to the ultimate owner of the investments or finance other, unrelated investments, in each case without liquidating – and thereby retaining the future upside to – the underlying investment portfolio.

In this chapter, we examine the typical structure of, and collateral securing, such NAV Facilities provided to individuals. And, importantly, we focus on issues to consider – and potential solutions – when providing such NAV Facilities.

Structure and collateral: NAV Facilities

As noted above, NAV Facilities "look down" to the underlying investment portfolio as the credit support for the financing. In a typical NAV Facility for an individual, the individual establishes one or more special purpose vehicles ("SPVs") to obtain the financing and hold the underlying fund interests included in the borrowing base. Where structured with a single SPV, the SPV will act as the borrower of the NAV Facility and provide a pledge of all assets of the SPV (other than the underlying fund interests) to the lender to secure its obligations under the NAV Facility. In turn, the individual will pledge 100% of the equity interests of the NAV Facility borrower (the "Equity Interest Collateral").[2]

This pledge of the Equity Interest Collateral provides NAV Facility financing sources, upon the occurrence of an event of default, with the right to exercise secured creditor remedies with respect to the equity interests of the SPV. This includes the right to foreclose upon or sell such equity interests in accordance with the uniform commercial code ("UCC") or other applicable law and/or manage an orderly disposition of the underlying portfolio investments via a power of attorney typically granted under the NAV Facility documentation. To perfect the collateral grant, UCC financing statements are filed against both the controlling individual and SPV borrower, and the parties enter into control agreements in favour of the lender with respect to all applicable deposit or securities accounts.[3]

Issues to consider in NAV Facilities provided to individuals or family offices

Evidence of ownership of portfolio investments

A fundamental structural element of NAV Facilities is that the borrower owns the underlying portfolio investments included in the borrowing base. Unlike liquid equity or debt securities credited to a securities or brokerage account, there is no simple mechanism for lenders to verify such ownership. As such, as a condition precedent to funding any NAV Facility, lenders will require satisfactory evidence of the borrower's ownership of the portfolio investments.

In NAV Facilities provided to private equity funds, such evidence often takes the form of an accountants' certification provided in connection with the most recent audited/reviewed financial statements of the borrower. This approach is not feasible in many NAV Facilities provided to individuals, however, as individuals often prepare a single consolidated tax return; they do not prepare financial statements – and, thus, their accountants do not conduct any such audit – solely at the borrower level.

To address this gap and give lenders comfort as to the borrower's ownership of the underlying portfolio, individuals should, at a minimum, be required to provide lenders with recent periodic account statements from the underlying portfolio investment sponsor naming the borrower as the limited partner (or other applicable equityholder) and stating the current capital account balance of the investment.

In addition, especially with respect to large investments to be included in the borrowing base, lenders may require that the individual obtain written confirmation from the general partner (or similar managing entity) of the underlying portfolio investments as to the borrower's ownership (and capital account balance) as of the closing date. Such communication may be a formal certification, or as informal as a response by such general partner to an email or other written communication from the borrower, copying the lender, requesting confirmation of the borrower's current capital account balance with respect to the relevant investment.

Finally, where the individual has retained a third-party advisor, administrator or similar custodian to manage the portfolio, lenders may also seek a written certification, confirmation and/or recent capital account balance statements from such third party.

A related concern of lenders in NAV Facilities is ensuring that the portfolio investments remain owned by the borrower – and thus appropriately included in the borrowing base – throughout the life of the financing. While private equity funds may be able to provide satisfactory evidence of such ownership through periodic accountant certifications together with ongoing financial reporting, as noted above, this may not be feasible for individuals. In such cases, lenders may require the individual to instruct underlying general partners (or similar entities) to include the lender as an "interested party" on all account statements, activity reports and other correspondence with respect to the applicable portfolio investments, ensuring that lenders receive both periodic confirmations as well as real-time updates as to any changes in the portfolio investment.

<u>NAV-specific representations, covenants and events of default</u>

As is typical in most financings, borrowers under NAV Facilities are required to periodically make representations and warranties and continuously comply with affirmative and negative covenants, the breach of which results in the occurrence of event of default under the NAV Facility and provides lenders with the right to exercise secured creditor remedies.

In addition to customary representations and covenants as to the borrower's organisation and activities, NAV Facilities include portfolio investment-specific provisions, including representations as to: (x) the borrower's ownership of the portfolio investments included in the borrowing base; and (y) the portfolio investment documentation not prohibiting the individual's pledge of equity interests in the borrower or limiting the lender's right to foreclose on such equity interests or exercise other creditor remedies (collectively, the "NAV-Specific Representations").

In addition, in order to ensure the integrity of the structure, NAV Facilities will contain negative covenants prohibiting the borrower from: (x) incurring liens on the portfolio investments; (y) making distributions or dividends of the portfolio investments to the individual; and (z) selling or otherwise disposing of any portfolio investment, in each case subject to limited exceptions (collectively, the "NAV-Specific Covenants").

In contrast to NAV Facilities provided to private equity funds – in which lenders often rely upon an extended course of financial dealings with the sponsor and the practical reality that "repeat-player" sponsors would suffer significant reputational risk and exclusion from the financing market as a result of an intentional breach of NAV Facilities – a lender to an individual will often not be able to rely on such a time-tested relationship. In particular, an individual viewing the NAV Facility as a one-time event may not ascribe the same value to its reputational risk in those markets.

There are a few potential mechanisms for borrowers to address this concern. First, the individual (or, in the case of a family office, additional individuals, trusts or other estate planning entities) may provide a personal guarantee of the NAV Facility. As individuals typically view NAV Facilities as "limited recourse" financings, in which lenders have claims solely against the borrower and its portfolio investments (but not the individual and its other assets), they are reluctant to provide full and unconditional guarantees of the NAV Facility.

Rather, such guarantees are most typically structured as contingent, "bad boy", guarantees under which the individual is liable for all obligations under the NAV Facility upon (or, in certain cases, an indemnification of the lender's actual costs and losses arising from) the occurrence of certain specified "trigger" events, including one or more of: (i) a voluntary or involuntary bankruptcy or insolvency event with respect to the borrower; (ii) any breach of the NAV-Specific Representations or NAV-Specific Covenants; (iii) any breach of any other representation or covenant to the extent such breach impairs (in a material adverse respect) the lender's security interest in the collateral or ability to be repaid; and/or (iv) any gross negligence, bad faith, wilful misconduct, intentional misrepresentation or omission of a material fact.

A second more proscriptive, but effective, approach is to require the individual to appoint an independent director, manager or administrator for the borrower. Such independent third party would be responsible for monitoring any non-ordinary course activities of the borrower, and its consent would be required under the borrower's organisational documents to sell, distribute or otherwise transfer any underlying portfolio investment, incur liens on the portfolio investments or engage in any similar transaction that may impact the lender's collateral and rights or remedies under the NAV Facility, including by seeking protection against the lender through a voluntary bankruptcy filing. Under such structure, any sale distribution, transfer, lien or similar transaction effected by individual/borrower without the consent of such third party would be *ultra vires* and, thus, an unenforceable violation of the borrower's organisational documents.

<u>Individual ownership of portfolio investments</u>

In addition to the primary items noted above, a number of specific issues arise as a result of the (ultimate) ownership of the portfolio investments by an individual. First, lenders under NAV Facilities to individuals may have well-established banking or other relationships with the individual. Thus, notwithstanding the intended "limited recourse" nature of such financings, lenders should consider including a "key man" provision that, upon the death or incapacity of the individual, permits the lender to either accelerate the loans and exercise its creditor remedies or unilaterally adjust the NAV Facility to address the impact of such death or incapacity.

A further, related issue arises where the individual provides a personal guarantee of the NAV Facility (whether full or "bad boy"). While the guarantee itself may be drafted to make clear that it is intended to be binding on the estate of a deceased guarantor,[4] creditors of a deceased individual may be required to follow jurisdiction-specific steps to enforce their claims against the fiduciary of a decedent's estate.[5] In some cases, it may also be the case that no such fiduciary will be appointed because, for example, all of the individual's assets have been transferred during lifetime to a revocable trust that becomes irrevocable at death. Accordingly, lenders may wish to familiarise themselves with the guarantor's estate plan and to, once again, consider including a "key man" provision triggered by the death of the guarantor or the failure of an acceptable successor to expressly assume the related guarantee obligation within some reasonable period of time following the death of the guarantor.

Finally, lenders should be aware of the potential implications of a personal bankruptcy filing by an individual.[6] In certain instances, bankruptcy courts may extend the "automatic stay" protection applicable to the individual (as debtor) to non-debtor entities owned and controlled by the individual on the premise that claims against assets owned by the individual debtor (even through a separate and distinct entity) are in effect claims against that individual.[7] Even where such stay is so extended, and absent substantive consolidation of the borrower with the individual, the lender's claim against the SPV borrower should still be structurally senior to any claims of creditors directly against the individual.

Taken together, while a lender may be subject to delay in exercising its rights and remedies in the case of a personal bankruptcy of the individual, the lender should ultimately be able to realise against the collateral held and pledged by the borrower entity on a senior basis to the extent the lender's security interest in the collateral has been perfected on a first priority basis.

Conclusion

As individuals increasingly explore the potential options for financing their hedge fund and private equity fund portfolios, we expect that an increasing number of individuals and other non-fund borrowers will seek to use NAV Facilities for a growing range of purposes, and with increasingly varied collateral and structural considerations. To ensure that lenders are appropriately protected in providing NAV Facilities to individuals, we expect to see further developments in structural and documentary protections to address this growth and evolution in the complexity of such financings.

* * *

Endnotes

1. For purposes of this article, we refer solely to investment portfolios held by high-net-worth individuals, although the specific organisational structure will differ in each case, based largely on the estate planning of such high net-worth individual, and often include both trusts and other corporate entities.
2. In contrast, in a "double-SPV" structure, a "holdings" SPV is established to hold the equity interests of the borrower, and most typically provides a "downstream" guarantee of the borrower's obligations under the NAV Facility, securing such guarantee with a pledge of both such equity interests, as well as the deposit and securities accounts into which distributions on and proceeds of the underlying portfolio investments are paid.
3. Where the portfolio investments underlying a NAV Facility are equity interests in hedge funds – rather than private equity funds – lenders will often require that interests be credited to a securities account, thereby creating a "securities entitlement" in favour of the borrower/customer which borrowers, in turn, pledge to lenders and perfect under the UCC upon entry into control agreements. Importantly, under this structure, upon an event of default, the lenders' remedies include directing the applicable securities intermediary to redeem the underlying hedge fund interests, pursuant to the terms of the underlying fund documentation.
4. One straightforward method to do so is to expressly provide in the relevant instrument that the guarantee is binding on both successors and assigns of the individual as well as on "the heirs and legal and personal representatives" of the individual.

5. After the death an individual, a court of competent jurisdiction (e.g., where the individual was domiciled at death) may appoint a fiduciary (e.g., executor, administrator, personal representative, etc.) responsible for the payment of the decedent's debts and other obligations as part of the settlement of the decedent's estate. Some jurisdictions may require creditors of a deceased individual to file proofs of claim with the relevant fiduciary within a specified period, or have special statutes of limitation applicable to claims against the decedent's estate intended to facilitate the efficient settlement of estates. Special rules may also apply to contingent claims.
6. We note that for purposes of this article we have assumed a U.S. bankruptcy and estate administration regime. In NAV Facilities provided to non-U.S. domiciled borrowers or guarantors, appropriate precautions and advice should be sought.
7. Factors that courts will look to in substantively consolidating the borrower entity with the controlling individual include whether customary corporate separateness formalities were complied with by the borrower and the individual and creditors were aware of their separateness or, in contrast, whether the individual simply treated the borrower as its "alter ego".

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The state of play on overcall limitations in the U.S.

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Introduction

Overcall limitations ("**Overcall Limitations**"), in their most simple form, limit the ability of a private equity fund (each, a "**Fund**") to overcall capital (each, an "**Overcall**") from its limited partners (each, an "**Investor**") to make up for shortfalls created by other Investors' failure to fund an original capital call ("**Capital Call**") as a result of a default or excuse.

Because lenders' (each, a "**Lender**") underwriting expectation is that each Investor is jointly and severally obligated to fund up to the full amount of its unfunded capital commitment ("**Unfunded Commitment**"), both established players and new entrants in the subscription facility (each, a "**Facility**") market continue to wrestle with the various forms of Overcall Limitations found in Fund partnership agreements ("**Partnership Agreements**").

Any Overcall Limitation is a credit exception that must be addressed. And their presence is meaningful: a full 38% of the 252 Facilities that Cadwalader, Wickersham & Taft's United States Fund Finance team worked on in 2017–2018 included some form of Overcall Limitation. In this chapter, we describe the various forms of Overcall Limitations that are most prevalent in Partnership Agreements and discuss their underwriting implications. We also describe the steps Lenders are taking in the market to mitigate the increased risks created by their presence as applied to a particular Facility. Finally, we provide some market color around the treatment of Overcall Limitations in practice, including their actual prevalence, impact on Facility pricing and likely future evolutions.

Percentage of Prior Call Overcall Limitations

<u>Formulation</u>. Historically, the most prevalent form of Overcall Limitation limits the amount a Fund can overcall from its non-defaulting Investors as a percentage of their original Capital Call. With brilliant creativity, we call this a "**Percentage of Prior Call Overcall Limitation**". Here is an example of a typical formulation:

"In the event that an Investor defaults on a Capital Call, the GP may require all of the non-Defaulting Investors to increase their Capital Contributions by an aggregate amount equal to the shortfall; provided that no Investor will be required to contribute an amount in excess of 50% of the amount specified in the original Capital Call."

This means, if an Investor defaults or is excused from funding a Capital Call, the Fund is authorized to overcall to make up the shortfall, but no Investor has to fund more than

50% of the amount it originally funded. In our 2017–2018 portfolio, nearly 20% of the Fund borrowers had a Percentage of Prior Call Overcall Limitation in their Partnership Agreement. While the 50% in the above example is a common percentage limit threshold, 35% is also seen with frequency, and we have recently seen a Partnership Agreement where the threshold was set at 20%.

Default Inflection Point. To properly underwrite a Percentage of Prior Call Overcall Limitation, the Lender should determine what percentage of Investors must default to leave the Lender's loans uncovered by Unfunded Commitments. We call this threshold the "**Default Inflection Point**". Below, we illustrate a simple example. We hypothetically assume a 50% Percentage of Prior Call Overcall Limitation and then simulate scenarios where 30% and then 35% of the Investors default. As you can see, the example illustrates that the Default Inflection Point is 33.33% with a 50% Percentage of Prior Call Overcall Limitation.

Assumptions

	$ 100,000,000	Aggregate Unfunded Capital Commitments
	30%	Advance Rate
	$ 30,000,000	Availability
	$ 10,000,000	Loan Outstanding
	$ 10,000,000	Capital Call to Repay Loan
50% of Prior Overcall Limitation in the LPA		
	30%	Investors Default on Capital Call
	$ 7,000,000	Capital Call Proceeds Received ($10,000,000 x 70% = $7,000,000)
	$ 3,500,000	Overcall to Non-Defaulters, Capped at 50% ($7,000,000 x 50% = $3,500,000)
	$ 10,500,000	Total Capital Contributions Received, Lender Gets Repaid ($10,500,000 > $10,000,000)
50% of Prior Overcall Limitation		
	35%	Investors Default on Capital Call
	$ 6,500,000	Capital Call Proceeds Received ($10,000,000 x 65% = $6,500,000)
	$ 3,250,000	Overcall to Non-Defaulters, Capped at 50% ($6,500,000 x 50% = $3,250,000)
	$ 9,750,000	Total Capital Contributions Received to Repay Loan ($6,500,000 + $3,250,000)
	$ -250,000	Deficit Owed to the Lenders ($10,000,000 - $9,750,000 = $250,000)

> The Investor Default Inflection Point is 33.33% with a 50% Percentage of Prior Call Overcall Limitation

Remember, it is essential to note that the borrowing base does not protect the Lender; Overcall Limitations apply to all Investors, even those that are excluded from the borrowing base. So what happens when the percentage limit threshold is set lower? The model figure below assumes a 20% Percentage of Prior Call Overcall Limitation. As you can see, the Default Inflection Point drops to slightly under 17% of Investors.

Assumptions

	$ 100,000,000	Aggregate Unfunded Capital Commitments
	30%	Advance Rate
	$ 30,000,000	Availability
	$ 10,000,000	Loan Outstanding
	$ 10,000,000	Capital Call to Repay Loan
20% of Prior Overcall Limitation in the LPA		
	15%	Investors Default on Capital Call
	$ 8,500,000	Capital Call Proceeds Received ($10,000,000 x 85% = $8,500,000)
	$ 1,700,000	Overcall to Non-Defaulters, Capped at 20% ($8,500,000 x 20% = $1,700,000)
	$ 10,200,000	Total Capital Contributions Received, Lender Gets Repaid ($10,200,000 > $10,000,000)
20% of Prior Overcall Limitation		
	18%	Investors Default on Capital Call
	$ 8,200,000	Capital Call Proceeds Received ($10,000,000 x 82% = $8,200,000)
	$ 1,640,000	Overcall to Non-Defaulters, Capped at 20% ($8,200,000 x 20% = $1,640,000)
	$ 9,840,000	Total Capital Contributions Received to Repay Loan ($8,200,000 + $1,640,000)
	$ -160,000	Deficit Owed to the Lenders ($10,000,000 - $9,840,000 = $160,000)

> The Investor Default Inflection Point is slightly over 16.5% with a 20% Percentage of Prior Call Overcall Limitation.

Underwriting implications. Lenders should consider the Default Inflection Point for a Fund in connection with the granularity of its Investor pool. Simulations should be run where all of the non-borrowing base Investors default and where the largest Investors default, as any combination of Investors theoretically could default. Only after getting comfortable with the likelihood of these risks should a Lender proceed. Of course, Investor pools can change over time (typically but not definitively increasing granularity, which is better for Overcall Limitation risk). The Facility market also has decades of underwriting history where Investor defaults are extremely rare, so this is often a risk Lenders are willing to accommodate (at acceptable thresholds) for top tier sponsors.

Intersection with Cumulative Investor Default Trigger. The Facility market typically includes an event of default trigger tied to a certain percentage threshold of Investors defaulting on Capital Calls (going forward, the "**Cumulative Default EOD**"). A typical Cumulative Default EOD would be triggered if 10–15% or more of the Investors are delinquent on Capital Calls for an agreed period of days past the date due. Lenders, of course, underwrite Facilities with the expectation that the credit wherewithal of unaffiliated Investors is minimally correlated. Thus, the purpose of the Cumulative Default EOD is to function as an early warning signal and protect the Lenders if something is going systemically wrong. Overcall Limitations have a direct linkage with a Facility's Cumulative Default EOD that often appears to be overlooked.

For example, consider a hypothetical Facility with an exceedingly tight 20% Percentage of Prior Call Overcall Limitation. Assume the Cumulative Default EOD percentage in the credit agreement is set at 20% of aggregate capital commitments (admittedly, off market on the high side, but helpful for an illustrative example). Below is a calculation of how this could play out. Assume the following:

$100,000,000	Aggregate Capital Commitments
$100,000,000	Aggregate Unfunded Capital Commitments
$65,000,000	Facility Borrowing Base
$20,000,000	Loan to Acquire the Initial Investment
$20,000,000	Capital Call Made to Repay Loan
18%	Investors Default on Capital Call
$16,400,000	Capital Call Proceeds Received from Original Capital ($20,000,000 x 82% = $16,400,000)
$3,280,000	Overcall to Non-Defaulters, capped at 20% ($16,400,000 x 20% = $3,280,000)
$19,680,000	Total Capital Contributions Received to Repay Loan ($16,400,000 + $3,280,000 = $19,680,000)
-$320,000	Deficit Owed to Lenders ($20,000,000 - $19,680,000 = $320,000)

This example illustrates that, with a Percentage of Prior Call Overcall Limitation threshold set at 20%, the Fund and Lenders are out of the money if 18% of the Investors default. But what if the Cumulative Default EOD threshold was set at 20%? The Cumulative Default EOD would provide the Lenders no utility. Thus, Cumulative Default EOD percentages, to truly function as an effective early-warning signal, should always be set with an understanding of the Default Inflection Point. If the Cumulative Default EOD percentage is not set well inside the Default Inflection Point, it offers the Lenders little benefit.

Concentration Limit-Linked Overcall Limitations

Formulation. Funds typically have concentration limits ("**Concentration Limits**") on the size of their investments ("**Investments**") included in their Partnership Agreements to ensure that the Fund invests in a reasonably diversified portfolio of Investments. A typical Concentration Limit would prohibit the Fund from investing greater than 15% of its aggregate Investor capital commitments in any single Investment. "**Concentration Limit-Linked Overcall Limitations**" cap a non-defaulting Investor's obligation to fund an Overcall at the amount of the Concentration Limit if it were applied on an individual basis. That is, each Investor's maximum exposure to a particular Investment stops at, for example, 15% of its Capital Commitment. Approximately 10% of the Facilities in Cadwalader's 2017–2018 portfolio included this type of Overcall Limitation. While these limits get papered in a variety of ways, this is a common formulation:

"*In the event an Investor defaults on a Capital Call, the GP is authorized to make a subsequent Capital Call on the non-defaulting Investors, provided that such non-defaulting Investor shall not be required to fund an amount with respect to any single Investment in excess of the investment diversification limit set forth in section [x] of the Partnership Agreement if such limitation was applied on a partner-by-partner basis.*"

Thus, for a very small Investment, a Concentration Limit-Linked Overcall Limitation is borderline meaningless. But, in reverse, if a large Investment was acquired that required each Investor to fund 15% of its Capital Commitment originally, and any Investor defaulted, no Overcall at all would be authorized. Thus, the Lender's overcollateralization varies with the size of any particular Investment, which complicates underwriting.

Use of proceeds limitations as a mitigant. Lenders frequently use a limitation on the use of loan proceeds in the credit agreement as a mitigant. The limitation is typically set at a percentage below the Concentration Limit-Linked Overcall Limitation to create an overcall buffer for the benefit of the Lender. For example:

"*No Borrower shall at any time use the proceeds of any Loan or Letter of Credit extended to such Borrower to acquire an Investment or otherwise finance an Investment or any costs and/or expenses related thereto if the aggregate Capital Commitments of the Investors of such Borrower to be called for such Investment are greater than 10% of the Aggregate Commitments of the Investors.*"

The provision does not restrict the Fund from making Investments over the 10% use of proceeds restriction; the Fund just cannot use the Facility to finance their acquisition. To size the acceptable degree of buffer, Lenders convert the buffer into its mathematical equivalent as a Percentage of Prior Call Overcall Limitation. For example, setting the use of proceeds limit at 10% on a 15% Concentration Limit is the equivalent of a 50% Percentage of Prior Call Overcall Limitation, and hence affords a 33.33% Default Inflection Point.

LPA buffer as a mitigant. Some Funds are now utilizing an explicit buffer of say 5% or 10% above the otherwise applicable Concentration Limit-Linked Overcall Limitation. This embedded buffer is hardwired directly into the Partnership Agreement and could greatly assist the Fund in two ways: (1) giving it flexibility to actually overcall if needed for the investment once contributions exceed the maximum investment threshold (how else could a Fund effectively function?); and (2) by negating the need for the use of a proceeds haircut in the credit agreement and thereby increasing the size of investments that are permitted to be financed under the Facility. Such a provision authorizes the Fund, in the context of a Concentration Limit-Linked Overcall Limitation, to call more – up to 20% or 25% of an Investor's commitment – with respect to any investment, even when the per investment diversification limit for the Fund is set at a cap of only 15% of total Capital Commitments.

Management Fee Overcall Limitations

Formulation. 21% of the Facilities in our referenced portfolio included a "**Management Fee Overcall Limit**", which prohibits the Fund from making Overcalls if the purpose of the Capital Call in question is to pay the Fund's sponsor's management fees. There is a certain logic to this: When an Overcall is made with respect to an Investment, the non-defaulting Investor gets a larger percentage of the Investment allocated to its capital account. With respect to management fees, there is no corresponding benefit to the Investor (although it does, of course, have an interest in the sponsor remaining solvent to manage the Fund). While Management Fee Overcall Limits can be articulated in a variety of ways, a common formulation is:

*"With respect to any amount **(other than the Management Fee)** that is in Default, the GP may increase the Capital Contributions of the Investors that have funded the amount specified in the Capital Call that is the subject of the Default."*

Lender implications and market compromises. The Facility market has taken the position that, depending on specific language, a prohibition on Overcalls for paying management fees may also apply to a Capital Call to repay debt if that debt was used to fund management fees. Thus, lending into a complete non-Overcall scenario conflicts with Lender underwriting guidelines and Lenders have refused to lend for this purpose. But, borrowing for this purpose is a nice utility for a Fund afforded by a Facility and the raw dollar amount at issue is relatively small with a natural cap.

With Investor defaults being rare and Funds wanting this use, Lenders are increasingly getting comfortable finding compromises. Some of the compromises that have been making headway include: (1) the Fund sponsor expressly agreeing (via an indemnity, giveback or otherwise) that if a loan is not repaid because of the Overcall Limitation, the sponsor will return the fees to the Lender; (2) the Lender will lend for management fees, but only if certain NAV thresholds are satisfied to bolster the Lender's secondary source of repayment; and (3) other conditions, such as no defaulting Investors and a tighter clean down period and/or cap on the amounts for such loans.

Market developments and practical considerations

In reviewing our data on Overcall Limitations, two counterintuitive points emerged: First, the larger Facilities to the top tier sponsors were far *more* likely to include some form of Overcall Limitation. That is, the sponsors with the greatest negotiation leverage are more likely to give Overcall Limitations to Investors than smaller sponsors. This begs the question as to whether Investors actually value Overcall Limitations and are insisting on them or if, instead, Overcall Limitations just repeat in certain new Funds because of repetition of historical precedent documentation. We would note that, while the Institutional Limited Partners Association ("**ILPA**") has been relatively quiet as to Overcall Limitations in its various guidelines, there is a 50% Percentage of Prior Call Overcall Limitation in the model Partnership Agreement that ILPA published in the fall of 2019.

Second, for as much heartburn as Overcall Limitations rightly cause Lender credit committees, their presence does not seem to result in risk-adjusted pricing. Rather, our average Facility with some form of Overcall Limitation priced 13 basis points *inside* average pricing for Facilities without any limitation. Facility size and sponsor assets under management size had a far higher correlation on spreads than Overcall Limitations.

Conclusion

In early 2020, Cadwalader will rerun its data analysis to see how Overcall Limitations in 2019 evolved. Anecdotally, we have not seen any material differences. The good news is that the vast majority of funds do not have Overcall Limitations. Where Overcall Limitations are present, we are seeing more Funds in their Partnership Agreements explicitly carve repayment of debt out from the application of the limitation, which results in Lenders giving full underwriting benefit to the Investors and optimal lending terms for Funds.

We are also seeing Funds embed their own buffer in their Concentration Limit-Linked Overcall Limitation, a thoughtful development. We think Management Fee Overcall Limitations are increasing. However, with a historical investor default rate of near zero, all of our collective learning on Overcall Limitations is yet to have much meaningful practical application. We are all, of course, completely content if this remains only an academic exercise.

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

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Introduction

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

Market differences

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

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

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

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

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

It is fair to say that the size of the fund finance market is largest in the U.S. In 2018, North America-focused vehicles raised $240 billion in private equity capital, with funds targeting Europe and Asia raising $95 billion and $85 billion, respectively. Although fundraising in 2018 was slightly down from 2017, an impressive $432 billion was still raised globally. In 2018, North America's share of the funds market increased by 4%, whilst Europe's share increased by 2%. Asia's share of the funds market in 2018 was down 6% from the previous year. Although smaller in size, the European market remains more innovative with products such as NAV facilities, hybrids, general partner ("**GP**") lines and SMA and secondary structures being more commonplace than in the U.S.

Due diligence

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

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

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

In recent years, European and Asian lenders have likewise started to focus more energy on investor diligence; now lenders in all three markets will review LPAs and typically side letters and subscription agreements too (along with any other relevant fund documentation). In performing this diligence, lenders will look for comfort on a variety of issues. In addition to the obvious borrowing, guaranteeing and security checks, of particular concern to a lender will be any provisions that could potentially limit the amount that may be called from investors. In Asia, however, side letters containing sovereign immunity provisions are commonplace; this is due to the fact that often, cornerstone investors in Asian funds are sovereign wealth funds. Some lenders in Asia are comfortable lending to such sovereign investors if they have a track record of advancing capital commitments, whilst other Asian lenders may require such investors to waive their immunity, as per the European and U.S. approach, if such investors are to be counted towards the borrowing base.

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

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

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

To the extent that an LPA does not contain these lender-focused provisions, the lender will often require the investors to deliver investor letters including the desired language. Conversely, European lenders tend to get comfortable if the LPA permits security to be granted over the GP's/manager's right to issue call-down notices, without specific reference to the lender. A lender would then be able to rely on the contractual relationship created under any security document which, amongst other things, assigns the right to issue call-down notices to the lender (and the power of attorney included in the related security agreement to execute any notices on behalf of the GP/manager).

Often, English law-governed LPAs do not include the "without defence, set off or counterclaim" language, and typically they explicitly state that there is nothing in the LPA that confers any right on any person not a party to the LPA, and furthermore that any person not party has no right under the Contracts (Rights of Third Parties) Act 1999 to enforce any provision of the LPA. In contrast, many U.S. law-governed LPAs state that the lenders will be third party beneficiaries under the LPA.

Anti-terrorism and sanctions due diligence is an ever-more prevalent part of all financial transactions, and the fund finance space is not immune. Asia, and Hong Kong in particular, have some of the most onerous regulatory requirements that can and do delay closings. The problem is more acute for U.S.-based funds that are not only unfamiliar with Asian procedures, but often put in difficult positions by conflicting laws across jurisdictions. For instance, the Hong Kong requirement that copies of passports for responsible officers be certified as true and correct by a certified public accountant or lawyer is at odds with liability-mitigating rules applicable to U.S.-based certified public accountants or lawyers. Reconciling these, and many other similar issues, can be time-consuming and costly. The relatively small nature of the Asian markets, coupled with the more recent emergence of both the Asian markets and Asian anti-terrorism and sanctions regulations, means that mechanisms for addressing these issues are just now evolving; however, lenders and lawyers alike are diligently working to develop cost-effective and efficient solutions.

Security

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

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

1. *Deposit account control agreements* ("**DACAs**") – under the Uniform Commercial Code (the "**UCC**"), the statutory authority governing secured transactions in U.S., in order for a lender to perfect its security interest in a deposit account, it is required to maintain "control" (as defined in the UCC) over the deposit account. The most common method of maintaining control is by the execution and delivery of a DACA, which is an agreement between the account bank, the fund and the lender, whereby the account bank will agree to honour instructions issued by the lender with respect to the account without the further consent of the fund. The DACA is usually in a form generated by the account bank, and account banks will typically not accept many changes to their preferred form.

   Though not required for control under the UCC, an account bank may insist on a DACA being in place in the U.S., even where the account bank and the secured party are the same entity, in order to set forth the relative rights and obligations of separate branches or divisions of the bank. This is most important in syndicated deals, where the lender syndicate has a vested interest in the agent bank clearly delineating its roles as agent and account bank. In England and Wales, and generally in Asia, it is usual for the terms of how any secured monies will be dealt with to be contained in the facility agreement and/or the account security agreement itself.

   In terms of account security in England and Wales, perfection is achieved by the receipt of a notice by the account bank, putting the account bank on notice that the monies they hold in that account are subject to a security interest, and to make the account bank aware of the secured party's signing rights. It is market standard for account banks to request that their own form of notice and acknowledgment be used, or to counter-sign the notice by way of acknowledgment.

2. *Notices* – In England and Wales, any security over the right to call down from investors will be perfected by notice being duly served on, and received by, the investors. Depending on the method of delivery of notice, a secured party may accept read receipts if notices are delivered to investors via email, or evidence of notices being sent by recorded delivery if notices are delivered by post.

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

3. *Collateral waterfalls* – Funds and investors that participate in U.S. law-governed fund finance facilities must also be mindful of certain regulatory and statutory regimes that could govern the relationship between the lender and the fund or the investors. For example, if an investor is a pension or retirement fund (an "**ERISA Investor**") that is subject to the Employee Retirement Income Security Act 1974, as amended ("**ERISA**") and if the credit facility is determined to create contractual privity between the lender and the investor, then this could result in a "prohibited transaction" under ERISA. Failure to comply with ERISA could expose the investor and the fund to significant liability, or trigger excuse rights that would permit the ERISA Investor to avoid funding capital contributions.

   As further protection for ERISA Investors, funds will often require ERISA Investors to be limited partners in a feeder fund that will then feed into the main fund. In this instance, a 'cascading collateral structure' is put in place whereby the feeder fund will pledge to the main fund its and its general partner's rights to call capital on its investors, and the main fund will then on-pledge to the lender its rights under the security documents between the main fund and the feeder fund. This type of cascading collateral structure may also be utilised by funds that are sensitive to the tax implications or other legal or structural considerations that could be triggered by creating privity between the investors and the lender, or else by virtue of the loans provided under the credit facility.

   There are no similar instances where this type of security structuring is required in respect of English funds, as generally there is no issue with English entities contracting directly with a lender. However, given that many European financings involving other jurisdictions are project-managed out of England, alternative financing structures such as equity commitment letters and put and call options may be adopted, as opposed to typical financing and security structures, to accommodate any jurisdictional tax or regulatory concerns.

Additionally, choice of governing law remains an important consideration for investors and lenders for the credit facility and the LPA and other investor documents. Typically transactions governed by the laws of a U.S. jurisdiction tend to see more Cayman, Delaware or Bermuda organised borrowers, as such jurisdictions offer preferable tax and corporate governance laws for a fund and its investors. Likewise, U.S. lenders are comfortable that the laws of such jurisdictions will enable enforcement by the fund or GP (or the lender, under the security documents) of the investor's obligations to fund their capital contributions.

For similar reasons, in European deals, it is more common to see Luxembourg, Channel Island, Scottish, English, Nordic, Netherlands or Cayman structures, whereas in Asia investors have historically favoured Cayman, BVI and Australian vehicles. Traditionally, Asian fund sponsors have used Cayman Island fund vehicles, typically formed as limited partnerships. Some sponsors have introduced Singapore and Hong Kong vehicles for local investors. The Asian fund finance market also sees Luxembourg, Delaware and Australian vehicles for larger funds.

In certain jurisdictions (particularly those in Europe that are subject to the Rome Convention), the governing law of where the borrower's assets are *situs* will dictate how security is taken in that jurisdiction; for example, if an LPA is governed by the laws of England and Wales, then the call-right security will be taken under the laws of England and Wales as the investors' obligation to meet a call-down notice is governed under an English law contract. Conversely, this is not strictly the case in non-EU jurisdictions, including New York and Delaware, where the governing law of a security agreement might not necessarily be the same jurisdiction as where that asset is based.

The majority of U.S.-based fund finance facilities are governed by New York law, as lenders are comfortable that the laws of New York contain favourable provisions for the interpretation of the credit documents and enforcement of remedies against the fund. Therefore, the law governing the security agreement, and the creation and attachment of a security interest in the collateral, would be New York law. However, under the UCC, security filings are required under the law of the debtor's location (as defined in the UCC) to perfect the security interest in the collateral. Consequently, if a fund is organised under the laws of Delaware, the UCC would specify that Delaware is the "location" of the debtor and perfection of the collateral would be made by the filing of a UCC-1 financing statement in Delaware. This would be the case regardless of what governing law is included under the LPA and investor documents (though such governing law typically corresponds to the fund's jurisdiction of organisation).

Covenants

Historically, U.S. deals have sought comfort from lending against a borrowing base (looking at each investor on an individual basis by applying individual advance rates, haircuts and concentration limits before aggregating results) and granular due diligence of fund documentation, including any side letters entered into by the fund or GP for the benefit of investors. By contrast, European deals have taken a more holistic view on the financial covenants (looking at the investor base as a whole and applying one advance rate), and sought comfort through covenants in the facilities agreement – for example, through a repeating representation that no side letter, or other agreement between an investor and the fund or GP, contain terms that are materially adverse to the rights of a finance party under the finance documents or, if taken one step further, which would affect the ability of the fund or GP to require investors to make capital contributions to the fund.

Historically, in Asia, deals were structured with a coverage ratio. Nowadays, facilities may be sized on a borrowing base calculation or coverage test. Negative pledges are also more likely to apply to all assets of the borrower in an English law-governed facility agreement, whereas in a U.S. credit agreement, a negative pledge may only apply to those assets of the borrower that are the subject of the transaction security.

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

Conditions precedent

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

Completion searches differ between jurisdictions, with lien searches under the applicable UCC and tax laws being carried out where a borrower is located under the UCC in the U.S., and in some cases in the U.S. jurisdiction where its chief executive office is located. The purpose of a UCC lien search is to determine whether any other creditors hold existing liens against the collateral that would take priority over the liens to be created by the credit documents. Likewise, under U.S. law, any tax lien filed against the fund by a governmental authority would hold higher priority than the liens created by the security agreement.

Whilst similar security searches are carried out at the relevant Companies House in the UK for corporate entities and limited liability partnerships, there is no security searches register for limited partnerships, which is the typical private equity fund structure in the UK. Therefore any security granted by a fund, in the form of a limited partnership, over its assets will not be noted at the registry, and so priority liens in respect of such a fund cannot be searched for. Depending on the type of security being granted, different filing obligations will also apply in the UK. Again, security filings can only be made in respect of security interests granted by corporate vehicles or limited liability partnerships over their assets, not limited partnerships.

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

Execution of documents/completion mechanics

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

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

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

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

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

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

Summary

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

Although lenders tend to have a very strong bargaining position in the U.S., investors are also starting to put pressure on GPs to be more transparent about the use of subscription line facilities through the published principles of the International Limited Partners Association ("**ILPA**"), particularly the 3.0 Principles which were published in June 2019. ILPA is less well known in the European and Asian markets, but no doubt will become more widely recognised, as the trend of the European and Asian markets following the U.S. continues.

As the phase-out of LIBOR is under way, each of the U.S., European and Asian markets will have to decide on a consistent approach towards replacement rates. As LIBOR is a global benchmark, the move away from LIBOR will affect loans throughout the U.S., Europe and Asia. In September 2019, the Loan Market Association (the "**LMA**") published 'Commentary to the Exposure Drafts of Compunded RFR Facilities Agreement', providing guidance on structuing syndicated loans with reference to SOFR (for U.S. dollar) or SONIA (for sterling). The Asia Pacific Loan Market Association also promotes this commentary from the LMA on its website.

In the U.S., a lot of the larger banks will have their own internal approach as to how they document the transition away from LIBOR, with the Loan Syndications & Trading Association announcing publicly that it has already seen a number of SOFR bilateral loans.

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Umbrella facilities: Pros and cons for a sponsor

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Overview

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

Description of umbrella facilities

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

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

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

Each time a borrower (whether the fund as original borrower or a new SPV borrower) requires a new facility, it submits a new facility request to the lenders detailing the type of facility it requires, the new facility amount and any other commercial terms relevant to that new facility (such as interest rates, currency and fees). The lenders will then approve (or not) that requested facility. Recourse for the lenders, for both borrowings by the fund and guarantees by the fund of borrowings of the SPVs, is to the fund's investors and the bank account into which proceeds of investor commitments are paid, as for a standard fund finance facility.

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

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

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

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

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

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

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

Recourse and security

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

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

This practice of taking additional security over the fund's or SPV's underlying assets is frequently required for a more mature fund where there are fewer uncalled investor commitments remaining. The positive benefit to the fund is therefore to extend the life of its financing, which might otherwise be unavailable due to that reduced level of investor commitments. That additional security can be combined with guarantees being provided by each of the fund's SPVs in respect of each other SPV and the fund's own obligations. When taken together with security granted by each SPV over its bank accounts and, potentially, subsidiary/ies, lenders obtain recourse to both any remaining uncalled investor commitments and the net asset value of the fund as a whole. The additional security and asset-recourse structure can be simply documented by a new facility request and security documents covering each of the relevant assets. It may, however, be necessary to conduct additional diligence on: (i) the constitutional documents of the fund and the SPV; and (ii) any facilities which have been made available to an SPV (or its subsidiaries).

For example, a key question for funds looking to enter into umbrella facilities (and for lenders looking to provide umbrella facilities) will be whether the existing constitutional documents of the fund permit the provision of guarantees and security in support of facilities to be provided to an SPV of the fund as borrower. A fund's constitutional documents will contain restrictions on the term of any of its borrowings (for example, for a maximum period of 12 months). If the fund is only permitted to provide guarantees and security to support borrowings of an SPV for the same term, this would restrict the tenor of a NAV-based SPV facility, making such facilities less attractive from a borrower perspective.

It will also be necessary to confirm that each SPV can cross-guarantee each other in the manner described in the above paragraph, although a detailed consideration of these issues is beyond the scope of this chapter.

History of umbrella facilities

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

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

Pros and cons

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

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

Flexibility and convenience

Compared to a standard fund finance facility, umbrella facilities can be hugely flexible. They can offer the convenience of an uncalled capital commitment together with an underlying assets (or NAV-based) facility within one agreement. They can provide for either single or multiple borrowers as well as different forms of borrower vehicle (e.g. both fund entities as well as corporate vehicles). They can also be adapted over the life of a fund as its needs change, without having to put multiple standalone facility agreements in place or make extensive amendments to existing standard fund finance facilities.

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

Umbrella facilities also provide funds with the ability to match their funding requirements to a club of lenders who can provide all of the necessary facilities. The facility should have the discretion to allow lenders to be selected according to their ability to provide certain facilities. Where revolving or ancillary facilities are required, lenders with the ability to provide those facilities (and the requisite rating, if required) will participate. Lenders who can only provide term debt can be selected to provide a proportion of the term debt facilities. The latter point also enhances the ability to syndicate these sorts of facility to non-bank (or alternative) lenders, providing greater liquidity for the lenders and, potentially, greater pricing competition for the borrower. Where a fund structure involves entities in a number of different jurisdictions, there can be tax issues in respect of certain lenders lending into some jurisdictions, so a club of lenders can be organised so that the appropriate lenders lend to certain entities within the structure, to avoid withholding tax issues.

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

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

Fees and costs

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

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

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

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

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

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

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

Who and where?

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

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

A multi-asset, multi-strategy fund manager (i.e. a fund manager that raises multiple pools of capital across more than one sector (e.g. credit and private equity)) is one of the most obvious beneficiaries of the umbrella facility structure. In addition to its flagship commingled funds, the manager might need the facility to be available for single managed accounts ("SMAs") and also require flexibility for parallel funds or feeder vehicles to accede to the facilities. An umbrella facility provides this flexibility from day one as, whatever form the relevant vehicle requiring finance takes, the finance documents already include the framework to allow those different types of vehicle into the facility.

However, for some SMAs, a bespoke individual committed facility may be better than an umbrella facility, if the reality is that their investment activity will be limited. A Model B facility would be best suited to this kind of situation, especially where a manager is looking to keep its commingled investments separate to those of SMAs. As above, however, a manager would need to assess which facility structure is most likely to be used by its managed funds, and whether the flexibility of having all entities in one structure is of genuine benefit.

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

Conclusion and outlook

We have considered what constitutes umbrella facilities and some of the pros and cons of using them, with a look at which types of funds are using these types of facilities, and in what jurisdictions.

A key driver in the continuing popularity of umbrella facilities is the tendency of managers to establish SMAs (due to the amount of cash investors are looking to invest) which, in turn, drives investors to seek bespoke investment strategies. If a manager can add those SMAs into an existing umbrella structure rather than have to go through the process of establishing a new structure (or indeed, put a single fund finance facility in place for each fund), then this is likely to appeal to investors and set the relationship between the manager and the investors off on a good start. Other positives for a manager are that investors will be attracted by the scope for cost saving (this is a direct benefit for investors as well as managers, because the return on their investment will be higher as fewer fees and costs will be deducted when calculating their profit), and managers will save themselves a significant amount of time and energy by not having to manage multiple single facilities.

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

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Side letters: Pitfalls and perils for a financing

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Overview

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

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

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

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

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

Background to side letter considerations

Disclosure

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

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

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

Impact of investor requirements

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

Investor views continue to evolve. The Institutional Limited Partners Association (a trade association for institutional LP fund investors) released guidance in June 2017 ("ILPA Guidelines") recommending (among other things) increased disclosure to investors with respect to the terms and impact of sub-lines. In response to the issuance of the ILPA Guidelines, the Fund Finance Association (a non-profit industry association in the fund finance market) issued its own analysis and recommendations on the ILPA Guidelines in December 2017 ("FFA Analysis") emphasising that the ILPA Guidelines should encourage and foster greater dialogue and awareness but should not be viewed as "absolute principles". A fulsome discussion of the ILPA Guidelines and FFA Analysis is beyond the scope of this chapter. However, the views of interested parties will continue to shape the scope of side letter provisions requested by investors and their related impact on fund financings.

Focus on side letter provisions

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

Timing

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

Limitations on debt incurrence

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

Practical considerations

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

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

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

Prohibition of direct obligations to lenders

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

Practical considerations

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

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

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

Administrative requirements of investors

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

Practical considerations

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

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

Sponsor co-operation with lenders

Some investors may request that, where the GP or manager has assigned its right to call capital to a lender and that lender has enforced such security by issuing drawdown notices to investors, the GP or Manager must provide written confirmation to the investors that those drawdown notices have been validly issued in accordance with the fund documents.

Practical considerations

This type of side letter provision presents a clear issue to lenders: in an enforcement scenario, the lender cannot rely on GP or manager co-operation. It is therefore important to ensure that failure by the GP or manager to provide such confirmation does not preclude the investor from its obligation to fund in response to drawdown notices issued by the lender.

Excuse rights

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

Practical considerations

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

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

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

Confidentiality restrictions

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

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

Practical considerations

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

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

Refusal to acknowledge third-party notifications

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

Practical considerations

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

However, a risk may remain even if the LPA contains terms that the sponsor considers will satisfy lender expectations. If the side letter is entered into before the fund procures financing, the fund will not know for certain at the point of negotiating side letters whether such a restriction could be an issue. The fund could soften any absolute restriction by instead agreeing to use commercially reasonable efforts to ensure that the investor is not required to sign documents in connection with a sub-line.

Similarly, investors may also resist providing financial information to the fund and any sub-line lender. Lenders and investors often get comfortable with limiting the scope of financial information on an investor to publicly available financial information or, in some cases, only to information that is required by the lender in order to assess the creditworthiness of an investor.

Restrictions on jurisdiction of enforcement

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

Practical considerations

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

Sovereign immunity

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

Practical considerations

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

Transfers to affiliates

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

Practical considerations

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

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

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

Overcall provisions and concentration limits

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

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

Practical considerations

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

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

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

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

Practical considerations

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

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

MFN provisions

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

Practical considerations

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

Conclusion

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

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

* * *

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What next for regulation of fund finance as the EU plans CMU "2.0"?

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Introduction

More than 10 years after the 2008 "great financial crisis", the role of private debt, as an asset class, continues to capture EU policymakers' interest; in particular, the activities of both investment funds that originate and/or purchase loans and the entities that finance such funds, i.e., the range of activities that can be grouped together as "fund finance". During and after the financial crisis, fund finance market participants stepped in to provide new sources of liquidity to borrowers that parts of the banking sector were under pressure to lend to. Private debt providers have been able to provide greater flexibility in bespoke terms and transaction structures to borrowers.

Invariably, the European Supervisory Authorities (**ESA**s), including the European Securities and Markets Authority (**ESMA**), largely recognise that funds, and those that finance them, do step in to support a range of borrowers and transactions. In essence, they support areas of the "real economy" where the banking sector often "cannot finance", due to blanket bans and prohibitions, or "will not act", due to unfavourable prudential regulatory, conduct of business and/or tax considerations, or simply as a result of being unable to compete on financing and funding costs.

Despite a range of EU legislative proposals and various "action plans", harmonised or sector-wide legislation is either piecemeal for some topics or absent for others. This means that for the wider European funds sector, and possibly to a lesser degree for those wanting to finance funds, the EU's "Single Market" still remains fragmented as a collection of national markets, with varying degrees of cross-border activity depending on transaction types, asset classes and counterparties. This remains the case despite past European Union (**EU**) integration projects delivering much of the post-crisis market architecture, such as for UCITS or Alternative Investment Funds, or looking to future projects in the funds sector and greater cross-border distribution. The current state of fragmentation also remains, despite the European Central Bank (**ECB**) taking some preliminary steps to extend its supervisory perimeter to certain firm types from outside the banking sector that engage in "bank-like" activity.[1]

Where do such investment funds go from here? Clearly, they have the potential to play a greater role. So too do other fund finance players. Whether they do or do not depends largely on regulation, especially on EU capital markets post-Brexit. The EU is taking measures to ensure that the EU's Single Market for financial services, in particular capital markets, can withstand the prospective departure of the UK from the EU. One overarching measure is the EU's relaunch of its most recent Single Market integration project, the Capital Markets Union (**CMU**), as version "2.0", which aims to break down the barriers that fragment and thereby diminish the EU's goal of a single capital market, as opposed to multiple markets drawn along national lines. CMU 2.0's goals pick up on some of the priorities, but also add new ones to those of CMU 1.0 that the EU announced in September 2015 and that were supposed to have been completed by 2019, had it not been for Brexit delaying some deliverables and altering others.

Brexit – barriers for fund finance on the horizon?

Much of the investment fund activity in the EU in connection with loans has taken place in the UK under English law. Presuming Brexit occurs, investment fund managers will need to adapt outstanding funds and shape future offerings to ensure their continued compliance with EU law. One certainty of Brexit is that its potential for disruption will be far-reaching across all types of financial markets, asset classes, participants and end users regardless of the type of Brexit.

Above all, managers will need to observe the ESA's "supervisory principles on relocations" (**SPoR**s),[2] which set specific quantitative and qualitative criteria that national competent authorities must apply in relation to those firms relocating to the EU-27 or those EU-27 firms looking to expand their UK business. The SPoRs set key pillars to be followed when planning and operationalising post-Brexit business models. In the fourth quarter 2019, the authorities began announcing that supervisory investigation and action would now concentrate on how firms were operationalising those plans.

For funds as well as those financing them, the SPoRs are relevant to how business can be funded, structured and executed as well as to how to meet supervisory expectations that have a much stricter tone. In summary, the SPoRs have legal entity structuring impacts for fund finance participants, which often translates into the question of "what legal entity should be doing what, where and with whom?" inasmuch as they have documentation issues that translate into considerations of "is my client-facing, counterparty-facing and/or lender-facing documentation sufficiently robust in the light of legal, regulatory, documentation, credit and enforcement/recovery risks in a post-Brexit world?"

There are many other questions in relation to whether and what a firm can delegate and/or outsource to another affiliated or third party and whether this meets the black letter of the law and, more importantly, the much sharper interpretation and approach of the ESA – and the individual national authorities they coordinate – which is much stricter in interpreting the application of those rules.

The SPoRs build upon but also refine existing EU regulatory principles and concepts. They are both broad in what they cover and prescriptive in setting supervisory expectations. And to further complicate matters, they have been often overlooked by firms operating from non-EU-27 jurisdictions and their professional advisers. This has caused some relocating firms to have their post-Brexit licence applications sent back, and others to have to rethink their Brexit planning, in particular as the ECB, as super-supervisor for the Eurozone's banking sector, started to change the tone in 2018 from "home" and "host" state responsibilities to "onshore" i.e., within the EU-27, and "offshore" i.e., non-EEA "capabilities" (human, financial and other resources). That trend continued in 2019, and is set to continue in 2020.

For fund finance, the issue of where transactions are executed and booked is firmly covered by supervisory expectations on where certain governance and risk-taking, as well as risk-management, functions should sit, as well as how transactions should be structured according to primary and back-to-back booking models. The EU Commission helped to set the tone for the post-Brexit regulatory landscape by proposing draft regulations that confer enhanced supervisory powers on ESMA to monitor delegation arrangements of MiFID investment firms, AIFMs and UCITS management companies. It remains to be seen how this proposal will be advanced. That being said, the ECB already has similar and other, wider-reaching powers, and its 2019 supervisory priorities bring within its remit the issue of delegation – which historically has been a conduct-of-business matter and thus outside its direct supervisory mandate – the governance and risk-management implications of which the ECB will now assess.

While the banking sector has led on relocating legal entities, but not necessarily Brexit-proofing documentation, including fund finance documentation, the asset management sector is slowly accelerating plans as the risk of a "No Deal Brexit" became ever more likely at the end of 2019 and then was postponed again to January 2020, with a UK General Election in December 2019. Even if a deal is struck between the EU and UK, at the time of writing the outlook for achieving a workable deal for financial services, offering any form of "equivalence", i.e., near frictionless and mutual access to EU and UK financial markets for participants, remains elusive, if not tied to tenuous and lengthy negotiations at the very least. While work may be under way on a legal entity and, to a lesser degree, contractual continuity restructuring, the jury is still out on how best to deal with dispute resolution. Options do exist, however, and more are on the way.

Deciphering dispute resolution, governing law and enforcement challenges post-Brexit

English law has traditionally been the preferred choice of governing law for financial institutions and predominates in a number of financial transaction types and master agreement documentation suites. This also applies to fund finance transactions. English law is and may remain a preferred choice for many market participants and their transactions with a European element. Furthermore, the English language has long been the *lingua franca* for documenting and disputing these transactions.[3]

English courts are often the preferred venue for resolving both international and domestic financial sector disputes, especially within Europe. For instance, the UK Commercial Courts Report of 2019 indicated that almost 60% of litigants during the past year were non-UK citizens, with the number of European litigants increasing by 24% within the same time period, and that there was a record 54% increase in litigants from 2018.[4] English courts are lauded for their expertise, transparency and certainty. Their judgments are published, and precedent applies. English courts also have a longstanding track record for being innovative, both in terms of how they adjudicate commercial disputes and also in the nature of the legal process.

The attractiveness of English courts for financial sector disputes was bolstered in 2015 when the High Court established the "Financial List", a specialist court offering litigants a forum for dispute resolution conducted by dedicated judges with financial markets expertise.[5] Parties may submit test cases to the Financial List without a "live" dispute to receive guidance in resolving legal questions.[6] A global, let alone a European parallel to the Financial List, has yet to emerge.

Under the Recast Brussels Regulation, English court judgments are automatically recognized in every other EU Member State by means of a process known as "mutual recognition".[7] This process applies to all civil and commercial matters without the need for a special procedure,[8] and virtually guarantees enforcement.[9] Brexit puts the current ease of access to this expertise and its track record at risk, due to the UK becoming a "third country" post-Brexit – regardless of the application (if any) of a transition period in the event of a final deal between the UK and EU-27.

The transition from EU Member State to "third country" may add complexity to decisions which arise in any financial transaction or exposure to a counterparty, and the ability to serve/enforce where required. Fund finance arrangements, regardless of whether documented under English law or laws of the EU-27, may merit review given the potential for uncertainty with recognition and enforcement outside of the UK once it leaves the EU. Though market participants will still have the ability to access English courts post-Brexit, they may (also) find a wider range of choices are on offer.

These alternative avenues may prove to be more suitable for resolving commercial and financial market-related disputes by guaranteeing a faster route to secure or recover damages. A potential consideration of alternatives to the English courts does not equate to a move to replace English law for a wide range of financial market transaction types, despite some industry associations such as ISDA, as gatekeepers of financial market transaction documentation, having already done so. The LMA, which does offer standard form documentation governed by laws other than English law, has not (yet) published similar fallback or alternative options as ISDA has done for relevant master agreements.

That being said, the use of English law and language for financial market transactions within the EU is unlikely to diminish due to Brexit. However, questions may arise on both sides of the divide on recognition and enforcement of English court judgments.[10] Without further action, the UK would become what the EU terms a "third country" once it leaves the EU; the Recast Brussels Regulation no longer applying.[11] As a result, its courts' judgments would be treated as foreign judgments by EU jurisdictions and would no longer benefit from mutual recognition and thus possibly greater costs and time to recovery. With the EU losing a major fund finance and financial centre with London leaving, CMU 2.0 will probably need to do more to propose to resolve or at least bridge these issues, especially as they affect all types of financial and commercial services and dispute resolution.

To date, various solutions have been envisioned, however, none have been agreed finally, and none adequately address the uncertainties that may arise when enforcing judgments obtained in the UK's courts abroad. For example, in an August 2017 paper entitled "Providing a cross-border civil judicial cooperation framework" (the **Paper**), the UK government announced its intention to replicate the Recast Brussels Regulation.[12] However, as this option would result in the European Court of Justice (more properly, the Court of Justice of the European Union – **CJEU**) not having the final say on the interpretation of Brussels Regulation provisions, its viability is contested. The Paper further stated that the UK will continue to participate in the Lugano and Hague Conventions,[13] but this might too change in line with the political tone of the time. Participation by the UK in the Hague Conventions is the sole option not requiring EU approval, and even it has its limitations, only applying to agreements containing exclusive jurisdiction clauses and not covering interim decisions. Furthermore, it is unclear whether it would apply to jurisdiction clauses in existence prior to the UK independently acceding to the Conventions.

With these issues in mind, it is conceivable that English court judgments may not be regulated on a pan-European scale and could instead be governed by the domestic laws of each Member State. Thus, creditors seeking to enforce an English court judgment in an EU Member State (e.g., due to the location of the debtor's assets in that jurisdiction) may be required to engage in the lengthy and potentially cumbersome process of recognition and enforcement of foreign judgments. Depending on the jurisdiction, this could include review by domestic courts of the findings of the foreign court, obtaining translations in relation to, say, complex security and/or collateral valuation disputes – which may or may not include an assessment of ISDA or other industry association-standardised financial transaction documentation or account and/or holding structures.[14]

In an industry where timing and certainty are often of paramount importance, these potential delays, coupled with uncertainty about recognition and enforcement, could amount to unacceptable risks for stakeholders.[15] Several potential solutions currently exist or are in development outside the UK; none are capable of maintaining the *status quo*. They include:

1. <u>International arbitration</u>

The dispute resolution mechanism offering parties to a transaction the greatest amount of flexibility and opportunity to tailor proceedings is international arbitration. By selecting arbitration in their underlying documentation, the parties have the option to shape any future disputes. They are, *inter alia*, able to determine the applicable law, magistrates, rules of procedure, venue of the dispute, language of the proceedings, and whether the outcome is to remain confidential. If specialised expertise is required of the decisionmaker(s), the parties may request it in advance (i.e., when contracting) or after the fact (i.e., once a dispute has arisen).[16] Expedited procedures may be selected, and the use of "emergency arbitrators" is foreseen under certain rules.[17]

The recognition and enforcement issues potentially arising from the UK's third country status post-Brexit would largely be eliminated if arbitration were to be chosen as the dispute resolution mechanism. Applicable in more than 150 countries, the New York Convention[18] applies common legislative standards to the recognition and enforcement of foreign arbitral awards. It prevents national courts from reviewing the tribunal's decision on its merits (*revision au fond*) and requires enforcement when presented with an award, the arbitration agreement and, in some instances, a translation of the award.[19] Exceptions to enforcement are limited to enumerated grounds including invalid arbitration clauses, violation of due process, improper constitution of the tribunal and a violation of public policy in the country where enforcement is sought.[20] To prevent unnecessary delays, some national laws place recognition and enforcement with the highest courts or courts of appeal.[21]

Ease of enforcement aside, the limited right to appeal the decision itself may dissuade some parties from choosing this method of dispute resolution and lead them towards alternative solutions. Furthermore, some financial industry niceties may dissuade users from the arbitration option. These include, for example, the issue that most financial market participants have a preference for public judgments with precedent-setting value. This underpins certainty of expectations, but also the ability to accommodate clear changes to documentation where needed – such as intricacies of the EU's Financial Collateral Directive and what constitutes (sufficient) "control" in relation to security financial collateral arrangements.

2. <u>Challenger courts</u>

Seeking to capitalise on the UK's third country conundrum, several EU Member States have established, or are considering establishing, "challenger courts" (see Box, next page). This trend is likely to continue regardless of what type of Brexit ultimately may be implemented and regardless of the availability to use arbitration.

Establishing a European Commercial Court?

In 2018, a study, "Building Competence in Commercial Law in the Member States",[22] was commissioned by the European Parliament's Policy Department for Citizens' Rights and Constitutional Affairs, at the request of the European Parliament's Committee on Legal Affairs. The study is focused on cross-border commercial contracts and their operation. It describes the legal framework within the EU in which commercial contracts operate. It shows that the legal framework in which commercial contracts operate is vastly unharmonised in the EU. The study also analyses current commercial practice as regards choice of law and choice of forum. The study shows that contracting parties are more likely to choose the laws and the courts of certain Member States. As a conclusion, it suggests creating a framework that will advance settlement of international disputes in the EU. One of the measures suggested is the introduction of an expedited procedure for cross-border commercial cases and establishing specialised courts for cross-border commercial matters in each Member State. Further, the study suggests establishing a European Commercial Court.

Such a "European Commercial Court" would provide commercial parties with an alternative to courts of Member States and international commercial arbitration. Specialised commercial courts are established in several jurisdictions outside the EU, such as the Singapore International Commercial Court and the Dubai International Financial Centre. This recommendation echoes the global competition that has arisen over the years for the resolution of international disputes. The idea of the European Commercial Court is yet to materialise in the form of a firm legislative proposal. Regardless, some Member States[23] have themselves begun establishing specialised courts for cross-border commercial matters, or expanding and upskilling existing infrastructure.

Frankfurt's E-LG

Frankfurt is the Continent's financial hub and is home to the ECB, the European Insurance and Occupational Pensions Authority (EIOPA) and a host of other international and EU financial service firms, as well as a much broader base of non-financial corporate entities. Since January 2018, the *Frankfurt Landgericht* [24] has offered English language proceedings in its "English chamber for Business Affairs" (*englischsprachige Kammer für Handelssachen*, E-LG).[25] The E-LG applies German rules of civil procedure (ZPO) to all disputes, even those in English concerning English law. Rights of appeal exist, however, judgments are required to be translated into German if an appeal is lodged.[26]

Brussel's BIBC

Brussels, the *de facto* capital of Europe, is home to myriad European and international institutions such as the European Parliament, the Council of the European Union and the European Commission. It plans to open the Brussels International Business Court (BIBC) by 2020, which will operate entirely in English. The BIBC will be a standalone specialist Belgian court. It will embed arbitration into its administrative proceedings and allow parties to choose what substantive law to apply. Procedurally, it will apply the United Nations Commission on International Trade Law's arbitration rules. Like much of international arbitration, awards will be final without the possibility of appeal.[27]

Amsterdam's ambition

On December 11, 2018, the Dutch Parliament adopted a bill to establish the "Netherlands Commercial Court". This specialised specialised court would operate in English but under Dutch procedural law, as a special division of the Amsterdam District Court and the Amsterdam Court of Appeal, and be equipped with state-of-the-art court technology.[28] Certain issues relating to this initiative are still under review, including the adjustment of court fees to make the facilities available to small and medium-sized businesses.[29] The NCC is expected to be operational as from the first half of 2019 or soon thereafter, and its primary focus would be on large and complex international commercial disputes, with moderate costs.[30]

Dublin's decision

Post-Brexit, Ireland will be the only English-speaking common law jurisdiction within the EU, and it intends to take full advantage of this position. In January 2018, the Irish Minister for Justice launched a plan put forward by, *inter alia*, the Bar of Ireland and the Irish Law Society,[31] which includes the creation of an implementation group and the reform of, and investment into, the judiciary and courts system.

Paris' plan

The proposed specialist chamber within the *Tribunal de Commerce* started its operations in June 2018. The chamber sits within the existing French court system in Paris, operates in English, and applies English law if required, but is subject to French procedural law.[32]

More courts also present the opportunity for more forum-shopping. The degree of competition among jurisdictions varies depending on the type of litigation. In the EU, before the UK's official decision to withdraw from the European Union, its most serious competitors were Germany and the Netherlands. Germany's advantages include: quicker and less costly proceedings; more certainty around lawyers' fees; and a somewhat modest initiative towards the use of English as the language in court under specific circumstances including Frankfurt's E-LG. These limitations in the use of English, as well as the dislike of incorporating new technologies, are likely to work against Germany. Dutch courts, on the other hand, are known for their efficiency in the management of complex and high-level litigation, as well as for "offering collective redress mechanisms not available anywhere else in Europe". The NCC may turn out to be better equipped in terms of language and use of technology in comparison with Germany but, unlike Germany, may impose high access fees on litigants.

Ireland meanwhile continues to position itself as a dispute resolution venue post-Brexit, most recently having launched the Brexit Legal Services Implementation Group on October 25, 2019. One of the aims of the group is to "promote Ireland as a leading centre globally for international legal services". The initiative is jointly proposed by the Bar of Ireland and its Law Society and also has the support of the Irish Government. The key objective of the Implementation Group is to identify the best way to promote the use of Irish law and Irish legal services in contracts and transactions by showcasing the advantages of Irish law, its courts and legal system.

A paper published by the Law Society, promoting Irish legal services, points out that the post-Brexit recognition and enforcement of English judgments across the EU is still unclear, and this adds an extra level of uncertainly and complexity for both businesses and individuals. With ISDA also introducing Irish law-governed derivative documentation, it is no wonder that the Irish courts and governmental and state agencies are keen to stress the policy and legal infrastructure advantages of the country as a cost-effective, pro-business, English-speaking, Common Law justice system with the judiciary having a record of impartiality and commercial awareness.

However, international commercial courts do not need to be seen as replacements of, or a threat to, international commercial arbitration, as they add to the options available to parties involved in international commerce. Furthermore, as public courts, international commercial courts can provide a range of remedies not available in traditional arbitration, and avoid some disadvantages associated with arbitration such as awards inconsistency, due to the absence of precedents.

Could the 2019–2024 EU legislative cycle be different in delivering CMU?

While many of the post-crisis reforms have led to greater harmonisation of how mutual and "alternative investment" funds and their managers are regulated across the EU, the EU Commission has still not created a European-wide regulatory regime to harmonise the regulation of private debt across EU Member States. This has meant that the way private debt and fund finance activity are regulated in Europe is subject to the regulatory rules and supervisory approaches of each individual Member State of the EU, to the extent those rules even apply.

Consequently, the level playing field that CMU aims to provide is compromised by the current European framework, subject as it is to various degrees of fragmentation and gaps in the rules, as well as structural exemptions or available waivers from those rules. It also may mean that new entrants need a certain firepower to be able to operate across European markets. Irrespective of these gaps, established, sophisticated market participants have thankfully been able to overcome these obstacles and satisfy local requirements across multiple jurisdictions when providing financing to a range of types of borrowers.

The degree of divergence in how these market participants and their activities are regulated and supervised has led some EU regulatory policymakers to point to the opportunity to reconsider how best to harmonise the regime without hampering the much-needed liquidity provision by these players. This is proving to be no easy task, partly given that policymakers have been drawn to other areas that may be perceived as being more of a priority. Yet the start of change may be on the horizon.

Some of this acceleration in change may be attributable, firstly, to the EU moving to restart the CMU and emphasising "real economy" financing through non-banking sector means, as well as, secondly, the UK's changing relationship with the EU and, ultimately, the concerns that have arisen due to linkages. Where policymakers (unsurprisingly) may have concerns is when credit risk transformation, funding mismatches and excessive credit leverage could form contagion channels as well as catalysts along the linkages in place between the EU's banking or otherwise regulated areas of the fund space, and unregulated areas.

The failures of EU and non-EU funds (notably the Abraaj Group) have shown that weaknesses in risk identification, mitigation and management are present, as are the contagion channels. All of this has renewed a wider-reaching regulatory policymaking interest in non-banking sector intermediated credit (the sector formerly referred to as "shadow banking"), including − as part of the ESA's and ECB's involvement − pushing the market to operationalise compliance with the EU's Benchmarks Regulation.

Lastly and perhaps more importantly, as fund finance matures in the EU − following growing asset allocation from institutional investors to steady levels, even though ultimate investments may be going to non-EU jurisdictions − fund finance is now too large for regulators to ignore.

CMU 1.0's delivery of its objectives, in the face of Brexit and certain national political barriers, has spent a considerable proportion of time focused on consultation as opposed to advancing "action" in terms of translating policy into legislative proposals and implemented solutions. Other concurrent actions that are relevant to the fund sector, such as moving from national private placement regimes for third country equivalents to EU alternative investment funds, to an EU-wide passport or more harmonised treatment of loan origination funds, have yet to be put back on the table for finalisation.

However, if current communications from the European Commission − including the "Mission Letter"[33] from the then Commission President-elect Ursula von der Leyen (**VDL**) − are anything to go by, CMU 2.0 is largely expected by EU-27 market participants to continue to boost capital market integration in the EU-27 whilst reducing reliance on the banking sector, and to have a much sharper focus on delivering "action" on the various building blocks of its overall "action plan", with the following key aims:

1. unlock more financing for growth companies;
2. accelerate supervisory and regulatory convergence in the EU to remove national barriers to cross-border investment (and in particular, the distribution of funds);
3. boost the role of fintech in capital markets;
4. encourage a more sustainable approach to finance and climate-based finance; and
5. develop a more proportionate supervisory regime for asset managers,

coupled with a shift in priorities to focus on:

1. resolving non-performing exposures;
2. sustainable and climate-based finance;
3. greater resource commitment to supervisory convergence;
4. incentives to mobilise private capital for long-term investment;
5. removing remaining barriers for cross-border distribution of funds;
6. helping build capital markets in less-financialised jurisdictions; and
7. implementing a holistic EU-wide regime for fintech companies.

While asset management, and thus mutual and alternative investment funds, are seen to be core components of what CMU aims to achieve, for loan origination funds, however, the latest CMU update still goes back to an Opinion published by ESMA in April 2016[34] (the **ESMA Opinion**). Action on this workstream appeared to have been slow tracked by the Juncker Commission as part of the June 2017 mid-term review on CMU 1.0 and the feedback statement,[35] as there was, at the time, "no clear consensus in favour or against the need for an EU framework". This development came during a period of ESMA having a lot on its "to do list", and resulted in an unfortunate situation for loan origination funds as well as those lenders wishing to provide financing on the basis of a Single Rulebook (i.e., possibly at lower cost of compliance). The question now is whether the incoming VDL Commission will reinvigorate that process.

To recap, the ESMA Opinion followed on from an EU-wide regulatory mapping exercise as part of the CMU "work plan", and provided the European Commission with a legal opinion detailing what such a pan-EU legislative framework might look like and where funds could have comparable "passport rights" to lend as those enjoyed by the banking sector. The ESMA Opinion recognised that private debt may provide a more appropriate credit channel compared to bank sector debt, and that action was needed to create a "more level playing field" across the Single Market. ESMA proposed that any future legislation could build upon existing EU fund sector legislation or be of a standalone nature, including in the form of a directly applicable EU Regulation.

Irrespective of the harmonisation objective, however, the ESMA Opinion focused on those funds that act as sole or primary lender. It thus bypassed those that engage in participations or restructurings as well as those acquiring exposures, including through syndication of credit exposures from the banking to the fund sector. It also ignored the growing role of the private debt advisory market, which has sought to intermediate and provide guidance on what may be a rather opaque market for some.

In terms of fund vehicles, the ESMA Opinion concentrated on those that, for EU regulatory purposes, qualify as alternative investment funds (**AIFs**), yet the "key principles" in ESMA's Opinion failed to fully account for those AIFs that are already permitted to conduct lending business, namely those that are European venture capital funds (**EuVECAs**), European social entrepreneurial funds (**EuSEFs**) and European long-term investment funds (**ELTIFs**). Irrespective of any future legislation possibly being expanded to a wider audience of funds, including third country equivalent entities (possibly as a legislative bolt-on to) the EU's existing rules on AIFs, any revision to the ESMA Opinion or an actual legislative proposal could also be expanded in terms of its content. This would improve interoperability with other related areas of the CMU or other regulatory reforms such as securitisation. It is conceivable that ESMA currently expects that the industry (and their counsel) will play a greater role in drafting proposals – and possibly the industry may have a vested interest in doing so, prior to the European Commission and/or ECB communicating their own proposals, which historically have not been favourable to the non-banking sector.

ESMA's key principles, as communicated in the Opinion, concluded that loan-originating funds should meet the following attributes (all of which may have an impact on what types of financing in turn might be offered to funds):

- be closed-ended as opposed to open-ended, have set maturities and sufficient liquid assets to meet redemption requests and focus their lending activity on non-financial institution borrowers;
- at the fund and management entity level, be authorised according to specific standards and comply with conduct of business standards on credit, valuation, risk, including a risk-appetite statement, set risk-management processes, collateral management, set governance criteria on pricing and origination of credit, monitoring of performance along with renewals and refinancing, a concentration risk-management policy and operational risk controls, management of arrears, forbearance and non-performing loans and exposures; and
- be subject to financial leverage restrictions (as in certain jurisdictions, a set percentage of the net asset value of the AIF) and limitations on the use of derivatives and securities-financing transactions other than for non-speculative purposes. Further specific protections are envisioned to apply where underlying investors are non-professional clients.

Interestingly, the ESMA Opinion did not consider who ought to supervise the operations of loan-originating funds beyond the existing national competent authorities discharging their supervisory mandate. Whilst the European Commission had, during the course of 2017, taken steps forward and proposed a new regulatory capital regime for a range of non-bank financial institutions (**NBFIs**) (but not AIFMs) that ought to reflect their risk contribution according to various "K-Factors",[36] it is the statements of the ECB, acting in its Single Supervisory Mechanism role within the Banking Union, that really matter.

The fact that the world's largest banking supervisor stated that it would, with the right mandate following an extension of the supervisory perimeter, be directly responsible for policing a range of NBFIs, begs the question of whether those potentially within the scope of regulation may want to consider what to do to prepare, or how to stay out of, any such expanded perimeter. If they fall within the regulatory perimeter, then would the EBA's efforts to finalise its rules and supervisory expectations in "Guidelines on loan origination and monitoring", while directed at the banking sector, then also be conceptually expanded to NBFIs? Furthermore, the ESMA Opinion speaks of an "authorization gateway", which implies that this will be at the national level but, as the EU moves to CMU 2.0 – and tries to deliver on the aims of integrating financial markets that remain fragmented due to barriers at the national level – such a gateway might gravitate towards its "entry point" being located at the EU level, as opposed to at the national level, where it is under the European System of Financial Supervision.

As it currently stands, the ESMA Opinion, despite being slow-tracked, currently states that any future regime should prohibit origination of loans to:

- individuals;
- financial institutions; or
- collective investment schemes or the manager of the AIF and its related parties (e.g. depositary, general partner or delegates).

While in many ways, when viewed from a systemic risk and policymaking perspective, this makes sense in putting a block on interconnectedness, it is also expected that, in order to keep a handle on loan origination funds in supervisory terms, ancillary activity may need to be structurally separated from lending activity. From an economic perspective and notably in terms of fund finance options, the proposed narrowing of what a loan origination fund can do does potentially limit structuring options for those wanting to provide it with financing.

Proposed limitations on the secondaries markets may also raise specific concerns. At the very least, one may expect that the ECB, acting in its central banking and financial stability as opposed to supervisory role, could continue the current trend and require a far greater amount of granular reporting from NBFIs that use leverage and/or those lending to them. Similar moves have already been pushed forward in the pension funds sector as part of systemic risk monitoring concerns.

Other key changes that were advanced in 2019 that have an impact on the fund finance sector may be more positive. These include Regulation (EU) 2019/1156 and Directive (EU) 2019/1160 that were published in the EU's Official Journal. The aim of these reforms is to make it easier, quicker and cheaper for EU asset managers to sell funds to a wider range of investors and thus for investment to flow better across the EU, which was a core CMU 1.0 component that was delivered. Both legal acts add new rules for the cross-border distribution of alternative investment funds (**AIF**s) and undertakings for the collective investment in transferable securities (**UCITS**) in the EU. The rules and their benefits are most likely to be fully felt towards the end of 2021, given the standard 24-month implementation period. Broadly speaking, the Directive focuses on pre-marketing and de-notification procedures, while the Regulation looks at marketing communications and the information made available by national and EU regulators.

The Regulation focuses on the requirements for marketing communications and their verification, as well as the requirements on ESMA and national competent authorities (**NCA**s) to publish and share information, including a central database of AIFs, UCITS and their managers. The Regulation also extends the new pre-marketing and marketing communications regimes to European Venture Capital Funds (**EuVECA**s) and European Social Entrepreneurship Funds (**EuSEF**s). The Directive includes rules on pre-marketing of AIFs but also, more broadly, a harmonisation of rules to provide "local facilities" applicable to both EU and non-EU AIFMs and UCITS marketed to retail investors. It also introduces a process of de-notification of marketing of an AIF or UCITS in a host Member State, as well as an alignment of certain notifications in respect of the marketing of an EU AIF or UCITS in a host Member State.

So what next?

Even if "action" on the ESMA Opinion, and delivering on the building blocks of CMU 1.0, is reinvigorated with CMU 2.0 in mind, it will take time to move from the recommendations in the Opinion to a legislative proposal. With the non-banking sector i.e., the industry formerly known as shadow banking, back on the supervisory agenda of EU policymakers, industry and their counsel may want to actively use the lull in legislative rulemaking to make the fund finance market more resilient and sustainable – in light of it having generally moved from being an opaque sector to being an active and competitive market.

Some of this market participation could include exploring what an "ideal" harmonised regulatory response could look like and how that might benefit CMU 2.0's aims – something which official policymakers might actually prefer and welcome. With macroeconomic pressures likely to accentuate during 2020, including concerns on trade and currency wars, a possible resurgence of concerns on credit and lending quality, along with a shift in the EU, this may become a more pressing initiative that, if left idle, could be a missed opportunity, especially if a credit downturn and pressure on funding line exposure(s) causes reactionary rather than supportive legislation. This becomes further complicated where a lender is providing facilities to one or more fund vehicles.

Moreover, even if there is a Brexit-deal and regardless of CMU 1.0, 2.0 or possibly 3.0, there is no "one-size fits all approach" to resolving post-Brexit financial sector disputes, and no panacea on the horizon from policymakers. What is certain is that dialogue with internal stakeholders across teams will remain crucial. The same applies to dialogue between financial services firms and their peers, supervisors and clients. Those discussions are not just limited to amending jurisdiction clauses and agreeing exclusivity and/or fallbacks, though these are key parts of the process. Much more, it is about mitigating any triggering of "other" regulatory obligations, as well as barriers or other adverse effects.

This also means looking at how to deal with an ever (now faster) expanding regulatory perimeter, despite some relief being offered in other fields, including in certain areas of MiFID II, to reduce the burden on smaller firms. What is, however, clear is that the 'Europeanization' of financial services regulatory policymaking and, ultimately, supervision will continue to grow as the EU remains committed to reducing fragmentation in a collection of national markets and transforming it into a true European Single Market for financial services that includes funds and the fund finance community as a core component.

As the EU begins to consider (again) what the CMU ought to look like, and as the most recent flagship Single Market integration project aims to make the EU's Single Market "more single" and less reliant on the banking sector, market participants will need to consider CMU with a host of other regulatory and EU-political developments. CMU, in its original form i.e., 1.0, was somewhat delayed as a result of "Brexit" and much of what was scheduled for completion for the end of 2019 is now being rebooted as "CMU 2.0" during the EU's 2019–2024 legislative cycle. It ought to be noted that this cycle itself may only get started when the VDL Commission takes up office – possibly as late as January 2020 or after the current Brexit date.

Another reason for greater supervisory interest is that the very success of credit origination funds has inspired other non-bank financial institutions, such as liability-driven investors and certain credit institutions, to search for yield and emulate what funds have led on, in terms of private debt, as their own asset class. As lending activity of fund vehicles, or special purpose vehicles owned by the fund, grows, so too do the needs for financing and the opportunities for those willing to finance. While the road to a more integrated Single Market for funds remains a CMU objective, there are plenty of active channels for those sourcing and providing financing to transact with one another.

A diverse range of lenders, their SPVs and holding companies, provide loan-originating funds as well as other types of funds (including secondaries as well as private equity funds), regardless of fund strategy, with various types of fixed/revolving credit lines or other structured facilities, including subscription lines or capital call facilities. Moreover, lenders are increasingly competing amongst each other on pricing, financial and non-financial terms, as well as the extent and strength of security/collateral, across products ranging from traditional or structured credit facilities to leverage and liquidity solutions, as well as derivatives for hedging and other financial needs.

In the end, whether the EU will progress slow-tracked or stalled workstreams under CMU 1.0, or whether policymakers will take a new approach rests much on the incoming VDL Commission as well as the expanded powers of the Executive Vice-President and Commissioner for DG-FISMA as the gatekeeper of financial services regulation and the CMU. For many incumbent market participants in the fund finance sector, this may provide opportunities for reinvigorating, shaping and then benefiting from the process and using CMU 2.0 to achieve just that.

Endnotes

1. See coverage from Dentons' Eurozone Hub on the European Commission's proposal for a new prudential regulatory regime for MiFID Investment Firms, which may be rolled out to other NBFIs including certain funds: https://www.dentons.com/en/insights/alerts/2018/july/18/the-impact-of-the-european-commissions-proposals.
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6. *Id*., p. 243.
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8. *Id*., Arts. 36 and 39. Judgment-creditors therefore need not obtain a declaration of enforcement if they wish to enforce an English court judgment in another EU Member State.
9. *Id*., Art. 45(1)(a). Enforcement may only be denied on limited grounds, e.g., if a judgment is manifestly contrary to the public policy of the country in which enforcement is sought.
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11. *Id*., p. 238.
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17. *Id*., p. 5.
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Fund finance lending: A practical checklist

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Introduction

In this chapter we have tried to set out some of the key issues that a lender and its counsel need to consider when entering into a typical subscription or capital call finance transaction.

We have looked at these issues from the perspective of a lender and as its local fund finance counsel. In other words, we have assumed that the fund has been formed in an international fund domicile, such as the Cayman Islands, Luxembourg, Jersey, Guernsey or the British Virgin Islands, and have set out some of the issues that will be relevant for a lender in order to establish that:

- the fund has the capacity to enter into the transaction and perform its obligations thereunder;
- the fund has performed the steps necessary to enable it to enter into the transaction and to ensure the transaction and the relevant finance documents are binding on it;
- the relevant finance documents are enforceable against the fund as a matter of the laws of the jurisdiction in which the fund is formed;
- the transaction and the fund's obligations under the relevant finance documents will not conflict with the fund's constitutional documents or the law of its jurisdiction of formation; and
- all security granted over the assets of the fund in relation to the transaction is first-ranking and properly perfected.

The issues outlined in this chapter are not intended to be exhaustive. In particular, there will be jurisdictional and deal-specific issues that will need to be considered and dealt with. Nor is this a substitute for legal advice. Lenders and funds would be well advised to seek the advice of their legal counsel at the outset of any transaction to ensure these matters are properly addressed on a deal-by-deal basis.

The fund structure

<u>Framework of the fund and its investment structure</u>

Of course, where the fund (and, if applicable, its general partner) is domiciled will determine: (i) the legislative framework of the relevant jurisdiction that underpins the fund; and (ii) which local fund finance counsel (if any) will need to be involved in the transaction. This will therefore be an important issue for the lender (or its lead counsel) to establish.

However, prior to undertaking a detailed legal analysis of the fund and its constitutional documents, it is important for the lender to understand the fund framework and the way in which the investors' capital commitments are to be contributed to the fund. The significance of understanding the fund framework is increasingly important, as fund structures become more complex and bespoke. The fund framework will likely influence a lender's analysis on the scope of the obligor net and the security required in order to ensure there is no leakage of value out of the lender's recourse structure. Some relevant considerations will be:

- Does the fund have any feeder fund vehicles that invest into the fund? The value of, and potential recourse to, the ultimate investors' uncalled capital commitments needs to be understood and the lender may wish to consider making any such feeder fund an obligor under the facility, and requesting that the feeder fund grants security over the uncalled capital commitments of the investors in the feeder fund and the right the feeder fund has (or the right the feeder fund's general partner has) to make and enforce capital calls on those investors.
- Does the fund have any parallel funds? Generally, parallel funds invest and divest in the same investments as the main fund, at the same time and on the same terms.
- Does the fund have any alternative investment vehicles (**AIVs**)? It may be advantageous for a fund to establish AIVs to hold certain investments for tax, regulatory or other reasons. In such circumstances, a portion of an investor's capital commitment may be invested in the AIV (thereby reducing the investor's capital commitment in the main fund).
- Does the fund have any co-investment or blocker vehicles?

If the fund has parallel funds, AIVs or co-investment vehicles, the lender may wish to treat them in the same way as suggested for feeder funds above. Alternatively if no parallel funds, AIVs or co-investment vehicles have yet been established, but if the fund has the right to establish them in the future under the fund's constitutional documents, the lender may wish to include a restriction in the subscription line facility agreement prohibiting their establishment unless: (i) the lender provides prior written consent; and/or (ii) those vehicles become obligors and grant capital call and account security upon their establishment. The subscription line facility agreement can also be "future-proofed" to provide that upon formation, such vehicles accede to the facility agreement and provide the required security.

These points will also be relevant from a capacity and due authorisation perspective, as any such feeder funds or alternative investment entities that are introduced into the obligor group will need to be diligenced by the lender in the same way as the main fund. Whilst it may therefore be possible that the obligor group extends to other entities in the fund group, for simplicity, we have discussed various points in this chapter by reference to the fund (and, where relevant, its general partner) only, on the assumption that the fund (and, if applicable, its general partner) is the only obligor and security provider.

Legal personality of the fund entity

In addition to the fund structure, it is important for the lender to understand the legal personality of the fund and any other relevant entities in the fund group and, if relevant, any regulatory regime applicable to them. The type of legal personality will determine the relevant steps and processes that the fund will need to complete to ensure that it has the capacity and authority to enter into the transaction. For example, some relevant questions will be:

- Is the fund structured as a limited partnership, a company, a limited liability company or some other legal entity?
- Is the fund structured as a regulated investment vehicle? Depending on the type of investment vehicle, certain regulatory restrictions on fund borrowing or on the ability of the fund to grant security or guarantees, may apply.
- Does the fund fall within the scope of the EU Alternative Investment Fund Managers Directive? In certain circumstances, Luxembourg collective investment undertakings which do no not qualify as UCITS (hereinafter referred to as a **Luxembourg AIF**) must appoint an alternative investment fund manager (**AIFM**), and a Luxembourg AIF's financial instruments are required to be held in custody with a Luxembourg-based depositary. As mentioned below, this can have implications for a subscription line facility.
- To put legal personality into context – if, for example, the fund is established as a Cayman Islands exempted limited partnership or a Luxembourg limited partnership, it must have a general partner (and it may actually have a series of intermediate general partners). It is important to understand which entity is the ultimate general partner. Neither a Cayman Islands exempted limited partnership nor a Luxembourg limited partnership has separate legal capacity – they both enter into documents through their general partner, which undertakes the conduct of the fund's business and has unlimited liability such that, in the event that the assets of the fund are insufficient, the general partner is liable for all of the debts and obligations of the fund.

<u>Any delegated authority or investment committee</u>

The type of legal personality of the fund will, in its relevant jurisdiction, largely dictate the steps that the fund is required to take to ensure it has capacity to enter into, and has properly approved and authorised its entry into, the transaction. However, the lender will need to be aware of other points that may influence this. Some relevant points include:

- Has the fund established an investment committee which needs to provide consent to the transaction? Some funds establish committees which, in addition to usual board/ management approval, are required to approve certain business activities of the fund. Sometimes this may include incurring indebtedness (particularly incurring indebtedness above or outside certain agreed parameters set out in the fund's constitutional documents).
- Is there an investment or portfolio management agreement or investment advisory agreement in place? If there is, has the ability to issue capital calls on behalf of the fund been delegated to the investment manager, the AIFM or the investment advisor? If so, any relevant approvals should be obtained from the investment manager, the AIFM or the investment advisor to ensure the transaction is duly authorised, and consideration may also need to be given as to whether the investment manager, the AIFM or the investment advisor ought to be party to the facility agreement and/ or grant security over its right, title and interest to issue capital calls to the fund's investors.
- Since a Luxembourg AIF's financial instruments must be held in custody with a Luxembourg-based depositary, consideration ought to be given as to whether any approval of the depositary is required. The depositary agreement may require that the fund notify or obtain approval from the depositary in order for the fund to enter into the finance documents.

Due diligence

As a general point, a significant part of a lender's due diligence analysis will likely be focused on an assessment of the identity and credit quality of each investor in the fund. This will allow the lender to establish which investors will be included in the borrowing base calculation and then set the borrowing base at the appropriate level.[1]

However, to ensure that the financing and the fund's obligations under the relevant finance documents will not conflict with the law of its jurisdiction of formation or, more pertinently, with the constitutional documents of the fund and (if any) its general partner, a detailed documentation review and analysis should be undertaken. We set out below some of the key documentary due diligence points a lender and its counsel should consider when reviewing a limited partnership agreement (**LPA**), investor subscription documents and related side letters.

<u>Deconstructing the LPA</u>

Some key points a lender should consider in the LPA in order to determine if the proposed subscription financing transaction does not conflict with (or, indeed, is not prejudiced by) the terms thereof, are:

- *Is borrowing/indebtedness permitted?*

  The LPA should specifically permit the fund to incur indebtedness (be that borrowing or guaranteeing obligations of an affiliate fund or portfolio company, should the financing structure require) and any limitations on the purpose, amount or term of such indebtedness should be noted. The lender will need to be aware of any such limitations when agreeing the parameters of these in the facility agreement.

- *What are the mechanics for capital call notices?*

  The provisions setting out how capital can be called (including the notice provisions and time frame for payment by investors) and the purpose for which the general partner is permitted to issue capital call notices to the investors need to be understood: specifically, whether the LPA permits capital call notices to be issued in order to repay principal debt, interest accrued thereon and costs related thereto is a relevant consideration, as is whether the LPA makes it clear how the total amount specified in a capital call notice issued in order to fund the repayment of indebtedness would be allocated among the investors.

- *Is the fund permitted to grant security over the investors' uncalled capital commitments, the right to make and enforce capital calls and its assets generally?*

  It should be checked that under the LPA, the fund is permitted to grant security over these assets. If the LPA (or any side letter (see below)) designates any investor as a confidential investor, whose identity cannot be disclosed or in relation to whom capital call rights cannot be assigned, these investors will likely be excluded from the borrowing base.

  In certain circumstances, in particular for tax, regulatory or ERISA reasons, a feeder fund may be prohibited from guaranteeing and directly granting security to a lender to support the main fund's obligations under a subscription facility. In such circumstances, a cascading pledge, where the feeder fund grants security over its investors' uncalled capital commitments to the fund borrower, which, in turn grants security to the lender over its rights under the security granted to it by the feeder fund (in addition to the fund borrower granting security over its rights to receive and call for the uncalled capital commitments of its investors, including the feeder fund), may have to be considered.

The LPA should also be checked to establish whether the LPA permits (or at least does not prohibit and permits by way of the general powers) the limited partners paying capital contributions into a specific bank account over which the lender under the facility agreement takes a security interest.

- *What is the term of the fund?*

  This should be considered in light of the proposed maturity date of the subscription facility. Given that, under the LPA, the fund will be dissolved at the end of its term, the lender should ensure that the maturity date of their subscription facility falls within the term of the fund.

- *In what circumstances may the fund be terminated and dissolved prior to the end of the term?*

  The applicable law of the relevant jurisdiction in which the fund is domiciled will likely set out how a fund can be terminated and the circumstances that result in such termination. For example, in the context of a Cayman Islands exempted limited partnership, Cayman Islands law states that a fund may be voluntarily wound up at the time or on the occurrence of the events specified in the LPA, or otherwise (unless otherwise specified in the LPA) upon the passing of a resolution by all of the general partners of the fund and not less than two-thirds of its limited partners. Similarly, Luxembourg limited partnerships can be liquidated if so resolved by limited partners representing three-quarters of the partnership's interests, unless otherwise provided in the LPA. The LPA may modify the starting position at law (to the extent permitted in the relevant jurisdiction) and will usually also set out other additional early termination events. The LPA will typically provide a contractual "waterfall" for distribution of the fund's assets upon its liquidation, and it should be established whether non-affiliated creditors of the fund are at the top of this waterfall.

- *What is the investment/commitment period and in what circumstances may it be suspended or terminated?*

  The right of the general partner to call capital from investors will likely be restricted upon expiry or suspension or termination of the investment/commitment period. Examples of potential suspension or termination events within a LPA are: expiry of the investment/commitment period; the occurrence of a key person event; upon the affirmative vote of a majority of investors; and removal of the general partner for cause. It should be established whether, notwithstanding such restrictions, capital may still be called from investors after suspension or termination of the investment/commitment period in order to fund repayment of the principal outstanding under the subscription facility and related accrued interest and costs.

- *Has each investor agreed that it will honour capital calls without deduction, set-off, counterclaim or defence?*

  A lender will want to ensure that each investor's payment obligations to fund capital calls are not capable of being reduced or extinguished by any claim that the investor has against the fund and/or the general partner. If this is not addressed in the LPA, such waivers could instead be provided in investor consent letters. In respect of funds formed in jurisdictions (such as the Cayman Islands) which require notice of security over capital call rights to be delivered to investors in order to fix the priority of such security, such notice will prevent set-offs arising after the date of service of the notice (although it will not affect any potential set-offs that might have arisen prior to the date of service of the notice).

- *Are there overcall provisions in the LPA for any defaulting investor or excused investor?*

  These are provisions that mean if an investor has defaulted or is excused from making a capital contribution to fund certain investments, the fund is permitted to call capital from the non-defaulting / non-excused investors up to the amount of such non-defaulting / non-excused investors' unfunded capital commitments. Often, the overcall obligations of other investors are capped under the LPA. For example, they may be limited to the lesser of the relevant investor's unfunded capital commitments and a certain percentage of its total capital contribution. Any such limitation should be noted. It is usual for any defaulting investors to be excluded from the borrowing base.

  The excuse provisions in the LPA should be checked to understand whether the capital commitment of an investor that is excused or opts out from making a capital contribution to fund a certain investment would remain unaffected (and so available) for the purposes of repayment of the principal outstanding under the subscription facility and related accrued interest and costs.
- *Recallable distributions*

  It should be ascertained whether, under the LPA, the general partner has the ability to "recall" distributions that have been made to investors and, if it does, what the limitations and terms of the recall are. The relevant considerations for a lender are likely to be: whether these distributed and recallable amounts increase the amount of the unused capital commitment of the relevant investor; and whether these distributed and recallable amounts will be available for recall to allow the fund to repay principal, accrued interest and other costs in respect of the subscription facility (including in circumstances where the investment/commitment period has been suspended or terminated). If such distributed and recallable amounts are not so available, a lender may consider excluding these amounts from the borrowing base.
- *Transfer provisions – limited partners and general partner*

  The transfer provisions in the LPA should be reviewed to understand in what circumstances an investor may transfer its interest in the fund, grant security over its interest in the fund or withdraw as a limited partner in the fund and, for example, whether prior consent of the general partner is required. As noted above, the identity of the investors in the fund will be an important consideration for a lender in its credit evaluation and in setting the borrowing base level. Changes to the identity of a limited partner may also have know-your-customer and compliance issues for a lender.

  The circumstances in which a general partner may transfer ("transfer" is usually a defined term within a LPA and it is common for this to be widely defined to include, amongst other things, the granting of a security interest over the general partner's interest in the fund) its general partner interest in the fund (and whether this needs a certain percentage of investors to give prior consent) or in which the general partner may be removed or replaced (with or without cause) should also be checked. The identity of the general partner will also likely be important to the lender and any change, unless approved by the lender, is likely to trigger an event of default under the subscription facility.

  Where these events will cause the investment/commitment period to be suspended or terminated, as mentioned above, it should be established whether capital calls may still be made to repay principal, accrued interest and costs of the subscription facility during such suspension or after such termination (as the case may be).

- *Are there any key person events under the LPA?*

  The LPA may name certain key persons who must dedicate a certain amount of their time to the fund during the investment period and/or term of the fund. If any such specified key persons fail to do so, this may constitute a "key person event" under the LPA. The occurrence of a key person event may cause the investment/commitment period to be suspended or terminated. If this is the case, it should be checked whether capital calls may still be made to repay principal, accrued interest and costs of the subscription line facility during such suspension or after such termination (as the case may be).
- *No third party beneficiaries / Third party rights provisions*

  Any 'no third party beneficiaries' or 'third party rights' clauses ought to be checked to ensure that these provisions are consistent with, and do not purport to restrict, the fund and the general partner granting security over the capital call rights. Under the laws of some international fund domiciles (such as the Cayman Islands) it is also possible to confer third party rights on a person who is not party to a contract in order for that person to enforce contractual rights as if it had been party to the contract, i.e. in these domiciles it is possible that a LPA could be drafted in a way that allows a lender to directly enforce LPA capital call rights against investors in the same manner as if the lender had been party to the LPA.

<u>Side letters</u>

Side letters are covered at length in another chapter of this publication, so we do not intend to cover side letters in any great detail but, given their potential impact on a subscription facility, they warrant a mention.

The terms of any side letters should be reviewed to confirm the absence of provisions that adversely affect any of the findings arising from the LPA due diligence review or any factors that would otherwise conflict with the obligations of the fund or that could potentially prejudice the rights of the lender under the subscription facility or its related security.

For example, we have seen a number of instances where side letters have expressly prohibited the fund from granting a security interest over a particular investor's uncalled capital commitment.

Some additional points to be considered when reviewing side letters are:

- Note any most favoured nation provisions. These provisions give an investor (the "subject investor") the right to select that it will get the benefit of provisions that another investor has the benefit of, and that are on better terms than the terms that would otherwise apply to the subject investor. There are sometimes parameters to the exercise by the subject investor of its MFN right. For example, it may need to exercise its MFN right within a certain time period, or the subject investor's MFN right may require it to accept a group of provisions that another investor has the benefit of relating to a certain issue, and prevent the subject investor from "cherry-picking" only certain of those provisions.
- Note any provisions which modify the transfer provisions contained in the LPA.
- Note any confidentiality / confidential investor provisions.
- Note any sovereign immunity provisions. It is not unusual for institutional investors to be connected to the state (for example, public body pension funds and sovereign wealth funds may make up part of the investor base in a fund). These entities may have sovereign immunity protection by nature of their connection with the state, under certain jurisdictions. The relevant investor may wish to reserve these sovereign immunity protections in a side letter, in line with its internal investment policy or other considerations. The impact

of any sovereign immunity on the requirement for the relevant investor to comply with capital calls should be considered.

Security

Another important element that a lender and its local fund finance counsel need to consider when entering into a fund finance transaction relates to the security package. Generally, subscription facilities are secured against the uncalled capital commitments of the investors in the fund including: (i) the right to make capital calls on investors in respect of their uncalled capital commitments, together with rights to enforce payments of them; and (ii) the right to receive the proceeds of such capital calls. It will generally also include security over the bank account into which investors are required to deposit their capital contributions. The type of security to be created over the capital commitments will be a factor of the legal regime in the jurisdiction of formation of the fund and the governing law of the relevant security document.

For example, in the case of a Cayman Islands exempted limited partnership, where the security is governed by the laws of the Cayman Islands, the security over the right to make capital calls and the right to receive proceeds of capital contributions will technically be granted by way of an assignment by way of security by the fund (acting through its general partner) of those rights as they arise under the fund's Cayman Islands law governed LPA and any applicable investor subscription documents. For Luxembourg funds the security package is the same, albeit that its legal characterisation is that of a 'pledge' rather than an assignment by way of security.

Prior security and/or existing indebtedness within the fund structure

It will be important for the lender to establish whether there is any existing security over the capital call rights and the capital call account they intend to take security over. Given the size of some fund structures, it is not uncommon for certain assets within the fund structure to be subject to existing security in favour of third parties. Clearly to the extent that there is any existing security, this will need to be considered to determine if it will prejudice the lender's position. The following ought to be considered:

- Can any security or lien searches be carried out to determine the extent of any existing security? For example, in the case of a Cayman Islands fund, there is no public register of security interests in the Cayman Islands, but the Register of Mortgages and Charges of the fund's general partner (if the general partner is a Cayman Islands company) should be obtained and inspected to see whether it contains any details of any prior security interests that have been granted by the fund over its assets (although this will not be conclusive evidence of the granting of any security, since the entry in the Register of Mortgages and Charges is an internal register only of the Cayman Islands company and making an entry in it does not affect validity or priority of the security). Similarly, in Luxembourg, except with respect to real estate, there is also no publicly available record of pledges or other security interests granted by a Luxembourg entity.
- To the extent that there is any prior security (over any assets), those security documents ought to be reviewed to determine the scope of the security and any applicable negative pledges contained within the security documents (and whether those negative pledges just pertain to the assets secured under that security document or to all the assets of the fund).
- To the extent that the fund has borrowed from any of the fund's investors, the fund's obligation to repay any such investor loans ought to be contractually subordinated to the debt owed to the fund finance lender. In addition, if the fund is a Luxembourg AIF, its financial instruments must be held in custody with a Luxembourg-based depositary.

A release from the depositary may be required in circumstances where the terms of the depositary agreement provide the depositary with a security interest over the bank account into which investors' capital commitments are deposited.

- If there is any existing financing to an investment manager of the fund, the investment manager may have granted security over its right to receive its management fee. Often, the terms of a subscription facility agreement will seek to subordinate payment of any management fee to the manager following the occurrence of an event of default under the subscription facility. This may be incompatible with any such existing financing to the investment manager.
- Have any investors granted security over their limited partnership interests in the fund? If the fund is formed as a Cayman exempted limited partnership, this ought to be established by reviewing the Register of Security Interests of the fund. If so, the implications of such security would need to be considered. There is no equivalent Register of Security Interests for Luxembourg funds so, in those instances, the lender will simply have to rely on the relevant representations and warranties given by the fund and/or its general partner in the finance documents.

<u>Priority/perfection of security</u>

A fund finance lender will want to ensure that if the fund defaults on any of its obligations under the facility agreement or becomes insolvent, the lender's security interests will constitute first ranking and enforceable security interests over the relevant assets of the fund, such that the lender could enforce its security and apply the enforcement proceeds in satisfaction of the obligations that the fund owes to the lender, in priority to the fund's other creditors.

In order to ensure this, the lender should consider at the outset how its collateral is perfected and how it ensures that its rights to the collateral have priority over third parties. The relevant steps that need to be taken will largely depend upon the jurisdiction of formation of the fund (and its general partner), the location of the collateral, and the nature of the collateral (as mentioned above, for a subscription facility the collateral will usually be security over the uncalled capital commitments of investors and security over the bank account into which the capital commitments are deposited). Some issues the lender should consider are:

- Are any security registrations required in the jurisdiction in which the fund or its general partner are formed (either on a public register or on internal registers)?
- If security registrations are needed, when should the registrations be made and are there any time periods within which the registrations need to be made?
- What other perfection or priority steps need to be completed?
- What are the implications and risks to the lender of not making the security registrations and/or taking the other perfection or priority steps?
- How can the lender ensure that its security ranks in priority to other creditors of the fund?
- Does notice of the security over the uncalled capital commitments need to be given to the investors for perfection or priority purposes? If notice does need to be given, consider:
  - What form does the notice need to take?
  - When does the notice need to be given?
  - How is notice to be delivered (for example, is there any procedure for delivery that must be followed under the fund's constitutional documents)?
  - Are any acknowledgments required from the investors?
  - What evidence of delivery of the notices should be obtained from the fund?

Enforcement of security

Another crucial point for fund finance lenders is to know how the security interests over the uncalled capital commitments of investors (and the fund's accounts) will be enforced upon the occurrence of an event of default under the facility agreement, and in particular, on the fund's and/or general partner's insolvency. Key points to consider will be:

- Will any power of attorney issued in favour of a lender/security agent to issue capital calls survive the fund's/general partner's insolvency?
- Can the lender/security agent exercise any remedies by stepping into the shoes of the general partner and call capital from all investors?
- Should the capital calls made on enforcement be carried out on a *pro rata* basis, pursuant to the provisions of the fund's constitutional documents and the relevant subscription documents, taking into account any existing investor excuse rights under the LPA?

Document execution

Proper execution of the relevant finance documents is also a key component to ensure that the finance documents are enforceable against the fund and/or its general partner. Generally, the lender's lead counsel will be responsible for ensuring that the finance documents are enforceable as a matter of the laws which govern them (unless, in the case of any security documents, these are governed by the law of the jurisdiction of formation of the fund, in which case the lender's local fund finance counsel will undertake this task with respect to those security documents). Local fund finance counsel's input will be needed to ensure that the finance documents are compatible with the laws of the jurisdiction of formation of the fund. The lender's local fund finance counsel will also check that the documents have been executed in accordance with the laws of the jurisdiction in which the fund is formed, the constitutional documents of the fund and the relevant corporate authorisations. The following ought to be considered:

- Certain jurisdictions may have jurisdictional specific requirements for execution. Is there any particular form that the execution blocks need to take? Are there any witnessing and/or notarisation requirements?
- Who is signing on behalf of the fund and/or general partner?
- Have the responsible officers that are signing on behalf of the fund and/or general partner been authorised in corporate authorities of the general partner?
- Have such corporate authorisations been validly passed?
- If the investment manager, the AIFM or the investment advisor is signing on behalf of the fund and/or general partner, is such delegation is valid?
- Is any stamp duty or other tax or fee payable under the laws of the jurisdiction in which the fund is formed?

Conclusion

The above outlines some of the structural, legal and practical considerations that lenders and their counsel ought to consider when advising on a subscription facility. As we have mentioned, this is by no means an exhaustive list and there will be many deal-specific issues that arise which will need to be considered on a case-by-case basis. However, what the content in this chapter does is illustrate the myriad of issues that lenders (and their local fund finance counsel) need to think about when structuring and documenting a subscription facility in order to ensure that the lender's position is protected.

Endnote

1. The "borrowing base" broadly caps the amount that may be outstanding under the subscription line facility at any time (together with hedging exposure and non-cash backed letters of credit) to the lesser of: (a) the available commitments under the facility; and (b) the aggregate of the uncalled capital commitments of each eligible investor as multiplied by a specified advance rate which is attributed to that investor, based on its credit quality. Only "eligible" investors to which the lender attributes a certain credit score will be included in the borrowing base calculations, with other investors in the fund being "excluded" investors, whose capital commitments do not form part of the borrowing base, or only being included (and then at a lower advance rate) if they meet certain additional information and due diligence requirements.

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Assessing lender risk in fund finance markets

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A zero-risk product?

Despite being a relatively long-standing lending product, until very recently there had been no public payment defaults by funds in the fund finance space, and consequently, no test cases to discuss or examine. As a result, the market has legitimately considered this to be a safe product for lenders, and encouraged more market participants to dip their toe, or even to jump feet first, into the water.

The complexity and cross-jurisdictional dimensions of many fund structures, coupled with the size of the financial transactions and their relatively slim margins, mean that lenders need to be more alert than ever to their possible exposure. This applies equally to new entrants and established players. Risks can be exacerbated by the lender having no direct contractual nexus with fund investors (who might ultimately be responsible for repaying fund borrowings).

As the market continues to be seen as an attractive method of generating returns for investors, managers and lenders alike, the number of funds, and lenders participating in them, have continued to increase. Moreover, recent trends show the secondaries market continues to boom, presenting new challenges and opportunities to lenders in that space. We examine below some of the key risks that lenders should be aware of, and discuss strategies to manage and mitigate these risks.

Our expertise is in advising lenders in relation to funds established in our key jurisdictions, principally the Cayman Islands, Guernsey and Jersey, although we also see activity in the British Virgin Islands and Bermuda. The market in each of these jurisdictions is broad and we see all types of alternative asset classes. The areas of risk that we focus on herein relate to:

- complex fund structures, primarily involving fund partnerships; and
- market risk.

In discussing these risks, we highlight the importance of engaging lender counsel at an early stage, both to conduct full diligence on the structure and to manage the documentation risk. We also explore and consider briefly how developments in fintech might be able to reduce or mitigate these risks or eliminate them altogether. Institutional lenders are investing heavily in fintech in other areas of their business, and there are some obvious efficiencies that could be achieved in this space.

Complex fund structures

Typical structures in our jurisdictions

In Jersey and Guernsey, funds are commonly established as either corporate vehicles/ corporate group structures (using companies limited by shares, PCCs or ICCs) or, more frequently, limited partnerships with a corporate general partner, often with an interposed GPLP between corporate GP and the Fund LP (referred to as the "private equity model", "layering", or "stacking"). To this basic framework is added any number of entities from a variety of jurisdictions: (i) fund asset holding structures; (ii) carried interest and fee-sharing structures; (iii) feeder funds; and (iv) co-investment and other managed entity arrangements, each of which may guarantee and cross-collateralise lending.

In the Cayman Islands, the exempted limited partnership is the most common form of entity used to establish closed-ended funds, although funds may also be formed as exempted limited companies or limited liability companies.

In the British Virgin Islands, closed-ended funds are most commonly structured as limited partnerships. Less common, but nevertheless possible, funds may be structured as British Virgin Islands business companies.

Feeder vehicles

Investors, for example, US investors will often invest in a feeder vehicle for ERISA purposes which, in turn, invests in a master fund.

Whilst, in many cases, the feeder fund will have a direct relationship with the lender and be an obligor under the facility agreement, there are a significant number of structures where the lender has no direct contractual relationship with the feeder fund and, in such cases, a common option is to take cascading security.

In these circumstances, the feeder fund may present a greater degree of risk to a lender, as the lender will be a further step removed from the ultimate investors and source of funds, and will need to rely on a chain of drawdowns (both at the master fund level and subsequently at the feeder fund level) in order for capital commitments to be paid down into the master fund borrower. To mitigate this risk, lenders will typically seek to join the feeder vehicle as a party to the finance documents, and take security over the uncalled commitments in the feeder vehicle in addition to that of the main fund, although this is not always permitted under the constitutional documents.

Where this type of security is not possible, either due to restrictions in the security regimes in certain jurisdictions or, if the constitutional documents of the feeder vehicle contain limitations as to borrowing or guaranteeing preventing the feeder from providing direct security, then the lender may be able to take cascading security as an alternative. Cascading security is where the feeder vehicle grants security over its uncalled commitments to the main fund and, in turn, the main fund grants security over its rights in the feeder vehicle security agreement to the lender (the terms of which would include an appropriate power of attorney and step-in rights).

Legal perspective

Capacity and authority

Complex cross-jurisdictional fund structures can present a plethora of capacity issues that need to be fully understood in each jurisdiction. This is most evident where there are layered or stacked general partner or manager arrangements across jurisdictions and it is crucial that the correct capacities are tracked through the relevant transaction document(s) and all ancillaries. In the fund documents, the power to issue drawdown notices to limited partners is almost invariably vested in the manager or general partner on behalf of the fund vehicle, and it should also be considered whether either entity holds any power or right in its own capacity.

Where the general partner fully delegates any of its powers relating to the calling of capital or the enforcement of the same to a manager, the security should fully reflect that chain of authority and capture both the rights of the general partner in the partnership agreement and also any such rights delegated to the manager pursuant to any management agreement. Failure to do so may cause step-in rights to be ineffective.

Similarly, it is surprising how often we come across bank account mandates which do not align with the structure as initially presented to the lending bank, or which do not reflect the correct chain of authority or rights in respect of the monies in the account. In these instances, either the mandate or security agreement should be amended to ensure that the named account holder is the grantor of the account security, and that both reflect the chain of authority for each of the grantor's capacities.

Cross-jurisdictional funds

Where a combination of jurisdictions are involved in a fund structure, there is an added level of complexity in determining the appropriate governing law for the security package, as the contractual arrangements may well be governed by a mixture of regimes.

We are often asked to advise on the most appropriate governing law for this security, particularly where the finance documents are governed by, for example, English law or New York law, and the general partner or the manager is a Jersey or a Cayman Islands entity.

In these circumstances, from a Jersey and Guernsey law perspective, we are likely to advise that specific local law security is taken over contractual arrangements where they are governed by such laws. Usually, such structures also have a general partner or manager in Jersey or Guernsey. An added complexity arises where there is a general partner resident in a different jurisdiction to the governing law of the limited partnership agreement. In such case, generally, we would expect the security of the call rights to follow the governing law of the limited partnership agreement, but careful analysis is required. In contrast, in the Cayman Islands it is not particularly common as a matter of market practice to take Cayman Islands security simply because the fund documents are governed by the law of the Cayman Islands or if the general partner or manager is formed within the jurisdiction.

Similar issues may need to be considered in light of the *situs* of the collateral involved. For example, some security regimes (such as Jersey) provide that security must be taken in the jurisdiction where the asset has its *situs*. Therefore, in the Jersey example, where a Jersey bank account is to be secured, a Jersey security interest will need to be obtained over that account, irrespective of the existence of any foreign law debenture.

Again, in contrast, the Cayman Islands do not generally have any mandatory provisions of law that would require Cayman Islands security be taken over assets with their *situs* within the jurisdiction, and courts will generally respect and give effect to valid foreign law security. However, it is worth noting that, notwithstanding the governing law of the security taken, there are a number of standard provisions which should invariably be included within Cayman Islands security documents that are helpful to lenders and are, in our experience, usually absent from foreign law security documents. It is also of integral importance to ensure that, no matter what the governing law of the security itself may be, any security taken properly reflects the perfection requirements applicable to the Cayman *situs* property.

Overall, we would also note that there is a relatively clear difference in practice between markets; the US market would tend to use US law security over capital call rights where local law permits, whereas the European market, and in particular in the UK, will largely see taking local law security as the preferred approach even where English law security is considered sufficient under local law. The former US style approach is not possible in respect of security over Guernsey or Jersey law-governed capital call rights unless the security agreement complies with all local law requirements and the relevant provisions are governed by local law. It is usually much more efficient to start with a local law document.

Contractual matrix

As noted above, a careful review of the full contractual matrix is vital in ascertaining the extent of the parties' capacities, rights and powers. In time-limited situations or repeat transactions, there may be pressure from parties to undertake a limited review of documents in an attempt to shorten the transaction time and lower the legal spend. This is likely to be a false economy, as the review may identify gaps and issues that, left unchecked, could have expensive consequences. Technology can be used to aid contractual review and reduce document review times; however, it should be used in conjunction with a traditional review to ensure there are no gaps.

For example, investors will regularly seek to effect changes to the terms of the partnership/constitutive documents to meet their requirements, whether by way of direct amendment to the documents themselves, or by way of side letter. If a complete and timely review is not conducted, relevant contractual provisions may be missed or discovered too late in the process. Indeed, what may seem a minor amendment from the perspective of an investor or a fund (such as restrictions on the power of attorney or additional procedural hurdles for the delivery of drawdown notices) could, for a lender, result in costly consequences; for example by defeating an integral aspect of the security package or rendering it difficult or impractical to enforce the underlying commitments.

Any introduction of conditionality to an investor's obligation to fund a drawdown may put the ability to draw the capital at risk. If lenders require the full pack of fund documents at an earlier stage, before they are executed and allow due time for these to be reviewed, this situation can largely be avoided. Further, if engaged early enough during the period when the fund is negotiating its constitutive documents and/or side letters with cornerstone investors, lender counsel can often add value by suggesting minor clarifications and amendments to the drafting, which could avoid the need for future complex drafting in the facility, or worse lending terms for the fund. There has been a notable shift in the market as both borrowers and lenders appreciate the value in this type of due diligence, as well as the potential exposure where it is not undertaken.

As technology develops and contract mapping, legal automation and smart contracts become more widely adopted in legal and banking practice, risks related to capacity may be almost entirely removed, as contracts can be programmed to be automatically drafted to track each party's various capacities based on the constitutional documents and wider contractual arrangements. Until then, this process will remain manual, and lenders and borrowers should continue to be mindful of its importance.

In parallel fund arrangements, there are often intra-fund limits in the parallel investment agreements or co-investment agreements, making guarantees subject to either a specific limit (being the lower of a percentage of the fund commitment or the aggregate of undrawn commitments) and/or requiring they be given in accordance with the partnership proportion (often linked to the capital commitments in each fund). This effectively caps the ability of each parallel fund to guarantee the liabilities of the other requiring amendments to be in the facility.

In practice it can be hard, or even impossible, for a lender to adequately monitor whether these caps have been breached, particularly as committed levels in parallel funds may shift as a result of defaulting or excused investors, or due to secondary movements where the transferee prefers to be an investor in the other parallel fund. This highlights the importance of robust information covenants within facility agreements and/or third party security documents, as well as the importance of relationships with fund administrators who will be in possession of key information, in the event that step-in rights are exercised following a default.

Again, if conditions and data contained in loan agreements are captured and monitored from the moment the facility is in place on an ongoing basis using technology (e.g. using blockchain technology) this could mitigate this risk. Presently, as we understand it, post-completion loan documents are sent to lenders in a pdf 'bible' of transaction documents from which only a limited section of information is pulled and input manually into monitoring platforms, immediately limiting the monitoring that can be done. If lenders had "live" access on a blockchain platform to: (i) account information for all accounts (even those not held with them) and if automated payments were set up on certain trigger events (e.g. payments in and out); and (ii) relevant client information (e.g. in relation to the fund assets and investors), constant automated monitoring of caps and covenants would become possible.

Equally, it is important to confirm the presence of other, more subtle, restrictions that may have similar consequences for a lender. For example, intra-fund cost-sharing limitations (where payments in respect of guarantees or indemnities given to lenders are classed as partnership expenses within the ambit of such provisions).

Waiver of commitments

Though clearly a notably rare event, and indeed, one which many lenders would perhaps see as a diligence matter, recent cases have demonstrated that it is perhaps worth considering how to prevent or protect against the unilateral waiver or release of investor commitments by a fund, notwithstanding that it may be a breach of the finance documents to do so.

Some jurisdictions have enacted specific statutory provisions to mitigate the risk of waiver in certain circumstances by enabling lenders to enforce the original fund obligations directly against the investors. While in the Cayman Islands this statutory protection has been introduced with respect to limited liability companies, it is not something that applies to exempted companies or exempted limited partnerships, which represent the majority of Cayman Islands funds. Similarly, under Jersey or Guernsey law, in the absence of express statutory provisions regulating lending to fund vehicles, lenders would only have access to more practical solutions (such as notifying the investors about the granting of security to the lenders) and traditional remedies.

Market practice has developed to mitigate such risks through practical means by ensuring that borrowers give their investors notice of the security being granted as well as relevant covenants in the facility agreement, including the usual covenant prohibitions on the GP as manager from cancelling or waiving investor commitments. Jersey practice remains pragmatic and does not usually require a signed acknowledgement of the notice to be provided by each investor (although this would be preferred), but lenders are advised to request and obtain evidence of notice being given to investors. Notice can be given: (a) in the traditional manner by hard copy; (b) by uploading the notice in investor portals; or (c) by emailing the investor. If notice is given using method (b) we advise lenders to request evidence that each investor has accessed and reviewed the notice if uploaded to an investor portal. This may not always be practical.

These steps are not required under statute but are practical steps to evidence actual notice of the security has been given to investors, and may go some way to mitigate certain risks or enforcement.

Remedies: The principal remedy for balance-sheet-solvent structures is to call an event of default, accelerate the debt and enforce the transaction security. However, for insolvent structures or where the default prompts insolvency, the remedies include:

(i) redress under the relevant statutory framework relevant to fraud and solvency generally and, in respect of corporate entities, transactions at an undervalue and fraudulent trading;

(ii) equitable remedies including claims against the management and dishonest assistance;

(iii) tortious remedies including inducing a breach of contract and lawful or unlawful means of conspiracy; and

(iv) customary law remedies in relation to fraud and, particularly, defrauding creditors.

These are explored in greater detail in respect of funds domiciled in the Cayman Islands in the article by Alistair Russell, Richard Munden and Ardil Salem entitled: "*Fund Finance And Releases Of Investor Commitments: How can lenders protect themselves?*"[1]

In Jersey, the relevant factual matrix will dictate the most appropriate course of action for the lender and clarify why the manager agreed to the waiver in the first place, but the starting point will usually be to consider what consideration (monetary or otherwise) the manager received in return for granting the waiver.

Ideally speaking, in our view, fund documents should be drafted so as to provide lenders with a direct contractual right against investors preventing such a waiver, or release without lender consent. While this may not be practicable in many cases, efforts to move the market in this direction for certain types of fund would no doubt be welcomed by lenders. Notably, this is a right they are afforded statutorily in certain jurisdictions (for example, in the State of Delaware).

Where such a right is not granted (for instance, because the fund documents have already been executed), we would recommend that lenders ensure that the usual contractual restrictions on the fund's ability to waive or release the commitments are clearly communicated to the investors. This may help a lender seek a variety of remedies in the event of an unauthorised waiver, given that many such remedies will involve demonstrating such level of dishonesty or knowledge on the part of such investors.

Market risk

As lawyers, we generally leave technical market analysis to those better qualified; however, in the course of our work, certain trends do become apparent which are of note in the context of risk. We look at three of those trends below, being:

- competition in the market;
- concentration risk;
- rogue sponsors and mis-selling to investors; and
- liquidity in the market.

Competition in the market

Recent years have seen an appreciable increase in the number of lenders and borrowers in the fund finance space; a fact echoed by many advisors and market participants.

Unsurprisingly, the presence of new market players has made the market more competitive. One result has been to drive down margins, serving to increase further the need to avoid unnecessary structural or other concerns, which is no doubt popular with borrowers; margins predicated on lenders rarely or never losing money require deals to be structured accordingly. Notwithstanding that fact, another result has been an increased pressure on lenders to accept greater levels of risk; for example, in the form of a more lenient covenant package, including hitherto "unfashionable" classes of investor within the borrowing base, or lending to funds whose managers have a shorter track record.

While the number of new participants, the reduction in costs and the innovation in terms are doubtless to be welcomed from the perspective of the market as a whole, lenders and borrowers alike should remain vigilant in ensuring that they and their counterparties are sufficiently familiar with the product and its pitfalls, and are being properly advised.

Concentration risk

Central to any lender's risk-management strategy will be how it approaches concentration risk and, more specifically, its exposure to specific investors, fund managers and fund sectors.

In relation to investors, lenders will often encounter the same entities across multiple funds (in particular, large institutional investors such as pension funds and sovereign wealth funds). Over-exposure to such an investor will increase the risk that its default on its commitments will translate into a lender ultimately being out of pocket.

European Banking Authority Guidelines,[2] which took effect on 1 January 2019 address, among other things, the aggregation of bank exposures, and in particular, exposures to connected clients.[3] The guidelines aim to help lenders identify all relevant connections among their clients, and specifically, two types of interconnection: (i) control relationships; and (ii) economic dependencies that lead to two or more customers being regarded as a single risk (subject to certain exceptions).

A control relationship is deemed or likely to exist where, for example, an entity appears in the consolidated financial statements of a structure or holds, with respect to another entity, a majority of the voting rights, the right to appoint or remove management, or the right to otherwise exercise a dominant influence.[4]

An economic dependency is deemed to exist where the financial difficulties or failure of an entity would be likely to lead to funding or repayment difficulties for another. For example: (i) where the source of funds to repay the loans of two or more borrowers is the same and there is no independent source of income to service the loans (for example, parallel funds with the same borrowing base); or (ii) where there are common investors or managers that do not meet the criteria of the control test (for example, there are common shareholders but no controlling shareholder, or they are managed on a unified basis).

Notwithstanding the foregoing, in the context of many fund structures, a lender may often be able to demonstrate an exception to the need for aggregation. In particular, this may be the case where the lender can show that:

(i) there is no economic interdependence;[5]

(ii) the entity is bankruptcy remote – this will normally be the case for funds which are limited partnerships, as there should be no commingling of partnership and general partner assets (even where the general partner is general partner of multiple partnerships), as the general will have access to its own assets on a bankruptcy only and not partnership assets (save in relation to partner liabilities owed to the general partner such as for fees); and/or

(iii) there is structural de-linkage of the obligations of an entity from its parent.

Nevertheless, lenders are advised to exercise caution in relying on an exception because, in practice, in the case of affiliated funds or funds under common management, they are more likely to be "connected" and will be affected by the success and reputation of the other funds and their managers, irrespective of ring-fencing of assets.

To that end, it is essential that lenders assess a fund functionary's credentials whether they are managers, sponsors or administrators. For experienced lenders active in the fund finance market, existing relationships with fund functionaries will enable lenders to have visibility on a given manager's track record and performance. Funds promoted by high-quality and established sponsors with a track record would be expected to be lower-risk. However, for more recent entrants to the market, relevant information will be less readily available. It is therefore important for lenders to understand the expertise and experience of the functionaries' key people both in terms of portfolio management, investment criteria, business plan and financial model.

At the investor level, the most active lenders will generally hold significant information in relation to the investors and their participation in calls made by funds with which such lenders have an existing relationship. The more informed the lender when assessing whether to include or exclude an investor from a fund's borrowing base, the more reliable the borrowing base should arguably be. Many institutional investors are themselves subject to various reporting standards, including in relation to the provision of financial and other key investor and stakeholder information. Further, there is a wealth of publicly available information in relation to many pension funds and sovereign wealth funds including their financial accounts, their executive managers, their organisational structure and details as to their investment portfolio. In addition, lenders that act as account bank to fund entities can also leverage their overview of account activity.

There is a range of sophistication in the financial modelling carried out by lenders and the monitoring thereof. Newer entrants to the fund finance sector may not have the same resources available to them, and this can lead to different conclusions being drawn by such lenders in relation to the inclusion of investors in borrowing bases, which can be apparent on syndicated or club transactions.

Conducting a thorough review of all the investor side letters and expanding the covenant package in the facility agreement to include: (i) covenants relating to concentration risk; and/or (ii) concentration limits in the borrowing base provisions relating to the calculation of the borrowing base, will assist the lender in managing concentration exposures.

With the increased use of automation, artificial intelligence and data science in the financial services industry and more widely, lenders are becoming increasingly aware of the value of the data that they hold in the course of, and for the purposes of, carrying out their business and understanding the dynamic between behavioural science and risk. By deploying new technology such as blockchain or other distributed ledger technology, innovation, and data analytics, lenders can use the data that they hold to build a clearer picture of market activity and, in turn, to determine and anticipate risks. The most obvious form of technology would be to use artificial intelligence to conduct due diligence on funds, sponsors, investors and keep up to date with sector trends and risks, valuations of fund assets, portfolio companies and net asset values. This in turn could feed into a blockchain storing and managing data about the borrowing structure and covenant package so that active monitoring can be undertaken, ensuring that more informed decisions can be taken more quickly, e.g. in relation to certain breaches and under defaults or automation of payments.

As outlined above, a lender's success will be intrinsically linked to its identifying to which parties to extend financing. Lessons can be learnt from the tech giants in modelling and manipulating data to establish trends and map the behaviour of key market players, noting the confines of ensuring that this is done for proper purposes in accordance with the prevailing data protection regimes.

In the future, market behaviour itself may well change, with the increased use of artificial intelligences and algorithms in investment management and strategy, and quantitative investing – which may well lead to more passive investment management, less influenced by human decision-making. When considered from a lender's perspective, trying to manage risks associated with investment management, the more clinical and analytical the investment decision-making, the easier it will be to model, predict and manage.

In a syndicated loan context, the more efficiently that data is shared among the syndicate, the quicker the syndicate will be able to react to situations such as requests to increase facilities and amend terms. The developments in the syndicated market space, and LMA initiatives to explore technology and automation, should mean that in the future, a common syntax is applied to syndicated lending, and a common standard can be applied which will improve the customer experience.

<u>Rogue sponsor/mis-selling to investors</u>

We outline above the importance of lenders conducting due diligence on the various players involved in their transactions and the fund sectors. An example of market awareness that lenders should be aware of stems from recent investigations by international regulators into financial mis-selling by sponsors of actively managed funds.[6]

It is therefore important for lenders to remain aware of changes in the regulatory landscape in which the funds they finance operate. Exposure to funds that are under-regulated, unregulated or that have censured sponsors may cause reputational risks to the lender and, if misrepresentations have been made by sponsors to investors, may increase investor flight risk, putting facilities at risk of not being repaid.

<u>Liquidity risk</u>

Liquidity is a perennial risk attached to lending and lenders will be familiar with the challenges this presents post-financial crisis, in the wake of the ***Basel III Framework*** and the introduction of new liquidity ratios. The revised regulatory landscape post-financial crisis has required banking institutions to increase their capital and liquidity buffers, which should help alleviate certain liquidity pressures and equip lenders to tolerate greater stress in financial markets. However, notwithstanding these positive developments, the ***October 2018 IMF World Economic Outlook Report***[7] warns that banks:

"remain exposed to highly indebted companies… and sovereigns; to their holdings of opaque and illiquid assets; or to their use of foreign currency funding".

It seems likely that an exposure might arise in the event of a significant correction or downturn in the private equity industry, causing illiquidity in the investor market or removing motivation for investors to fund their respective commitments. This could be exacerbated by the practice of certain investors to overcommit, as investors may have limited control over how and when investments are made or called for by the fund.

In essence, lenders may take a number of steps to manage this exposure including: (i) stress-testing the loan book; (ii) monitoring for concentrations of investors, functionaries and sectors as outlined above; (iii) considering the profile of investors with higher potential for exposure (including in terms of jurisdiction of domicile, ticket size, track record of making payments following drawdown requests, likelihood of themselves being a levered fund) and other reputational matters, noting that if a borrower is at the later stages of the fund cycle or the fund is fully committed, the lender may be less sensitive to the inclusion of such investors and borrowing base requirements may be relaxed accordingly; and (iv) considering whether there are any mismatches between the level and frequency of fund distributions made to investors and the level and frequency of capital calls made by the fund.

In terms of NAV and hybrid facilities, there is an additional liquidity risk to lenders, where assets provided as collateral for the facilities are overvalued or lose value and become insufficient to meet the borrower's obligations under the facility. Inability of lenders to challenge valuations could also play a role here.

Facility information covenants, requiring borrowers to obtain robust and frequent asset valuations or requiring notification of any significant change in NAV, would assist the lender to monitor downstream valuations, and in addition to the typical loan-to-value covenants and other financial covenants within facility documents.

As noted above, many of these risks may be managed and mitigated by real-time access to information (e.g. by way of blockchain or otherwise), as it adds colour to the facts, which are borne out through the financials, and facilitates better-quality decision-making by the lender. In the near future, technology could provide solutions to data management and analysis, making it easier and quicker to access, record and analyse data collated by the lender. In addition, artificial intelligence programmes may be implemented to assist with collating due diligence, monitoring and harnessing publicly available information.

However, there are steps that lenders can introduce now to maximise the information they receive, such as placing the burden on fund functionaries to store, maintain and share management information, financial information and investor lists on systems that can be readily accessed such as private web portals or a private blockchain, for the lender to freely access. This would increase transparency, as such information could be made available in real time to lenders and assist in easing the burden of monitoring the performance of the loan. The recent LMA conference on syndicated lending shows the level of interest and planned development in this space, show-casing initiatives such as developments in legal tech e.g. automating document production (which is being used in the legal market) and blockchain initiates of LMA and Euroclear.

* * *

Endnotes

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3. As defined in Article 4(39) of Regulation ((EU) No 575/2013).
4. Although these criteria are non-exhaustive, and other aspects may be relevant.
5. For completeness, there should also not be a material positive correlation between the credit quality of the parent and subsidiary entities in a control relationship, however, this should not apply to fund structures either.
6. A recent European Parliament paper on the asset management industry raises concerns over the industry practice for closet-index funds to charge active asset management fees when fund assets are linked to the performance of index funds (referred to as "index-hugging") and not actively managed in practice. The paper queries whether this practice amounts to sponsor misrepresentation on the basis that the investors are not receiving the service they have paid for and notes that, whilst the German regulator BaFin has not detected any cases of this, it has called for more transparency, noting that this practice could be a problem of providing "false or misleading information" (BaFin, news). As regulatory investigations continue, lenders need to be aware of the potential for litigation and censure of certain funds and practices in different jurisdictions.
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Fund finance meets securitisation

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Introduction

The substantial and rapid growth of the European fund finance market over recent years has been well documented in the pages of this book and elsewhere. We have seen a diversification of both financing techniques and willing financiers, and a consequent proliferation of deals, looking not only to undrawn limited partner commitment, but also to manager fee income and dividends from underlying assets. We have also seen asset-based deals based on portfolios of secondary or fund of fund managers, co-investment lines, GP-led restructurings, dividend recaps and preferred equity transactions.

The world of fund finance today is a vibrant and diverse market. Another aspect of this evolution of fund financing techniques is the growth in the number of deals now being done by way of securitisation. This chapter aims to provide a summary of what this involves, and the typical features that we often see when documenting one of these transactions.

On 1 January 2019, the EU Securitisation Regulation (the "**Securitisation Regulation**") came into effect, having completely overhauled existing sectoral legislation and regulation applicable to banks (the Capital Requirements Regime), insurers (Solvency II regime) and fund managers (the Alternative Investment Fund Managers Directive regime) and recast those provisions in a new harmonised securitisation regime applicable to all institutional investors.

The Securitisation Regulation is therefore relatively new, it is wide-ranging in scope, and there is a fair degree of complexity in its terms that the market is required to interpret. It is also worth noting that there are serious consequences for failure to comply with the Securitisation Regulation for an in-scope entity, so there are pitfalls for the unwary (including large fines of up to 10% of annual net turnover on a consolidated basis for non-compliance).

As it is relatively new, there are also aspects of it that are untested and where the requirements have not been fleshed out in detail. Prior to the Securitisation Regulation, individual compliance obligations were largely on investors rather than the originator, sponsors, original lenders and issuers. This meant that treating a transaction as a securitisation for the benefit of an investor did not impose regulatory obligations on sell-side entities. This is no longer the case under the Securitisation Regulation, as determining that a transaction is a securitisation will carry much more onerous obligations, imposed directly on the sell side.

In a fund finance context, this means there is a different community of investor and a different type of expertise required of legal advisors as compared to the more traditional forms of fund finance deal. It is important to understand the nature of a fund, but it is also necessary to be familiar with this kind of structured finance technique and the regulatory backdrop that underpins it.

Why securitise?

So, if a securitisation is more specialised and relatively complex the question arises, why would a fund consider taking this financing route as opposed to the more traditional NAV (net asset value or asset-backed) financing facility? As fund managers seek increased returns and more innovative portfolio management techniques to release value, a securitisation is a useful leveraged financing tool to provide a flexible, long-term liquidity solution at an attractive price, utilising a type of securitisation – usually referred to as a private securitisation – that is not as complex as a full-blown public securitisation that would likely not be available or attractive to these funds.

For investors, this offers exposure to a broader spread of asset classes with an attractive risk return profile, without the need to set up the origination or servicing infrastructure, and a preferential capital regime for certain securitisation positions held by credit institutions and investment firms. Notwithstanding the additional operational and structural complexity which it brings for the lender, a securitisations structure will generally be attractive from a commercial perspective as, in most cases, it will lead to a reduction in the amount of regulatory capital the lender is required to hold in respect of its exposure to the fund.

Typically, most funds will be unrated and, accordingly, an exposure to a fund by a lending institution will attract a 100% risk weight. Conversely, if the lending institution is able to treat the loan as an exposure to a senior tranche of securitisation (rather than as an exposure to the fund itself), the risk weight associated with the senior tranche would likely be significantly lower, subject to a floor of 15%. By reducing the amount of capital which the lender is required to hold against the exposure, the lender's cost of providing the funding will be significantly reduced, thereby allowing it to offer more competitive pricing and improve its return on the transaction.

What is a securitisation?

In Europe, the relevant definition of a securitisation (under the Securitisation Regulation) is based around tranched credit exposures. It is a transaction or scheme where "the credit risk associated with an exposure or a pool of exposures is tranched, having all of the following characteristics:

(a) payments in the transaction or scheme are dependent upon the performance of the exposure or the pool of exposures;

(b) the subordination of tranches determines the distribution of losses during the ongoing life of the transaction or scheme; and

(c) the transaction or scheme does not create "specialised lending exposures"."

It should be noted the definition of a securitisation in the United States is different and so, for regulatory purposes, it is key to understand which jurisdiction prevails. Depending on the parties involved, there could be multiple jurisdictions that are relevant to any given transaction. This chapter will focus exclusively on the rules that apply to European securitisations under the Securitisation Regulation.

The various elements of that technical definition are not necessarily intuitive and so this requires further explanation as follows:

(i) **A pool of underlying exposures**

The main requirement here is that there is a pool of underlying exposures on which there is credit risk. For these purposes, credit risk means risk of principal losses. So a pool made up of owned real estate, for example, would not meet this requirement because the risk in that scenario is market risk on the value of the real estate. However, a pool of leases over those same properties, or a pool of mortgage loans secured on those properties, would meet the requirement because the risk is credit risk on the lessees or borrowers. This means the underlying assets will usually be financial assets.

(ii) **Tranching**

To meet the regulatory requirements, tranching must be contractual (so structural subordination, subordination in time or subordination arising purely by operation of law will not suffice), it must be done at the transaction level (not investor level), and it must come from an assumption of risk more junior or senior to another tranche. The consequence of this requirement is that many arrangements that may have the appearance of a securitisation, or that would economically produce the effect of tranching, are not caught by the regulatory definition. Obviously, single tranche securitisations that are common in the US are not securitisations for EU regulatory purposes.

(iii) **Distribution of losses**

It has to be possible for junior tranches to suffer losses whilst senior tranches continue to perform. For this reason, a single asset securitisation will not generally be possible as that single asset either defaults, leading to a default on all tranches of debt, or it does not. Tranching may determine the distribution of losses but it will only do so at a single point of default, not on an ongoing basis. A securitisation will feature tranches of debt where the probabilities of default, and hence the allocation of losses during the life of the deal (and not just the loss on a given default), will be different.

(iv) **The specialised lending exception**

Even where a transaction meets the criteria described above, "specialised lending arrangements" will not count as securitisations for EU regulatory purposes. Specialised lending exposures are, broadly speaking, debt exposures related to a physical asset, typically lending to an entity specifically created to acquire and/or operate that physical asset where the debt is repaid primarily by the income from operating that asset and the lenders have a substantial degree of control over the asset and the income it generates. Aircraft finance, for example, would often meet this criteria.

Who are the parties caught by the Securitisation Regulation?

If a transaction meets the definition of a securitisation, certain parties to that transaction will have obligations under the Securitisation Regulation. Those parties are the originator, sponsor, original lender, issuer and any institutional investors. These terms require more explanation, as set out below:

Originator – someone who was directly or indirectly involved in the original creation of the asset or someone who acquired the asset for its own account and then securitised it. An entity will not be considered to be an originator where the entity has been established or operates for the sole purpose of securitising exposures (the so-called "sole purpose" test). The originator should be an entity of real substance that holds actual economic capital on its assets for a minimum period of time in order to comply with the spirit of the risk-retention requirements, which are outlined in more detail below.

Sponsor – broadly, an entity that sets up and manages a securitisation but who does not actually securitise its own assets. Historically, an entity has only been capable of being a "sponsor" if it had one of a limited number of EU regulatory permissions but it is thought, under the Securitisation Regulation, that third country (non-EU) sponsors are permitted which may be particularly relevant post-Brexit. At the time of writing, clarification on this point from the relevant authorities is expected but has not yet been provided.

Original Lender – generally thought to be a narrow definition and often included in the concept of originator in respect of the origination of financial assets.

Issuer – this is the entity that borrows the loan from the investors or issues the securities purchased by the investors.

Institutional Investor – the definition includes credit institutions, investment firms, UCITS (whether self-directed or UCITS management companies), alternative investment fund managers, insurers, reinsurers and pension funds (or institutions for occupational retirement provision).

Main regulatory obligations associated with securitisation

Once it has been determined that a transaction meets the definition of a securitisation and it has been determined which are the parties to the deal who have obligations under the regulatory regime, the next question is: what are those obligations? We explain below three of the most important being risk retention, transparency and due diligence.

<u>Risk retention</u>

One of the key reforms to the regulation of securitisation which was introduced in Europe following the global financial crisis of 2007 was the requirement for an originator, sponsor or original lender of a securitisation to retain a material net economic interest in the transaction – this is known as risk retention. The rules were slightly different under each of Capital Requirements Regime, Alternative Investment Fund Managers Directive and Solvency II but have now been codified under the Securitisation Regulation and so one of the originator, sponsor or original lender must have a direct obligation to retain 5% of risk in the securitisation.

"Sole purpose" originators who exclusively exist to securitise assets are now banned from retaining risk. Since fund structures are often complex (certainly as compared to a typical bank originator of loans), a key part of the legal analysis required is the identification of an eligible risk retainer with sufficient substance. Securitised assets should not be chosen, because they perform significantly worse than comparable assets retained on the balance sheet of the originator over the life of the transaction.

The European Banking Authority has published draft Regulatory Technical Standards ("RTS") specifying the requirements for originators, sponsors and original lenders as they relate to risk retention under the EU securitisation framework. These draft RTS aim to provide clarity on the requirements relating to risk retention, "thus reducing the risk of moral hazard and aligning interests". At the time of writing, whilst this is commonly agreed market practice it has not yet been adopted formally by the EU Commission.

<u>Transparency</u>

There are detailed disclosure requirements that apply regardless of the regulated status of the originator, sponsor or issuer (although such entities do still have to be in scope in terms of the Securitisation Regulation – which, broadly speaking, means they will not have direct obligations if they are established outside the EU, although the diligence obligations may bring them back into scope indirectly if they are selling to EU institutional investors).

Detailed disclosure is required in all cases regardless of whether the transaction is a public or private transaction. The audience for this disclosure in private securitisations is investors, competent authorities and, upon request, potential investors. Private transactions do not have a prescribed mechanism for disclosure, although certain national competent authorities (e.g. the Financial Conduct Authority and Prudential Regulation Authority in the UK) may prescribe the method, frequency and content of information to be reported to them.

The content that must be disclosed is: full documentation essential for the understanding of the transaction (including a deal summary where there is no prospectus); loan level data on a prescribed template; investor reports on a prescribed template; and reports of any significant events/material changes (also on a prescribed template where the deal is public – which is unlikely to apply to one of these transactions).

Due diligence

The Securitisation Regulation sets out detailed requirements for due diligence that must be conducted by institutional investors and which harmonise the specific items to be diligenced for all categories of institutional investor. Generally, due diligence is limited to the underlying assets of the securitisation and the behaviour of the entities involved in respect of the underlying assets. Therefore, before holding a securitisation position, institutional investors are required to verify that credit-granting standards have been satisfied by the originator or original lender, risk retention requirements have been fulfilled, and information about the securitisation transaction has been made available as required by the transparency rules in the Securitisation Regulation.

Institutional investors are permitted to delegate the obligation to carry out regulatory diligence to a third party but this delegation is only effective to transfer the regulatory obligation (and sanctions for failure to comply) where that third party is itself an institutional investor and makes investment decisions on behalf of the principal. These broad investor due diligence requirements mean that non-EU securitisations need to comply if they are to be sold into the EU.

Structures commonly utilised in fund finance transactions

Whilst we have seen a number of different structures (and noting that the Securitisation Regulation is less than a year old at the time of writing, and that has given rise to some changes), the common features of the debt structure we see in funds financings that are to qualify as a securitisation may be summarised as follows:

Private deals – these transactions are private securitisations rather than full public securitisations and so are less complex and cheaper to set up. They are usually unrated, although often capable of being rated at some point, if required.

Eligibility criteria for assets – the portfolio will generally be required to comply with certain eligibility criteria, concentration limits and diversity tests which have been agreed between the originator and investor. These criteria generally relate to: the types of exposures which may be included; the number of exposures; the jurisdictions of the underlying obligors of the assets within the portfolio; the credit grade of the exposures; the maturity profile of the exposures; and the industry to which the underlying obligors belong. This is formulated on a bespoke basis for each transaction depending on the fund and the nature of the assets comprised within the portfolio.

Generally, eligibility criteria will only be tested at the outset of the deal rather than on an ongoing basis. It is still possible for the fund to purchase assets which do not meet the eligibility criteria, provided that is funded by way of equity. Whilst some deals will have a static portfolio of exposures which does not change over the life of the transaction other than to reflect repayment of the exposures, many securitisations will permit additions to the portfolio – particularly to replenish the portfolio as original exposures are repaid or otherwise disposed of by the originator. It is a commercial question as to how additions to the portfolio are treated, with some deals only permitting it on the satisfaction of pre-agreed criteria, and others where investors have no approval or veto rights.

Borrowing base – this is clearly a key commercial component of the transaction and will include the advance rates for the eligible assets, agreement on the valuation procedures (including the identity of the valuer), and the revaluation events.

Form of debt – we have seen investors fund deals by way of revolving loan facility, and deals done by way of variable funding notes issuance. There is often the ability to increase the size of the financing subject to agreed tests, which provides an important element of flexibility for funds. The financing can be repaid and redrawn, providing added flexibility for new acquisitions during the life of the deal, subject to pre-agreed criteria.

Tranching – the junior tranche is funded by way of loan facility or note structure, often by another entity within the fund structure.

Issuer – in a public securitisation, there would usually be an orphan special purpose vehicle issuer, whereas in a private securitisation for fund finance, it is common for the issuer to be part of the originator's group. We see different types of fund utilising this structure, but usually it is a credit fund of some description, as the underlying portfolio of exposures to be securitised are financial assets. In a securitisation, there are usually standard "separateness" and "special purpose" representations, and undertakings given by the issuer to underpin its special purpose vehicle status, so that it is clearly acting on arm's length terms and has undertaken limited activities outside of what is required for this transaction. In a private fund securitisation, these provisions will be necessarily more limited or tailored, given the issuer's status as part of the group. Thought needs to be given to the analysis here, and the relevant provisions may need to permit certain intra-group arrangements, for example in relation to cost-sharing (subject to group claims being subordinated), financial statements and use of premises.

Originator – in a private securitisation for a fund, an analysis exercise will usually need to be conducted involving the fund and the relevant lawyers, to determine which entity within the fund structure is the originator and which entity is undertaking the risk retention.

Limited recourse – the investors agree the financing is limited in recourse to the secured portfolio. There will be a strict 'waterfall' of payments setting out all payment flows from the designated account structure set up for interest and principal collections in relation to the portfolio, with reserve accounts and operating accounts (and a regime that operates both pre- and post- an event of default). In some deals. there will be a cash manager, often a professional entity that is unrelated to the originator. There will also be non-petition provisions where investors agree not to institute or join in insolvency, winding-up or similar provisions in relation to the issuer.

Servicer/Administrator – to be discussed on each transaction, but it is important to have an entity that undertakes regular reporting on the portfolio for the investors, which is an important role underpinning the integrity of the payment waterfall. There will also be controls around the issuer's credit and collection policies to back this up.

Security – security will be taken over the assets in the portfolio and all the bank accounts. As with any financing, it is necessary for investors to do a cost/benefit analysis as to how the security package is structured, but in many deals, there is no local security that is taken in relation to each asset comprised within the portfolio, given the time and expense involved in creating that. Therefore an English law debenture is common. Also, often there is no upfront notification of the security given to the underlying borrowers in the portfolio.

Securitisation analysis on a fund finance

It will be clear from this chapter that because these transactions are creatures of regulation, there is a fair amount of analysis to be undertaken to understand whether the regulatory components of a securitisation are present as defined within the Securitisation Regulation; which parties in the fund structure are carrying out the roles of the various entities described as falling within the Securitisation Regulation; and whether the various requirements of the Securitisation Regulation in terms of risk retention, transparency and due diligence, in particular, are met.

Private securitisations for funds need to be structured in such a way that the regulatory hurdles are met – but in a way that makes legal and commercial sense, given the structure of a fund group and the nature of the portfolio that is to be securitised.

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Room for market growth: Second liens and shared liens in subscription credit facilities

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Introduction

Private equity and other types of private investment funds (each, a "*Fund*") are increasingly taking advantage of subscription credit facilities (each, a "*Facility*" and collectively, the "*Facilities*") secured by the rights of the Fund and/or its general partner to call upon the capital commitments of the Fund's investors ("*Investors*"), and the bank accounts into which those capital contributions are funded (collectively, the "*Collateral*").

Generally, loan availability under Facilities is determined by a borrowing base comprised of the unfunded capital commitments of all, or only certain "Included" Investors, multiplied by a specified advance rate (most commonly, a percentage of the unfunded capital commitments of certain Included Investors or a lower percentage of the unfunded capital commitments of all Investors).

Additionally, Facilities typically contain a negative pledge that prohibits any additional liens on the Collateral. This combination of limited borrowing bases and a negative pledge likely results in overcollateralisation for the lender and inefficiency for the borrower (the Fund usually receives less borrowing base availability than capital it can call from Investors, and the negative lien restricts the ability to borrow against the rest).

While a Fund could seek to utilise a larger Facility to have greater access to liquidity, a larger Facility size alone would not provide a complete solution to the overcollateralisation issue, or make more efficient use of the capital commitments via leverage.

While historically there has been little in terms of permitted second liens in the subscription credit facility market, we think there is potential for significant growth in this area. According to Preqin, Funds' capital-raising has maintained high levels for close to two decades, surpassing the $1 trillion mark in 2018, with total committed capital available to private equity funds (which serves as Collateral for Facilities) totalling $1,905.2 billion at the beginning of 2019, with $1,057.2 billion for North American-based private equity funds (over $100 billion more than one year before and almost double the amount available a mere six years ago), $413.6 billion in Europe and $356.3 billion in Asia.[1]

As fundraising has increased, the financing needs of Funds have increased, and fund finance lenders have taken action to meet this demand. In our experience, most lenders provide an effective advance rate as low as 30–45% across the entire pool of unfunded Investor commitments. That leaves a significant amount of dry powder remaining to be advanced against, and certain inefficiencies for Funds and lenders.

Given: (i) growing interest among lenders in participating in these Facilities and other fund financing products such as net asset value ("*NAV*") and hybrid credit facilities; (ii) increased use of Facilities by Funds to meet their bridge financing, working capital and investment needs; and (iii) consistent increases in the amount of dry powder year-on-year for nearly two decades straight (with an estimated total of $2.4 trillion in dry powder available as of September 2019[2]), there has been increased interest in the market to find ways to more efficiently leverage Funds' Collateral and provide Funds with greater access to credit though second liens and/or shared liens.

The fund finance market continues to find new ways to provide additional credit to Funds, as evidenced by the rise of unitranche, first lien/second lien, NAV, hybrid and other types of credit facilities.[3] The business case for these types of facilities reflects not simply a greater risk tolerance for Lenders (whether coming from experienced and knowledgeable industry veterans or new market entrants looking to establish a platform), but also increased leverage appetite from Funds. The market should find comfort looking to the historically low (near-zero) payment default rates for Facilities generally, and the near absence of Investor payment defaults by institutional investors.

This chapter considers some potential structures involving second liens or shared liens in Facilities, as well as the opportunities that each of these structures presents. We also discuss some potential intercreditor considerations and other concerns arising from such Facilities, such as lien and payment subordination, debt caps, rights and remedies upon enforcement, and limitations on amendments to the underlying Facilities. While some of these issues may not be present in all scenarios, it is beneficial for Funds and lenders to be cognisant of potential concerns.

Potential intercreditor structures in subscription credit facilities

Though the second lien financing market for Facilities is relatively undeveloped, interest is rapidly expanding, and we are aware of multiple different transaction structures that Funds and lenders have considered and documented. While the increased borrowing capacity with any of the structures may be higher than in a single first lien facility, considering many Fund limited partnership agreements contain limits on debt for borrowed money that are tied to capital commitments and/or unfunded capital commitments, we expect that the maximum amount these structures could provide for such Funds is a 100% advance rate on the unfunded capital commitments. We note that some lenders are already comfortable providing up to a 100% advance rate on unfunded capital commitments to Funds under certain circumstances.

One potential intercreditor structure is a Facility with a first priority lien over the Collateral, with an additional Facility with a second lien on the same Collateral. The second lien lender could underwrite any overcollateralisation in the first lien Facility. If the first lien lender provides an advance rate of 90% of the unfunded capital commitments of select "Included Investors", a second lien lender could underwrite and provide an advance against the remaining 10% of the "Included Investors", as well as any Investor not otherwise designated as an "Included Investor" by the first lien lender.

A Fund may have a few Investors whose capital commitments are subject to sovereign immunity issues, or disclosure or other issues, that cause the first lien lender to exclude such Investors from the borrowing base, while the second lien lender may nonetheless be comfortable lending against the capital commitments of such Investors. In cases where the first lien lender provides a flat advance rate against the unfunded capital commitments of all Investors, a second lien lender may also be comfortable lending against the Investor pool and be willing to provide an additional flat advance rate against the same Investor pool (adjusted for any amounts outstanding under the first lien Facility).

Another potential intercreditor structure is a cross-lien Facility, where one lender has a first priority lien on capital commitments of a specific subset or tranche of the Fund's investors and/or assets, while a second lender has a first priority lien on a separate set of capital commitments of the Fund's investors and/or assets. The lenders in such a Facility could each underwrite and provide an advance rate against the unfunded capital commitments of certain investors allocated to a specific tranche, but would also have a second lien on the collateral of lenders under any other tranche.

For example, lenders in tranche one would have a first priority lien on the unfunded capital commitments of certain "Included Investors", and a second priority lien on the unfunded capital commitments of the remaining investors (non-"Included Investors"), and *vice versa* for the lenders in tranche two – much like a split collateral financing to an operating company, with certain lenders taking a first priority security interest in accounts and inventory, while other lenders take a first priority security interest in all other assets, and each set of lenders takes a second priority security interest in the other assets.

Such a structure provides flexibility, in that it benefits from both a borrowing base structure that provides high advance rates against "Included Investors", as well as a flat coverage rate structure that provides some level of advance against all Investors. Combining the separate collateral pools into a single facility could be both functional and efficient, in that there would be a single lender (acting as agent for all the lenders) with a security interest in the right to make capital calls on all Investors (for the benefit of all lenders).

There is also potential to structure this as a unitranche Facility, where the lenders share a lien on all investors' capital commitments. The key benefit of unitranche Facilities for the Fund is efficiency (in terms of speed, execution, and cost) of a single credit agreement, single set of security documents and dealing with a single agent for the lenders, without having to negotiate separate credit agreements with separate representation and covenant packages, on separate forms for separate lenders. All of the intercreditor provisions regarding Collateral sharing, pricing, payments, remedies and other key intra-lender terms could be negotiated and documented separately by the lenders in an Intercreditor Agreement (generally referred to as an "Agreement Among Lenders" in the unitranche context) to which the Fund is not a party.

Another potential intercreditor structure is a Facility with a first priority lien over the Collateral, and a second credit facility underwriting the same Collateral on an unsecured basis. The structure could include an outright unsecured facility that co-exists with a fully secured Facility, in which case, the unsecured facility takes advantage of the overcollateralisation from the secured first lien Facility.[4] Issues with respect to these structures are generally limited to Fund constituent document debt limitations and potential conflict with negative pledges in the first lien Facility documents, and do not otherwise invoke the same Collateral or intercreditor issues as the structures described above.

Structures such as some of those described above allow a Fund potentially to negotiate separate credit agreements, or maximise efficiency via combined unitranche documents, and in each case, the best terms that each lender is comfortable providing, while also allowing lenders to provide pricing and advance rates in the amounts and against investors in a manner that matches yield to the lenders' respective risk tolerances.

Whenever lenders are considering Facilities that will share Collateral, there are certain key issues to be aware of. Given the common requirement in Fund-governing documents that capital calls must be issued *pro rata* among all Investors, there are constraints on how the Collateral can be allocated while still permitting each of the first lien lender and a second lien lender full rights to call for capital contributions. Absent an unusually structured limited partnership agreement, a Facility will not typically be secured by the rights to issue capital calls to only some Investors.

We would also expect that even in separate Facilities with first lien and second lien lenders, there would be a single subscription collateral account into which all Investors fund capital contributions. There are inherent risks to both Funds and lenders when requiring capital contributions to be funded to separate subscription collateral accounts, including confusion of Investors, misidentifying Collateral on deposit, and issues related to control and blocking withdrawals. Potential cross-default of the Facilities is also an area of concern for both Funds and lenders.

Intercreditor issues

In addition to the considerations above, intercreditor issues will be an area of focus with multiple credit facilities sharing common Collateral.

<u>Lien prioritisation and payment subordination</u>

Two of the defining aspects of intercreditor arrangements are the subordination of liens and priority of payments. A second lien lender's lien on the Collateral is by definition subordinated to the lien of the first lien lender. Accordingly, the first lien lender typically receives payment on account of the Fund's first lien obligations before the second lien lender receives payment on account of the Fund's second lien obligations, in each case from the proceeds of the shared Collateral. Payment subordination provisions are heavily negotiated and can take various forms, ranging from "total" to "partial" (e.g., permitting interest payments only), and may be effective full-time from the closing of the Facility, but more typically spring into effect upon a triggering event such as the happening of an "event of default" as defined in the Facility documents.

<u>Enforcement rights and remedies</u>

Restrictions on the enforcement of the lenders' rights are another highly negotiated area of Intercreditor Agreements. It is important for lenders to clearly specify the triggering events for any enforcement against the Collateral, and any standstill period during which a second lien lender agrees not to take any enforcement action or pursue rights or remedies against the Fund or the Collateral. The mechanics regarding the activation and termination of any standstill period, and any other agreed-upon conditions for the standstill period to remain in effect and unchallenged by the second lien lender, will be areas of intense scrutiny.

In the context of a Facility, we would expect the Intercreditor Agreement to specifically address the issuance of capital calls by the lenders and any release of funds on deposit in the controlled subscription account during enforcement.[5] In addition, given the nature of capital call Collateral, it may make sense for the first lien lender to act as a limited collateral agent for the second lien lender to call capital to repay both the first lien and the second lien Facilities in an enforcement scenario.

Application of proceeds/debt limitations

Intercreditor Agreements will often cap the amount of debt permitted that will be entitled to first lien priority, with a similar cap for permitted second lien debt. The Intercreditor Agreement will then specify the priority of payments for proceeds of shared Collateral with respect to such debt. A typical waterfall provision may be set up such that payments are applied: first, to obligations owed by the Fund to the first lien lender, up to the amount of the applicable first lien debt cap; second, to obligations owed by the Fund to the second lien lender, up to the amount of the applicable second lien debt cap; third, to any excess obligations owed to the first lien lender, above the applicable first lien debt cap; fourth, to any excess obligations owed to the second lien lender, above the applicable second lien debt cap; and fifth, any remainder to the Fund.

Amendment restrictions

Certain amendments to a Facility could have a drastic impact on any intercreditor arrangement, including altering the risk allocation and underwriting criteria upon which the lenders (particularly the second lien lender) entered into the Facility/Facilities. Accordingly, Intercreditor Agreements often require the consent of the other lender prior to the effectiveness of such amendments. In the context of a subscription credit Facility, examples of such amendments would include changes to (i) the applicable advance rate, (ii) the definition of or designation of "Included Investors", and (iii) the designated subscription account.

The aforementioned provisions are only a sample of the numerous complex and nuanced provisions that may be included in an Intercreditor Agreement. Other provisions that might be incorporated into an Intercreditor Agreement include, without limitation: (i) limitations on the rights of the agent for the second lien lenders, in the event of a bankruptcy of the Fund (for example, rights to offer debtor-in-possession financing to the Fund, to take action in opposition to the agent for first lien lenders or to contest the priority of first lien obligations, etc.); (ii) waivers by the agent for the second lien lenders or the second lien lenders themselves of their rights to oppose a sale of the shared Collateral; and (iii) conditions for partial or complete releases of liens on Collateral or guarantees of the Fund's obligations. While these provisions are beyond the scope of this article, lenders and Funds considering this type of financing (particularly second lien and/or other multi-lender financing) should consult with counsel experienced with such financing arrangements and Intercreditor Agreements at the appropriate time to appropriately address such provisions and their potential consequences.

Conclusion

With the expansion of the subscription credit Facility market generally, growing interest in fund financing products (including second lien loans) and increasing financing needs of Funds, it is likely that multi-lender Facilities (and hence, Intercreditor Agreements) will become increasingly common. Because of the benefits to both Funds and lenders discussed above, we anticipate that the second lien financing market for Subscription Facilities will grow, much in the same way that the second lien market developed and grew for leveraged financings to operating companies. Intercreditor Agreements and arrangements can be extremely complex, so it is in the best interest of Funds and lenders to work with experienced and knowledgeable counsel to understand, negotiate and properly document them.

* * *

Endnotes

1. https://pro.preqin.com/analysis/drypowderAUM.
2. *Preqin Dry Powder Report*, Sept. 2019.
3. For an article summarising key points and considerations of (i) unitranche credit facilities, (ii) hybrid credit facilities and (iii) NAV credit facilities, see *Unitranche Credit Facilities: An Untested Trend Gains Traction*, by Barbara M. Goodstein, *New York Law Journal*, available at: https://www.mayerbrown.com/files/News/abb7689c-375e-489a-a6d9-a9192827c784/Presentation/NewsAttachment/9cb64727-875c-481a-aa53-aa167a9959da/New%20York%20Law%20Journal%206-5-14.pdf, https://m.mayerbrown.com/files/Publication/1b755c30-39b7-448e-8752-52bbc757ab04/Presentation/PublicationAttachment/2faec38b-3131-4e29-8110-62162339cc4e/Hybrid-Credit-Facilities.pdf, and https://www.mayerbrown.com/files/Publication/4c7194b8-6cd1-4bee-94f3-f64ec5cee225/Presentation/PublicationAttachment/360d11f1-2af1-49ea-8e16-08e279406972/MayerBrownUnencumberedAssetPoolCreditFacilitiesAnAlternativetoSubscriptionNAVandHyb.pdf, respectively.
4. For an article detailing forms of credit support in Fund financings, see https://www.mayerbrown.com/files/Publication/be4e4a44-4de3-4f8c-b3e3-dc74914c0f60/Presentation/PublicationAttachment/d0504b05-39d0-4bd3-b31c-e4c8f20536db/MayerBrownFormsofCreditSupportinFundFinance.pdf.
5. For more information on and a discussion of default remedies in Facilities, see https://www.mayerbrown.com/files/Publication/7a398d7c-3c77-4298-b24c-b7685a9895fa/Presentation/PublicationAttachment/cbbc159b-ba2c-4314-ab2a-c295ba8b6e22/MayerBrownDefaultRemediesunderSubscriptionCreditFacilities.pdf.

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Regulatory registrations, filings and officer appointments to Cayman Islands funds: The questions for lenders

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Introduction

The Cayman Islands continue to be at the forefront of the implementation of global standards for transparency and regulatory oversight in respect of the financial services industry. While the primary responsibility for implementing regulatory requirements in respect of Cayman Islands investment fund structures falls to the relevant fund, a knock-on effect is that prospective lenders to such funds must now also verse themselves on the relative importance of certain Cayman Islands regulatory measures to their due diligence and lending processes.

The past five years have seen a whirlwind of new regulatory and transparency initiatives on a global level which the Cayman Islands have moved to adopt (e.g. FATCA/CRS), as well as developments specific to the jurisdiction which have arisen as the maturity of the Cayman Islands as a domicile for private equity and venture capital funds has grown (e.g. AML requirements for private funds). A third category of regulatory change could be described as initiatives aimed at ensuring that the Cayman Islands remains as a jurisdiction that meets the standards prescribed by international organisations (such as the OECD) in transparency and prudential regulation (e.g. the Economic Substance Law – described in further detail below).

While the tide of regulation which Cayman Islands funds have been required to comply with shows no sign of abating, the industry remains buoyant and the position of lenders in the fund finance market, and their approach to lending to Cayman structures, remains relatively unchanged – save for having to ask some additional due diligence questions.

This article addresses what Cayman Islands regulatory requirements lenders in the fund finance arena should be aware of, and breaks down our views as to what questions can reasonably be asked of borrowers as part of the due diligence process.

This chapter is based on the most frequent scenario encountered – which is the 'fund' vehicle being a Cayman Islands exempted limited partnership, and the ultimate general partner of such vehicle being either a Cayman Islands or Delaware incorporated exempted company or limited liability company.

Anti-money laundering requirements

In order to comply with the Cayman AML Regime[1] a Cayman fund is, amongst other things, required to: (i) appoint certain money laundering compliance officers, namely an Anti-Money Laundering Compliance Officer, a Money Laundering Reporting Officer and Deputy Money Laundering Reporting Officer (together the "**AML Appointees**"); and (ii) adopt (or rely upon) written policies and procedures to meet the requirements of the Cayman AML Regime.

From a lender's perspective, the relevance of the Cayman AML Regime is that the backbone of a lender's security is the ability to call undrawn capital commitments from limited partners. If a fund is not in compliance with the Cayman AML Regime at the time of a default, then the lender is potentially in a position where, in enforcing its rights, it may unintentionally be calling capital from investors who have not been correctly verified under the Cayman AML Regime. While most lenders will have a good understanding of the potential AML risks attaching to the respective limited partners, in an extreme (albeit unlikely) scenario, the failure of the borrower to comply with the Cayman AML Regime could lead to capital being called and received into the lender's designated account from bad actors.

From a risk perspective, we view compliance by borrowers with the above obligations as relevant for our lender clients both: (i) from the perspective of the security package; and (ii) from a reputational perspective – so that lenders are not drawn into a net of negative publicity if they provide a facility to a borrower who has not complied with the Cayman AML Regime.

As part of our due diligence process when acting for lenders, we suggest that a prudent approach is to request that the borrower provides at least some information in respect of its compliance with the Cayman AML Regime and, from a transactional perspective, we view it as prudent that representation also be added to the credit agreement confirming compliance (if the Cayman AML Regime is not already caught within the definitions of AML/Sanctions, etc.).

A number of approaches can be utilised by lenders, depending on their comfort level with the borrower's compliance programme:

- *A conservative approach*: An approach that will gain full confirmation of the position is to request from the borrower full details of the relevant AML Appointees (including any service agreements they may have), and disclosure of how the fund meets its requirements to maintain and implement policies and procedures under the Cayman AML Regime.[2]
- *A midway approach*: A second approach is to request confirmation by email (from legal counsel or a borrower representative) of the names of the AML Appointees, and that the relevant fund maintains and implements policies and procedures under the Cayman AML Regime.
- *Alternative approach*: An alternative approach is to rely on representations in the credit agreement that the fund is in compliance with the Cayman AML Regime. This approach is generally used if the lender is comfortable with a particular borrower's business (for example, from previous transactions or an ongoing relationship with a borrower client). Admittedly, at present the approach of relying on the credit agreement representation (the "alternative approach") remains something that most lenders are comfortable with, but over time we expect that this will change, and that information disclosures on Cayman AML Regime compliance will increase as part of the due diligence process.

Economic substance requirements

The Economic Substance Law[3] was introduced in the Cayman Islands in December 2018 and came into effect for entities in existence prior to 1 January 2019, from 1 July 2019.

For the most-part the Economic Substance Law will be of limited relevance in the fund finance space (as limited partnerships are not 'relevant entities'), but it will be of relevance in due diligence of Cayman Islands funds to the extent (and in the unlikely scenario) that:

1. the general partner is a: (i) Cayman Islands exempted company or limited liability company; or (ii) a Delaware limited liability company registered in Cayman as a foreign company, and in each case the fund structuring and activities are such that the general partner is considered to be a 'relevant entity' conducting 'relevant activities' under the Economic Substance Law; and/or
2. the borrower fund or a portfolio company is a Cayman Islands exempted company or Limited Liability Company.

Similar to compliance by funds with the Cayman AML Regime, we expect that an approach may develop over time in respect of the Economic Substance Law to ask the borrower for at least some information in respect of its compliance with the Economic Substance Law – or reasoning for such law being inapplicable to the given general partner/fund.

One additional repercussion of the Economic Substance Law is that Cayman Islands law firms may update their standard legal opinions to include assumptions/qualifications in respect of the Economic Substance Law. We don't expect, however, that such additional assumptions/qualifications will generate material debate between the respective borrower/lender counsel on a fund finance transaction.

Data Protection Law

In June 2017, The Data Protection Law (the "DP Law") was published in the Cayman Islands Official Gazette. The DP Law and Data Protection Regulations, 2018 came into force on 30 September 2019.

The DP Law establishes a framework of rights and duties designed to safeguard individuals' personal data, balanced against the need of public authorities, businesses and organisations to collect and use personal data for legitimate purposes. The DP Law was developed in line with international best practices while ensuring that it reflects the specific needs of the Cayman Islands. It is based substantially on the Data Protection Act, 1998 of the United Kingdom.

The DP Law applies to funds in the context of the information that they collect on investors and accordingly most (if not all) Cayman fund entities which are parties to a fund finance transaction will have obligations under the DP Law. Non-compliance may have serious ramifications. The DP Law defines "personal data" very widely, to include any data which enables a living individual to be identified and is centred around eight data protection principles.

While the DP Law is a relatively newly introduced piece of legislation (and so industry guidance and market practice is still developing), the question of compliance with the DP Law does not generally arise as part of the lender-side due diligence on a fund finance transaction. Generally speaking, compliance with the DP Law will be covered by the representation in most credit agreements regarding regulatory compliance but, if not, it will be important (as with the Cayman AML Regime) to build in representations that the fund is in compliance with its DP Law obligations.

Additionally, if a scenario were to arise where substantial fines were to be levied on a fund for non-compliance, we would envisage the DP Law (and compliance with its terms) may become something that is more applicable to the due diligence process.

FATCA/CRS

FATCA is a US federal law that aims to reduce tax evasion by US persons. FATCA has significant extra-territorial implications and, most notably, requires foreign financial institutions ("FFI") (a definition which includes almost all private equity and venture funds registered in the Cayman Islands) to report information on accounts of US taxpayers to the US Internal Revenue Service ("IRS"). If an FFI fails to enter into the necessary reporting arrangements with the IRS, a 30% withholding tax is imposed on US source income and other US related payments of the FFI.

In order to facilitate reporting under and reduce the burden of compliance with FATCA, the Cayman Islands has signed a Model 1B intergovernmental agreement with the US (the "US IGA"). The US IGA allows Cayman Islands entities that are FFIs to comply with the reporting obligations imposed by FATCA without having to enter into an agreement directly with the IRS. Instead, a Cayman Islands FFI may report directly to the Cayman Islands Tax Information Authority (the "TIA") and, provided it complies with the relevant procedures and reporting obligations, will be treated as a deemed compliant FFI that is not subject to automatic withholding on US source income and other US-related payments.

A Cayman FFI for which an exemption is not available, is required to take the following steps:

(i) Obtain a Global Intermediary Identification Number ("GIIN").

(ii) Identify reportable accounts (FATCA and the US IGA impose an obligation on Cayman Islands reporting FFIs to identify and report details of "reportable accounts" to the TIA). "Reportable accounts" are financial accounts where the account holder is a "Specified US Person". In the case of Cayman Islands funds, the relevant account is the shares/interests each investor holds in the fund. Existing accounts (maintained as at 30 June 2014) should have been identified and due diligence obtained.

(iii) In respect of new account procedures and due diligence: For all new accounts opened with a FFI after 1 July 2014, it has been necessary to carry out due diligence and obtain self-certification regarding whether the account holder is a Specified US Person. If US indicia are found that suggest the person may be a US taxpayer, prescribed steps need to be taken to confirm this. For accounts opened by another participating FFI, the FFI's GIIN should be obtained and verified against the publicly available IRS FFI list. In general terms, all Cayman Islands FFIs should have revised their account opening forms and/or subscription agreements to ensure they comply with FATCA rules in relation to new accounts. For funds, it is also important to have updated offering and constitutional documents to ensure FATCA is appropriately addressed.

(iv) In respect of notification: All Cayman Islands FFIs that have reporting obligations under FATCA are required to notify the TIA of that fact no later than 30 April in the first calendar year in which the Cayman Islands FFI was required to comply with the reporting obligations. Thereafter, the information set out in the notification should be immediately notified to the TIA. Changes to the information supplied must be immediately notified to the TIA. Where the Cayman Islands FFI ceases to have a GIIN, it is required to notify the TIA.

(v) In respect of reporting: On or before 31 May in each year, Cayman Islands FFIs should report to the TIA in relation to accounts held by Specified US Persons or a non-US entity with one or more controlling persons that are Specified US Persons. The US IGA prescribes the information that needs to be reported. Most significantly, it requires the balance of value of the relevant account held by the Specified US Person to be reported. Upon receipt of a report, the TIA will pass the reported information to the IRS.

While the above may appear to be a lengthy list of obligations for a Cayman Islands fund to comply with (and FATCA/CRS compliance is by no means a walk in the park), from a lender perspective it would be very unusual for specific disclosures of Cayman Islands filings or officer ('PPOC', etc.) appointments to be made.

As with compliance with the Cayman AML Regime, compliance is currently captured within the FATCA specific or regulatory representation in the credit agreement for a given transaction. Given the widespread compliance with FATCA/CRS registration and reporting, and the lack of issues that it has caused on lending and security transactions, we do not foresee this position changing in any material way.

Cayman due diligence – a barrier or a benefit for lenders?

Ultimately lenders will (and do!) make decisions as to which of the above (numerous) regulatory measures they view as important, or less so, when managing the credit risk of a potential or ongoing borrower relationship.

An additional 'ripple effect' of increased regulation which we have seen occur, to the benefit of both parties to a fund finance transaction, is that as regulatory and transparency measures such as the above are introduced, corresponding changes immediately occur in fund LPAs and credit agreements produced by the leading US firms. This 'document seepage' lessens negotiations between Cayman legal counsels and protects lenders – but of course, it does not solve issues with documents of older vintage funds, nor occur across the board, so it is not a global solution.

While the burden may be seen to be increasing (and associated costs are, of course, borne by investors) we do not view any of the initiatives that have been introduced to date as having a negative effect on lending to Cayman Islands funds. Indeed, one of the few benefits of increased regulation has been that lenders have become increasingly comfortable with more regulated borrowers.

What's next?

As international initiatives are introduced or amended, the Cayman Islands will continue to develop its regulatory framework to satisfy such requirements. Accordingly, lenders will continue to need to remain informed in respect of these developments. We expect that over time, due diligence requests in respect of such regulatory initiatives will become standardised, and will be included in closing deliverable checklists in fund finance transactions.

As ever, the point will always remain that the lender is entitled to ask for such information as it reasonably requires – and information on regulatory compliance by funds is always a reasonable request, in our view.

* * *

Endnotes

1. Proceeds of Crime Law (as revised) ("POCL"), as supplemented by the Anti-Money Laundering Regulations (as revised) ("AML Regulations") and Guidance Notes on the Prevention and Detection of Money Laundering and Terrorist Financing in the Cayman Islands (as revised) (the "AML Guidance Notes" and together with the POCL and AML Regulations the "Cayman AML Regime").
2. Our experience is that this approach is currently met with considerable resistance by borrower counsel, but that ultimately if the lender seeks the information, and the relevant borrower is in compliance with the Cayman AML Regime, there is limited reasoning as to why full details should not be provided.
3. The International Tax Co-operation (Economic Substance) Law, 2018 ("Economic Substance Law").

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Understanding true leverage at the fund level: A European market and sector approach

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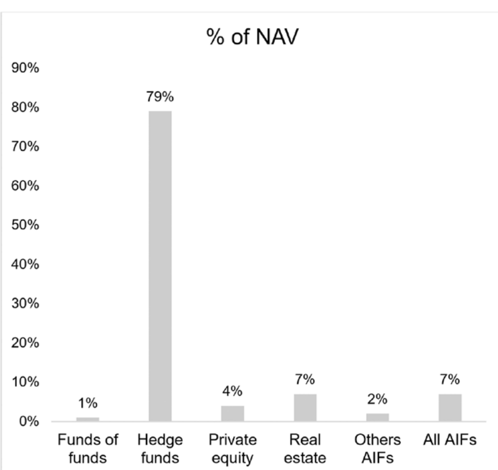
Statistical reports on the use of leverage by funds

On 7 March 2019, the European Securities and Markets Authority ("**ESMA**") published the first annual statistical report on EU Alternative Investment Funds ("**AIFs**") (the "**Report**"),[1] providing significant information on the AIFs industry and, more particularly, on fund leverage across the various fund structure types.

In the AIFs market, borrowing currently represents approximately 7% of the net asset value ("**NAV**"). The breakdown of borrowing as a percentage of NAV per fund type is as follows: less than 1% for funds of funds ("**FoFs**"); 7% for real estate funds ("**REFs**"); 79% for hedge funds ("**HFs**"); 4% for private equity funds ("**PEFs**"); and 2% for other AIFs. The Report points out that the AIFs industry is characterised by a significant difference in the use of leverage measured by the ratio of gross exposures to NAV.



With the exception of HFs, the use of leverage by AIFs remains limited. The results of the Report should, however, be analysed bearing in mind that the data collected did not cover all existing AIFs. Furthermore, according to ESMA, the data may contain errors due to the complexity of the calculation rules and the reporting requirements, including those related to leverage embedded at the individual fund level or at the level of a special purpose vehicle ("**SPV**").

The European Systemic Risk Board's ("**ESRB**") Shadow Banking Monitor 2018[2] shows that, while levels of leverage in investment funds remain low for debt (bond) and equity funds, there is growing leverage among hedge funds, and some other types of AIFs such as REFs.

The International Capital Market Association's ("**ICMA**") Asset Management and Investors Council ("**AMIC**") and the European Fund and Management Association ("**EFAMA**"), in their joint paper of July 2017 entitled "Use of Leverage in Investment Funds in Europe AMIC/EFAMA Joint Paper", are of the view that leverage in the sector is low.

What is leverage?

Leverage can be created either by borrowing money (called "*physical leverage*") or assets like securities from financial counterparties (also called "*financial leverage*") or by using derivative instruments such as options, futures or swaps (also called "*synthetic leverage*"). In case of financial leverage, the proceeds of the borrowing are used to reinvest in other assets. Borrowings are registered in the balance sheet of the fund as liabilities. Synthetic leverage is used to mainly manage risks within a portfolio such as exchange rate risks and interest rate risks, but it can also be used to gain exposure to certain assets.

Under the AIFMD, leverage is defined as any method by which the AIFM increases the exposure of an AIF it manages, whether through borrowing of cash or securities or leverage embedded in derivative positions, or by any other means.

Financial leverage at a fund level is also defined as the ratio of total assets to NAV, while the synthetic leverage is referred to as being the ratio of exposures acquired through the use of derivatives to NAV.

How is leverage measured?

Leverage is measured by two different metrics in accordance with the Commission Delegated Regulation (EU) No. 231/2013 of 19 December 2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (the "**Level 2 Delegated Regulation**"): (i) the gross method, providing information on the total exposures of a fund (in other words, the "footprint" at the individual fund level); and (ii) the commitment method, measuring the leverage as the ratio in between the net exposure of the fund and its NAV. A third method can be employed, the value-at-risk method, which focuses more on the portfolio risks rather than a measure of leverage *per se*.

According to the Level 2 Delegated Regulation, the gross method calculates the ratio between "*the sum of the absolute values of all positions valued in accordance with [the AIFMD]", (a) excluding the value of any cash and cash equivalents which are highly liquid investments, (b) converting derivative instruments into the equivalent position in their underlying assets, (c) excluding cash borrowings, (d) including exposure resulting from the reinvestment of cash borrowings; and including positions within repo or reverse repo agreements and securities lending or borrowing* held by the fund and the fund's NAV (in other words, leverage is calculated as the ratio between the fund's investment "gross" exposure and the NAV).

The commitment method calculates the ratio between the net exposure of the fund (without excluding cash and cash equivalents) and its NAV. The commitment method takes into account netting and hedging arrangements. For the calculation, the AIFM needs to: "*(a) convert each derivative instrument position into an equivalent position in the underlying asset; (b) apply netting and hedging arrangements; (c) calculate exposure created through the reinvestment of borrowings where such reinvestment increases the exposure of the AIF; and (d) include other arrangements: namely convertible borrowings, repos, reverse repos, securities lending and securities borrowings*."

Sector approach

A sector approach of the Report reveals that FoFs account for 16% of the NAV of AIFs, at around €770bn. Typically, their underlying portfolio is composed of equity interests in hedge funds or private equity funds, most FoFs being managed by the same manager. Nevertheless, the Report shows diversified investment strategies of FoFs going beyond portfolios composed of HFs' and PEFs' interests, which represent only 17% of the NAV. Considering that FoFs are historically amongst the main users of NAV facilities, one would have expected to see a higher level of use of leverage for FoFs. Their regulatory assets under management ("**AuM**") to NAV equal 115% on aggregate and their low leverage levels are mainly due to a limited use of financial and synthetic leverages (less than 1% of NAV).

HFs are in general highly leveraged and represent the highest level of leverage in the market, with 7.8 times the NAV (or 780% of the NAV). Such level is due to both synthetic (being a strong component of their investment strategy) and physical leverages (amounting to around 160% of the NAV (against 7% for all AIFs)). Such strategies are in line with the US market, where the figures reported to the US Securities and Exchange Commission show qualitative similarities. The Report shows that secured borrowing through repo and reverse repo accounts for 60% of the NAV, and funding from prime brokers for 12% of the NAV.

According to the Report, REFs account for 11% of the NAV of AIFs, at €540bn, invested mainly in commercial real estate. The industry is concentrated in a few countries. While the synthetic leverage is employed on a marginal side, REFs use financial leverage, being the second largest by AIFs' type (after HFs), with some of them engaged in short-term borrowings, e.g. subscription lines. The regulatory AuM to NAV is 136% on aggregate, with outright borrowing that amounts to 7% of the NAV.

The statistics are in line with our observations of the market. In spite of the reluctance of some lenders due to the illiquid nature of the underlying asset, REFs' financing transactions are very popular (and represent an important share in the Luxembourg market), structured either through dedicated SPVs or within umbrella funds via dedicated compartments. Long-term borrowing enhancement techniques, featuring low interest rates and bullet repayments, are particularly suited for REFs, within the context of considerable upfront capital commitment, long lock-up periods and slow distributions paid mainly out of cash flow versus liquidation distributions.

PEFs account for 4% of the NAV of all AIFs, or €204bn. PEFs have the lowest use of leverage among the AIF types, with a AuM-to-NAV ratio at 113% on aggregate, and very limited use of derivatives and borrowings, representing 4% of their NAV. These figures do not necessarily reflect the reality considering that in leveraged-buy-out transactions, leverage is incurred at the level of the BidCo (the SPVs acquiring the target company) rather than at the level of the fund itself.

While no specific date is provided with regard to debt funds, falling by default within the category of other AIFs, it is established that financial leverage is used as part of the investment strategy.

To understand these figures it is important to understand what true leverage at the fund level is and what the possible limitations are.

What are leveraged facilities for funds?

Leveraged facilities, or NAV facilities (also referred to as "asset backed" facilities) are loans provided to the fund itself, or at a level below, to a SPV. Unlike the subscription facilities, the leveraged facilities are put in place at a later stage of the fund's life, immediately after the fund's close, for a long-term period. The aim is to supply liquidity needs of the fund, notably after the acquisition of the investments when the portfolio becomes illiquid or as a leverage tool. The leveraged facilities are secured by the underlying portfolio and the related distributions. The borrowing base is calculated on the NAV of "eligible" underlying assets.

Specific criteria of the "eligible" underlying portfolio are established by the lenders and include, among others, particular types of assets, geographic and industry sector limitations. A strong component of such financing is the loan to value ("**LTV**") ratio, meaning the ratio of outstanding loans under the NAV facility to the borrowing base, as adjusted from time to time. The security package focuses on the underlying assets and can be structured either at the level of the fund itself or, more commonly, at the level of the SPV(s). It will include, for example, a pledge over 100% of the equity interests of the fund in the SPV, holding in return the underlying portfolio and the SPV's bank accounts where the distributions are made, as a portfolio investment payment.

Why is leverage used by funds?

Leverage techniques used by funds are an integral part of their investment strategy. Their aim is to optimise investment returns and improve asset allocation and portfolio diversification. Using leverage in various proportions, depending on the nature of the underlying asset, enables funds to increase their net equity multiple. This benefits investors from two perspectives: (i) a higher return; and (ii) greater investment diversification opportunities.

Various metrics are used to measure the impact of leverage on the fund's performance or on a given transaction. The most common would be the internal rate of return ("**IRR**") which measures the monthly portfolio performance. An *unleveraged IRR* measures the cash flow that the business is expected to generate as if the asset would have been acquired with 100% equity only. While the *leveraged IRR* takes into consideration the leverage from debt financing to measure the performance of the underlying asset, the IRR is considered as a market standard performance indicator. It has, however, recently faced rising criticism: notably, regarding "on-the-paper" inflated performance, which some investment managers have been using to achieve IRR thresholds triggering, in return, higher incentive awards.

Within the context of a "true leverage" operation, it is more interesting to look at the net multiple or investment multiple, which provides performance information with regard to the fund, rather than at the IRR. This shows the total value as a multiple of its cost basis. For example, in case of the acquisition of a real estate asset for a purchase price of €50m, financed by a ratio of equity to external debt of 40/60 and an unleveraged IRR of approximately 7%, the net multiple increases from 1.5 to 1.7, while the leveraged IRR would equal approximately 10%. In the same line, a deal structured, for example, on the basis of external debt equal to a 60% LTV and a 40% equity-to-mezzanine debt, with 5% equity and 35% mezzanine debt provided by the investors, a 7% IRR calculated on year one, would amount 10.5% in year six. This is a 350-basis-points increase. The operation would generate an exit multiple of approximately 19 and a return of equity of around 10% with, again, a profit of around 1.7.

Limitation of leverage

Regulatory limitation

The existing EU regulatory framework addresses systemic risk concerns. Unlike investment funds subject to the Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (the "**UCITS Directive**"), where the borrowing is strictly limited in respect of the amount and the purpose – to 10% of the assets for liquidity needs translated on a temporary basis, and 10% of the assets for financing the acquisition of a real estate property necessary to the pursuit of its business, and on a cumulative basis not exceeding 15% of the total assets in Luxembourg – AIFs are less restricted in their borrowings. Such restrictions may come from national regulations governing the overall supervision. In Luxembourg, for example, the legal framework does not provide for any restriction in terms of leverage.

According to article 111 of the Level 2 Delegated Regulation, leverage is considered to be used on a "substantial basis" when the exposure of an AIF, as calculated according to the commitment method, exceeds three times its NAV, triggering as such an extended disclosure information obligation for the AIF manager (the "**AIFM**"), in accordance with Article 24(4) of the AIFMD to the competent authorities of its home Member State. *De facto*, this becomes a limitation.

The AIFMD requires AIFMs to "*set a maximum level of leverage which they may employ on behalf of each AIF they manage as well as the extent of the right to reuse collateral or guarantee that could be granted under the leveraging arrangement, taking into account, inter alia: (a) the type of AIF; (b) the investment strategy of the AIF; (c) the sources of leverage of the AIF; (d) any other interlinkages or relevant relationships with other financial services institutions, which could pose systemic risk; (e) the need to limit the exposure to any single counterparty; (f) the extent to which the leverage is collateralized; (g) the asset-liability ratio; (h) the scale, nature and extent of the activity of the AIFM on the markets concerned*." Furthermore, "*the AIFM should demonstrate that the leverage limits for each AIF it manages are reasonable and that it complies with those limits at all time*." The level of leverage employed must then be monitored and periodically disclosed to investors.

According to the ESMA's Q&A on the application of the AIFMD, an AIFM should calculate the leverage of each AIF that it manages (to be understood, the leverage employed at the level of the AIF, including any exposure of a legal structure controlled by such AIF which has been specifically set up to increase, directly and indirectly, the exposure of the AIF), as often as it is required to ensure that the AIF is capable of remaining in compliance with leverage limits at all times. The current level of leverage used of a fund is disclosed in the annual report of each financial year.

It is to be noted that temporary borrowing is to be excluded when it is fully covered by the capital calls from the investors. In other words, subscription line facilities are not part of the leverage calculations and reporting.

Strategy limitation

While leverage creates opportunities to increase the total return on investments, it can also potentially increase losses. Although not mandatory from a regulatory perspective, funds will have a leverage limitation imposed by the fund documentation, reflecting the investment strategy and the general consensus among investors or potential investors. The limited partnership agreement (the "**LPA**") would generally provide, in a borrowing section linked to the purpose investment strategies and restrictions, rules regarding the fund's authorisation to use external financing. The general terms may include the possibility for the fund to borrow, trade on margin, utilise derivatives and otherwise obtain leverage from banks and others, on a secured or an unsecured basis.

In a leverage-oriented investment strategy, the overall leverage of the fund or a sub-fund (in case of an umbrella structure) will depend on the investment strategies employed by the AIFM in respect of the fund or the sub-fund and specific market opportunities. In an umbrella structure, the leverage limitations will vary from one compartment to another. Limitation for investment purposes can range from a maximum that can be employed in connection with the fund's investment program, calculated in accordance with the AIFMD's gross method and commitment method of the fund's NAV, e.g. from 300% of the NAV, for example, or below (which is the maximum level before the substantial basis qualification), to no external leverage foreseen at all.[3] Depending on the type of investors and/or the geographical area the fund is sought to be marketed to, the leverage and borrowing levels may be lower or inexistent. Internal leverage can or cannot be permitted, meaning that in the latter case, no shareholder loans are allowed.

For example, insurance companies subject to the Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance ("**Solvency II**"), invest in unleveraged funds. For the qualification leveraged *vs* unleveraged, the insurance companies refer to the Level 2 Delegated Regulation. In a letter addressed to the European Insurance and Occupational Pensions Authority in 2018, ESMA declared its view that AIFs which use borrowing arrangements that comply with the criteria set out in article 6(4) of the Level 2 Delegated Regulation, namely, temporary in nature and fully covered by contractual capital commitments from investors in the AIF, should be considered unleveraged.

The qualification leveraged *vs* unleveraged will be then the main refrain for lenders to provide true leverage financing to funds. While capital call facilities are expressly excluded from the leverage qualification for the reporting purposes, there is no legal definition of what "short term" borrowing is. It is commonly accepted in the European market that all loans with a maturity below or equal to 364 days would correspond to the criteria of a temporary financing.

External limitations to funds

Limitation of true leverage can further come through external regulations not applicable to the fund but to certain investors and lenders. Insurers, for instance, have limited options to invest in certain kind of assets, in units of certain AIFs, due to Solvency II which provides for a number of requirements for insurers; in particular, in respect of capital requirement and risk monitoring. Credit institutions such as banks also have regulatory requirements to comply with pursuant to Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC ("**CRD IV**"). Investors and lenders may, in addition to those external regulations applicable to them, have specific internal regulations which may have an impact on the conditions under which they respectively invest and lend money to AIFs.

Private banks, or other agents like family offices, may act for an investor or a pool of investors pursuant to a management mandate, which may contain a certain number of investment restrictions having the effect of limiting the leverage ratio of a borrower.

In practice, those regulations result, in the case of insurers willing to invest in debt funds, in specific structuring scenarios and limitations to be included in the offering documents. For banks, the LTV is one of the expressions of such limitations, i.e. indebtedness on the fund level to the value of assets, within the context of a financing transaction. This also means that two concurrent financings of the fund of two separate assets may limit reciprocally or incidentally, although the limit imposed by the LPA would not have been reached otherwise.

From another practical perspective, when financing a fund through a NAV facility, lenders generally need to run a significant due diligence on the funds' portfolio. This is especially the case in debt portfolio acquisitions. As the financing also covers future acquisitions and investments which fall within the eligibility criteria, an ongoing due diligence is necessary. Extended to hybrid facilities, lenders' due diligences are even more complex and require the involvement of several teams, and smooth coordination between them.

Conclusion

According to the data provided in the Report, the leverage level in the AIFs sector is rather low. At such low levels, leverage for investment funds in Europe should not constitute a systemic financial stability risk. AIFs subject to AIFMD show a large dispersion of leverage. This leads to the conclusion that there are many more opportunities to grow the sector.

We note an increased appetite, on both debt funds' and lenders' sides, for true leverage financing. With a low interest rate market and competitive financing terms, the appetite of funds for leverage is set to rise, making it a more pre-eminent part of the investment strategy. As borrowed money is cheaper than equity money, a tendency can be seen for higher debt commitment and lower equity commitment, when structuring deals. The interest rates on senior/bank loans are just half, or below half, the ones applied to debt commitment, mezzanine financing or notes.

Furthermore, the overall success of a leverage transaction, within this context, implies a growing interest and use of derivatives to mitigate interest rate risks. In practice, this is translated by the development of new strategies and products, with an important focus on the development of hybrid solutions, such as capital call arrangements converted after a ramp-up period, in asset-backed borrowings.

* * *

Endnotes

1. ESMA50-165-748. The Report is based on a set of the Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers (the "AIFMD") data reported by the managers to national authorities and to ESMA and presents the EU AIFs market at the end of 2017.
2. No. 3 / September 2018.
3. Different limitations would apply for bridge financing, in the case of subscription lines where the authorised amount of borrowing is linked to the capital call commitments available (15% to 25% – according to the ILPA Principles 3.0 2019, the limit should be 20%) and short term borrowings for management purposes to, for example, satisfy redemption requests in open-ended funds (generally 10% of the net assets, which basically echoes the limitations imposed by the UCITS Directive to UCITS).

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Fund finance in Ireland and Luxembourg: A comparative analysis

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Introduction

Ireland and Luxembourg have long been the preferred jurisdictions in which to establish a fund in Europe, and the prevalence of funds established in Ireland and Luxembourg make them important jurisdictions for lenders to understand. The ever-increasing use of Ireland and Luxembourg funds for private equity structures and the long track record in both jurisdictions, combined with Brexit (however it ultimately unfolds), means that the importance of Irish and Luxembourg funds is likely to further increase, both for capital call/subscription line facilities and NAV/asset-backed facilities. Each jurisdiction offers managers access to the EU-wide marketing passport for UCITS and alternative investment funds ("**AIFs**").

This chapter considers, on a comparative basis, a number of key legal and practice issues that should be considered when an Irish or Luxembourg fund is a borrower (or other obligor) in a fund finance structure. Although Ireland and Luxembourg have different legal systems (Ireland is common law; Luxembourg is civil law), as each is an EU Member State, they share much in common when it comes to fund finance. Both jurisdictions facilitate credit lines to investment funds in a manner that allows flexibility to borrowers, and certainty and robust security to lenders. In each jurisdiction, the following EU legislation plays an important part in fund finance structures: the Alternative Investment Fund Managers Directive (Directive 2011/61/EU) ("**AIFMD**"); and the EU Directive on financial collateral arrangements (Directive 2002/47/EC) (the "**Collateral Directive**").

Legal entity types and introduction to regulatory framework

<u>Common considerations</u>

Each of Ireland and Luxembourg have a number of different legal entity structures: corporate, partnership, contractual and, in the case of Ireland, trusts. Umbrella funds with segregated liability between sub-funds/compartments are a feature of each jurisdiction. In each jurisdiction, a sub-fund may, as an economic matter, be analysed as a separate entity.

An Irish or Luxembourg sub-fund benefits from legislative ring-fencing, and each jurisdiction allows a sub-fund to be wound-up and liquidated, leaving the remainder of the umbrella structure intact. However, and importantly, a sub-fund of an Irish/Luxembourg fund does not have separate legal personality. Accordingly, care needs to be taken, in drafting the parties clauses, granting clauses and execution blocks, that the appropriate legal entity is expressed to be the party (with further care taken where, as is common, an investment manager is entering into the financing as agent of the fund).

- *Ireland*

  Irish structures can be broadly divided into regulated and unregulated structures. Regulated structures are regulated by the Central Bank of Ireland ("**CBI**") under the Irish law implementation of the UCITS Directives or, much more commonly for fund finance, the AIFMD – as considered in detail further below). The main types of regulated fund structures in Ireland are: (i) variable capital investment companies; (ii) Irish collective asset-management vehicles ("**ICAVs**"); (iii) unit trusts; (iv) common contractual funds ("**CCFs**"); and (v) investment limited partnerships ("**ILPs**"). Each of these entity types (other than ILPs) may be established as AIFs or UCITS. ILPs are AIFs, only. The limited partnership (under the Limited Partnership Act 1907) is the most favoured structure for unregulated investment funds in Ireland.

  At present, the ICAV (a corporate entity which can elect to be fiscally transparent for US federal tax purposes) is the most common Irish structure encountered in funds finance. ICAVs may be UCITS or under AIFMD. In fund finance, they will invariably be under AIFMD. Changes to the ILP legislation are expected to mean ILPs, once the legislation takes effect, will become more commonly used and more frequently seen in fund finance.

- *Luxembourg*

  Luxembourg offers a wide range of vehicles which may suit various needs and expectations that fund initiators may have. Luxembourg funds may either be regulated or non-regulated vehicles, with or without a legal and/or tax personality, with the possibility of using an important number of corporate entities, to which a regulatory framework may be added.

  There are various structuring options, in particular, in an AIFMD context. The fund-specific legislation is rich and mainly composed of the following: the Luxembourg law of 12 July 2013, as amended, on alternative investment fund managers ("**AIFMs**"), ("**Luxembourg AIFM Act**"), implementing AIFMD, as well as the law of 15 June 2004, as amended, on risk capital investment companies (SICARs); the law of 13 February 2007, as amended, on specialised investment funds (SIFs); the law of 23 July 2016 on reserved alternative investment funds ("**RAIFs**"); and the law of 17 December 2010, as amended, on undertakings for collective investment (UCIs that are covered by the Luxembourg AIFM Act and UCITS). RAIFs bearing the corporate form of a SCSp (special limited partnership) have recently been extremely successful given the important flexibility that they offer (most aspects may be contractually agreed).

AIFMD and other regulatory considerations

<u>AIFMD</u>

Regulatory considerations deserve close attention as part of the due diligence on a fund finance deal. Non-compliance with the regulatory requirements by a fund adversely impacts the financing transaction. Although Irish and Luxembourg funds may also be

UCITS, in fund finance structures, lenders will typically encounter only AIFs, so the AIFMD considerations should be noted in financings involving Irish or Luxembourg funds.

Under AIFMD, the relevant fund (Irish or Luxembourg) will have appointed to it an Alternative Investment Fund Manager (AIFM). The AIFM is responsible for the risk management and portfolio management functions of the fund, and will typically delegate (under an investment management agreement) the portfolio management function to an investment manager (as agent of the AIFM). This chain of delegated authority, and in particular, the terms of the investment management agreement, should be verified as part of the diligence process. AIFMs are typically required to be regulated by their home member regulator (CBI, in the case of Ireland; CSSF in the case of Luxembourg).

Another key requirement of, and actor in, the AIFMD structure, is the depositary – which must be a separate entity to the AIFM and will have its registered office or a branch in the AIF's home member state (Ireland or Luxembourg). The depositary is responsible for the safekeeping of the fund's assets. The depositary is also generally liable for the failure of its delegates.

Another key actor is the administrator. The administrator plays an important role in processing subscriptions, and recording and registering subscriptions. In addition, the administrator performs the role of calculating the NAV of the fund and its units/shares.

Other EU regulatory regimes may require close attention when dealing with an Irish or Luxembourg fund. Where derivatives are used at the fund level, the European Market Infrastructure Regulation (Regulation (EU) No 648/2012, known as EMIR) will apply (and, as an EU Regulation, its terms should not vary between Ireland and Luxembourg). EMIR is, insofar as derivatives are concerned, broadly the EU equivalent of the relevant aspects of the Dodd-Frank Act in the US.

Where the transfer to the lenders of personal data relating to natural persons is involved (for example, in the case of a subscription line involving investors who are high-net-worth individuals), the General Data Protection Regulation (Regulation (EU) No 2016/679, known as GDPR) may be relevant. This privacy law is an EU Regulation which should apply equally as between Ireland and Luxembourg.

- *Ireland*

  A typical Irish fund structure is set out below in simplified form (Fig. 1) and illustrates the AIFMD architecture. In fund finance, lenders dealing with Irish funds will typically encounter Qualifying Investor Alternative Investment Funds ("**QIAIFs**"), whose corporate structure will most commonly be an ICAV. A QIAIF is marketed to professional investors only. It is not subject to any investment or borrowing limit. In Ireland, the AIFM may be an external manager of the AIF or, in the case of an ICAV or investment company, the fund itself.

- *Luxembourg*

  The *Commission de surveillance du secteur financier* (Luxembourg financial supervisory authority, "**CSSF**") has not specifically addressed fund finance activities. Nevertheless, fund finance is considered as being covered by the general regulatory framework applicable to a fund entering into a financing and to its manager, and in particular, the guidelines on portfolio management. A typical Luxembourg fund structure is set out below (Fig. 2). As with Fig. 1 (for Ireland) the AIFMD "actors" are the same – AIFM and depositary.

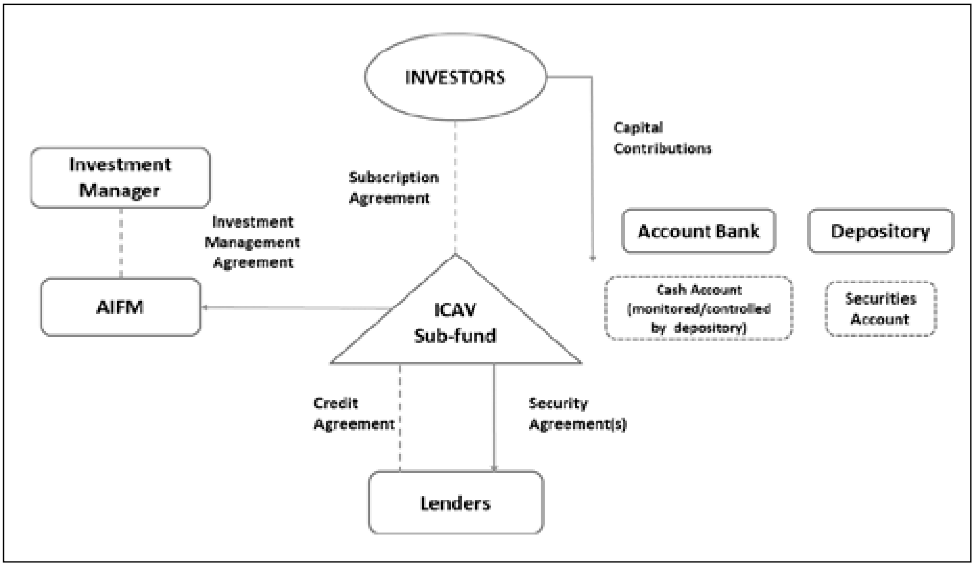

Fig. 1 – Ireland

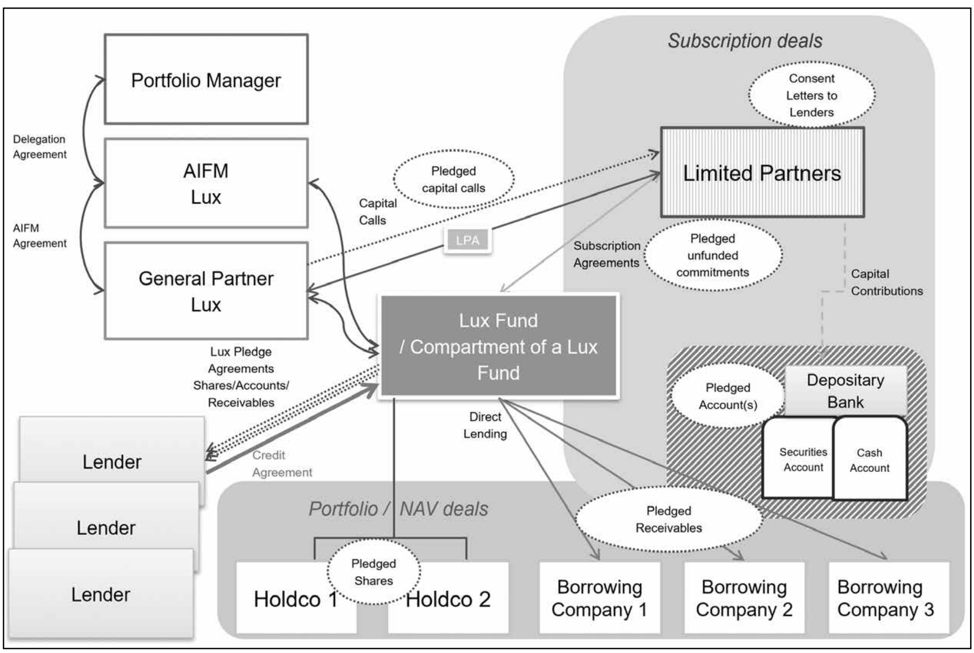

Fig. 2 – Luxembourg

Diligence

<u>Common considerations</u>

In any lending structure, it is essential that appropriate due diligence is undertaken in good time. As in any jurisdiction, the usual issues of capacity and authority need to be examined at an early stage so that any issues may be identified and addressed early in the transaction. The AIFMD aspects introduce additional diligence requirements (for example, on the AIFM (or its delegates) and the regulatory authority of the fund), all of which underlines that in the case of Irish or Luxembourg funds, early engagement on diligence is recommended. In the case of both Irish and Luxembourg funds, typically there are no leverage limits imposed, but this needs to be verified by reference to the nature of the fund and any self-imposed leverage restrictions.

In addition, the AIFMD, adopted in the wake of the financial crisis and the Madoff scandal, has put increased liability on the depositary, who holds a duty to monitor and reconcile the fund's cash flows and supervise its assets, and a prevention and detection role (the scope of obligations may vary depending on the type of fund used but, in general, the foregoing applies to all funds that are subject to the AIFMD).

Any action that might affect the fund's assets requires the approval of the depositary. Hence, a smooth enforcement of the pledge requires that the depositary be informed beforehand of the existence of the pledge and acceptance by the depositary of its terms (it might even be a party to the pledge agreement). Contractual arrangements would normally be included to ensure a periodic valuation of and reporting on the pledged portfolio, with the consent and contribution of the depositary. Moreover, the depositary arrangements commonly provide for a pledge over all or part of the fund's assets in favour of the depositary. Any security to be granted over such assets will need to take into account the existing pledge in favour of the depositary, either by releasing such pledge or by creating a higher-ranking pledge in favour of the lenders.

- *Ireland*

  The establishment documents of the fund should be carefully reviewed. Subject to any self-imposed leverage limit (for which the prospectus should be reviewed), the fund can be expected to have broad powers, in its establishment documents, to borrow and create security. It is particularly important, in a subscription line facility, to determine that the power to create security extends to security over the fund's uncalled capital commitments.

  In a subscription line facility, plainly the agreement between the fund and investor in relation to the subscription is a key document. Typically, this document is set out in a subscription agreement. It is important to determine the subscription process: (i) who can make calls on investors; (ii) who determines the price at which units or shares are issued and by what means; (iii) when capital calls can be made on investors; (iv) what an investor can be asked to fund; (v) the implications of an investor not funding a capital call; and (vi) to what account subscription proceeds are paid.

  Finally, as the management function of the fund is vested in the AIFM (or an investment manager as its delegate), the correct authorisation of, and approval of the transaction by the AIFM (or the investment manager) should be appropriately addressed.

- *Luxembourg*

  The fund's organisational documents (limited partnership agreement, subscription agreement, articles of association, AIFM and/or portfolio management agreements, depositary agreement, etc.) set the rules governing commitments and any limits on the involvement of each of the fund parties.

  It is important to make sure from the outset that there are no contradictions between the facility agreement and the organisational documents. In the context of the Luxembourg AIFM Act, for instance, the AIFM bears the regulatory responsibility as part of its portfolio management responsibilities; consequently, the financing transaction must be approved by the AIFM and, if applicable, the party to which the AIFM has delegated the portfolio management function.

In the last few years, it has become increasingly accepted to have specific provisions on fund financing included in the fund's organisational documents. This is particularly helpful in the context of subscription facilities, for which – as stated earlier – provisions on capital calls, disclosures, escrows, clawbacks and certain waivers are included.

Most Luxembourg alternative investment funds (within the meaning of the Luxembourg AIFM Act) are not subject to statutory limitations on leverage, although there may be some limitations – resulting mainly from the fund's organisational documents. A Luxembourg AIF is required to conduct a self-assessment of its leverage level in order to determine whether or not it must appoint an authorised AIFM. If exceeded as a result of the bank financing, leverage level might trigger statutory obligations to appoint an AIFM and a depositary.

Common features for security interests

Collateral Directive

The European Directive 2002/47/EC on financial collateral arrangements (the Collateral Directive) is important in relation to taking and enforcing collateral. It has been implemented into both Irish and Luxembourg domestic law and is an important feature of security arrangements in each jurisdiction.

The Collateral Directive provides to collateral takers, in the case of qualifying collateral arrangements, a number of perfection and enforcement benefits. This includes rights of rehypothecation, substitution of collateral, disapplication of stays, and a right of appropriation on enforcement.

As regards the Collateral Directive and its impact on perfection, first, a preliminary note on what we mean by the term "perfection". When used in some jurisdictions, "perfection" is taken to mean the steps needed to ensure a first-ranking security interest. In each of Ireland and Luxembourg, "perfection" generally refers to the steps which, if not taken, mean that the security is void but which steps, by themselves, will not necessarily render the security interest first-ranking. In this regard, it should be noted that the Collateral Directive disapplies, in respect of any qualifying collateral arrangement, any filing or registration requirements that may otherwise apply under the domestic regime of the applicable EU Member State.

Security agency

Both Irish and Luxembourg law accommodate security being held by one entity for the benefit of many, whether through a security trustee or security agent structure in Ireland; or a security agent structure in Luxembourg.

Security through insolvency

In general terms, security granted by an Irish or Luxembourg fund is effective on and through insolvency and may be enforced without court intervention.

No stamp or transfer taxes

Generally speaking, no stamp, transfer or other similar taxes are typically payable under Irish or Luxembourg law on the creation of security or execution of security documents.

Conflicts-of-law considerations

Due to the multi-jurisdictional nature of finance transactions involving Irish and Luxembourg funds, it is essential to properly address questions of private international law. This is the case for the choice of law and choice of jurisdiction in the finance documentation, but more specifically, as it relates to the recognition of the right *in rem* over the collateral and its enforceability against the pledgor, the investor and any other third party (competing creditors) in a context where all such parties are located in different jurisdictions. Moreover, the impact of an insolvency of the fund or of any other guarantor or security provider should be considered in an international context.

Whereas it is fairly typical for the lending documents to be governed by New York law or another law chosen by the lender, local law considerations come into sharper focus in relation to collateral arrangements. In general terms, similar conflict-of-laws principles arise for consideration in Ireland and Luxembourg. In each case, for the creation, perfection and enforcement of collateral, the law of the location (or deemed location) of the secured asset (the *lex situs*) is very relevant.

Accordingly, whereas there is no concern with the credit agreement or other document regulating borrowing being governed by the law preferred by the lender (typically New York law or English law), in each of Ireland and Luxembourg, there is a preference for security to be taken under the *lex situs*. The *lex situs* will often be Irish law or Luxembourg law (as the case may be). Claims governed by Irish or Luxembourg law or owed to a debtor located in Ireland or Luxembourg or cash or securities accounts in Ireland or Luxembourg will generally be regarded as having an Irish or Luxembourg *lex situs*.

Regulation (EC) No. 593/2008 is also relevant. Better known as the Rome I Regulation, or simply Rome I, applies equally in Ireland and Luxembourg and refers to the law chosen by the parties for all contractual aspects. Article 14 of Rome I Regulation also addresses the relationship between assignor and assignee under a voluntary assignment of a claim against another person (the debtor). This is relevant to security over capital calls exercisable against investors. Article 14 provides that the relationship between assignor (i.e. the fund) and assignee (i.e. the lender or the security agent) under a voluntary assignment of a claim against the debtor is governed by the law that applies to the contract between the assignor and assignee (i.e. the governing law of the subscription agreement or, as applicable, limited partnership agreement). Article 14 also provides that the law governing the assigned claim shall determine its assignability, and certain effects against the debtor of such claim (investor).

As fund documentation is typically governed by the law of the location of the establishment of the fund (so Ireland or Luxembourg, as the case may be), Irish or Luxembourg law will apply to such matters and such application will, throughout the EU, be supported by Rome I. However, Rome I does not expressly provide for conflicts-of-law rules as regards the enforcement of such security interests against third parties. The impact on third parties is dealt with by national rules, which often designate the law of the location of the relevant investors to govern the effect on third parties. Investors in funds (whether Luxembourg or Irish) are typically located outside the fund jurisdiction (and often outside Europe), so this is something to be taken into account. A draft EU Commission proposal for a regulation on the law applicable to the third-party effects of assignments of claims, published on 12 March 2018, is set to deal with this question. The draft proposal aims to reduce the uncertainty as to the law applicable to perfection requirements and the enforceability of security interests over claims against third parties. The proposal provides that, as a rule, the law of the country where the assignor has its habitual residence will govern the third-party effects of the assignment of claims.

In addition, Regulation (EU) No. 2015/248, which applies equally across Ireland, Luxembourg (and the rest of the EU other than Denmark) is of relevance. More commonly known as the EU Insolvency Regulation, this regulates the insolvency proceedings of corporates throughout the EU. Under the EU Insolvency Regulation, claims against an EU investor with an EU centre of main interest ("**COMI**") will be considered located in the EU Member State where that COMI is located.

Typical security package

The security package for a financing of an Irish or Luxembourg fund will, as with any other jurisdiction, depend on the nature of the financing – capital call or NAV facility. Typically, in each of Ireland and Luxembourg, a combination of at least the following is used: a security interest over unfunded capital commitments, together with security over the bank account into which investors are required to pay subscription/commitment amounts. NAV and other asset-backed facilities will involve collateral over other of the fund's assets and, in particular where this involves securities owned by the fund, the role of the depositary in the security arrangement becomes of central importance.

Typical security package for subscription deals

In both Ireland and Luxembourg, security interests provided by a fund in respect of capital call rights against an investor are recognised and enforceable against the fund, even if no notice is given to the investor. As regards enforcement against the investor, until the investor is given notice that its rights have been assigned, it may be validly discharged (including by set-off) as against the fund. For this reason, consideration is given to notifying investors of the creation of such security, where practicable. Ideally, such notice is acknowledged by the investor.

- *Ireland*

  As with any financing, there is no universal security package. That said, the following are typical features. In a capital call/subscription facility, a typical security package includes security over the fund's rights on capital calls against investors, and security over the relevant bank account into which the subscription monies are to be credited. In addition, a security power of attorney is usually sought from the fund.

  As mentioned, the administrator plays a key role in the subscription process. In certain cases, it is appropriate to seek security over the fund's interest in the related administration agreement to provide a lender with "step-in" rights. In other cases, a side letter to the lender is obtained from the administrator in relation to the performance of its duties following enforcement. Control agreements in respect of the subscription proceeds account may be appropriate. The appearance of an Irish fund in a financing will not necessarily be limited to the Irish fund in the role of borrower. The use of Irish funds (particularly ICAVs) in feeder fund structures is common.

  One issue which will require careful consideration in this context is the issue of guarantees and other third party credit support. An Irish AIF cannot generally provide "guarantees" (which is generally taken as including third party credit support more generally) to collateralise the obligations of third parties. The use of "cascading pledges" can be a useful tool in this regard. In the case of security created by an Irish fund the Collateral Directive, where applicable, displaces any security filing requirements. Nonetheless, it is market practice to consider precautionary security filings (particularly where contractual rights are secured). These are made at the Companies Registration Office or (in the case of ICAVs) the Central Bank of Ireland. Unless there is a transfer of the security interest to a new lender, these are one-time filings with no renewal requirement (unlike, for example, financing statements in certain jurisdictions). It is permitted under Irish law to take security over future assets.

- *Luxembourg*

  The collateral package in Luxembourg subscription deals usually consists of security over: (i) the unfunded commitments by the fund's limited partners to make capital contributions when called by the general partner; and (ii) the account where the contributions are funded. The Luxembourg law of August 5, 2005 on financial collateral arrangements implementing the Collateral Directive, as amended (the "**Luxembourg Financial Collateral Act**"), captures these two types of assets to offer lenders a secure and bankruptcy-remote pledge while allowing the fund, as pledgor, to benefit from a continuing and flexible management of the collateral.

  Pledges under the Luxembourg Financial Collateral Act can be granted over virtually all types of securities and claims (the latter include bank accounts and receivables). In addition, they can be granted under private seal and, in principle, are not subject to any filing or publication requirements in Luxembourg.

  Contributions in the form of equity, notes or loans can be captured by the Luxembourg Financial Collateral Act, with flexibility as to any contractual arrangements on timing and mechanics. Furthermore, the Luxembourg Financial Collateral Act allows pledges to be granted not only over present assets, but also over future assets. Consequently, counsel in Luxembourg have a large degree of flexibility in structuring the security package for subscription facilities.

  In order to be fully effective, a pledge over a claim, including bank accounts, must be notified to and accepted by the debtor of the relevant claim. There are no stringent rules with respect to the form of the notification. Acknowledgment of the notice by the investor may be sought, for evidence purposes only.

<u>Typical security package for NAV deals</u>

- *Ireland*

  NAV facilities, involving as they do, security over the fund's securities and other assets within the fund's investment portfolio, invariably involve account security. Control agreements may be an important feature of this. As the depositary is charged with safe-keeping of a fund's financial instruments and has an overall supervisory obligation, the role of the depositary in taking and enforcing collateral is important. As with subscription line facilities, the security may benefit from the Collateral Directive even if precautionary security filings may be made. Where security requires enforcement over an Irish situated account or other asset in the investment portfolio located in Ireland, there is a strong preference, from a lender perspective, to take Irish law security.

- *Luxembourg*

  When structuring a NAV facility involving a Luxembourg fund, the Luxembourg counsel to the lenders will always seek to ensure that the security package is structured under Luxembourg law to avoid discrepancies upon enforcement and, in particular under the Luxembourg Financial Collateral Act, to take full advantage of a bankruptcy remote security package recognised across the EU.

In terms of composition of the security package, in addition or as an alternative to the deposit accounts on which the capital contributions are funded, NAV facilities are mainly granted against the fund's investment portfolio. Depending on the investment policy of the fund, and the way it is structured (whether it is a fund of fund or not, and the way the holding of the underlying assets is structured), the collateral might fall into a different class of assets, and hence be subject to a different form of pledge.

The most common approach in Luxembourg is to have the security package in a NAV facility include a pledge over the portfolio companies (HoldCos), a pledge over receivables (in particular, for credit funds), and a pledge over bank accounts. All such pledges can be governed by the Luxembourg Financial Collateral Act and take advantage of its flexible and efficient regime. With a flexible legal framework, variations are possible around these types of pledges, which can be adjusted to align to the type of transaction and the structure involved. For funds of funds, when the portfolio is composed of hedge funds, certificates are held within a bank account chosen by the lender, who further benefits from a control agreement.

Under Luxembourg law, the terms that are normally used in a control agreement may be incorporated in a pledge over bank account receivables, so that they may take advantage of the robust protections offered by the Luxembourg Financial Collateral Act.

Conclusion

The continued importance of Ireland and Luxembourg as fund domicile jurisdictions will ensure that Irish and Luxembourg funds will continue to be prominent in financing structures, whether as borrowers or part of a broader master/feeder structure. The laws of both Ireland and Luxembourg, although different in many respects, allow lenders to obtain a comprehensive security package in relation to an Irish or Luxembourg fund.

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The fund finance market in Asia

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Overview of the Asia-Pacific private capital market

Fundraising

A lot has happened in Asia over the last few years.

Total private market investor exposure to Asia has tripled over the past 10 years, and this upward trend is expected to continue, given that Asia still represents less than 10% of global exposure. With Asia GDP forecast to represent just over 34% of global GDP in 2019 and 63% of total GDP growth in 2019, Asia's markets have arguably been underweighted in investors' global allocations, and there is the potential for Asia markets to generate investment on a similar scale to that of Europe over the next 5–10 years.[1]

By the end of 2018, the Asia-Pacific private equity market boasted US$883 billion in total assets under management, representing 26% of the global private equity industry. Private equity funds operating in the Asia market held dry powder totalling US$317 billion, equating to three years of future supply at the current pace of investment.[2]

The year 2017 had been a record-breaking one for fundraising, with 593 Asia-Pacific-focused fund closings. Momentum started to slow throughout 2018, with fewer new fund launches that year (256), which has been partly attributed to global trade disputes and pressure on China-based funds, lenders and investors, to tighten leverage. However, those funds that did manage successful fundraising achieved a higher average size (US$294 million) than the previous year. Despite the relative decline in 2018 fundraisings compared to 2017, it seemed that larger, established funds with a strong track record were still able to raise funds successfully, whereas it was more of a struggle for smaller or newer funds.[3]

Fundraising in 2019 is expected to be lower than previous record highs. However, there is evidence that larger funds with established reputations have still been successful, with new ASEAN-focused private equity and venture capital funds averaging a 117% target fundraising success rate.[4] There have also been reports that 2020 will see some of the larger funds in the region return to the market to raise new capital.

Investment activity

Fund investment strategies in Asia-Pacific tend to focus on buyout, growth equity and venture capital in the more developed economies (e.g. Japan, South Korea and Australia). Growth and venture capital are the focus of funds in developing economies (e.g. China, India and South East Asia), although buyouts do occur in these regions too, and will become more prevalent as their economies further develop.[5]

In terms of private equity deals, the average deal size in 2018 was US$213 million, with almost 75% of total regional deal value relating to investments in China and India. Investments into internet and technology companies made up 50% of all deals.[6]

Beyond China and India, the Southeast Asian market also saw significant activity. By the end of 2018, there were US$19.2 billion private equity and venture capital assets under management in Singapore, and US$6 billion in Malaysia. In terms of deals, in 2018 there were 380 announced deals worth a total investment of US$14.1 billion in this region.[7]

Southeast Asian unicorns have also recently attracted regional headline attention. Grab (Singapore), and Go-Jek and Tokopedia (Indonesia) attracted more than US$1 billion of growth capital in 2018. In Vietnam, Techcombank (financial services) and Vinhomes JSC (luxury home developer) each raised US$0.9 billion as pre-IPO funding from sovereign wealth funds and leading private equity funds.[8]

<u>Asia market trends</u>

ESG

This year has seen visible growing public concern relating to the importance of environmental, social and corporate governance ("**ESG**") issues, e.g. climate change, diversity and equality. Awareness of and support for these concerns is being adopted by many international corporates, financial institutions, and investors and general partners ("**GPs**") find themselves having to adapt to address these issues.

A number of prominent regional investors are leading the market in championing ESG investment. For example:

- Japan's Government Pension Investment Fund, the world's largest retirement fund with US$1.5 trillion in assets, now requires its fund managers to incorporate ESG principles, allocates its investments based on a number of ESG benchmarks, and is reported to have agreed to pay higher fees to a fund manager for managing investments in accordance with these principles.
- Temasek Holdings Pte., Singapore's state investor, is one of the world's largest investors, investing US$17.6 billion in the previous financial year. In October 2019, Temasek reportedly declined to invest in Saudi Aramco's initial public offering, in part due to environmental concerns. In November 2019, its Chief Executive Officer announced that it would start reporting its air miles, water, paper and electricity usage as part of an environmentally sustainable corporate governance strategy.[9]

Although there are some global sponsors that now have impact investment funds which have been making investments in the Asia-Pacific region, Asia-Pacific has been somewhat slower than other regions in implementing ESG integration; often the focus has been on corporate governance rather than on environmental or social aspects.

According to Preqin, 55% of Asian limited partners ("**LPs**") do not have an ESG investing policy for private equity, and 60% of Asian private equity funds do not require their portfolio companies to report on ESG issues or responsible investment. Research undertaken by Bain & Company indicates that only 13% of Asia-Pacific GPs have fully integrated ESG considerations at investment committee level.

However, it is expected that pressure from international investors will drive uptake in due course and, accordingly, that this will be prioritised by GPs and lenders.

There is clear evidence that this is starting to take place in the banking community. In October 2019, ING announced it had made available a US$65 million revolving "sustainability improvement capital call facility" for Singapore-based Quadria Capital Management, being the first in the world to link the interest rate of a facility provided to a private equity fund to the sustainability performance of its portfolios. Measurement of the ESG metrics would be based on key performance indicators provided by an analytics data provider and an independent materiality assessment.

In response to growing demand, the Loan Market Association published a set of "Sustainability Linked Loan Principles" in March 2019 which are intended to promote the development and preserve the integrity of sustainability-linked loan products.

We expect that sustainability and ESG principles will continue to filter across the range of financial products, and will form increasingly important aspects of lender strategies.

New Cayman regulation

The vast majority of Asia-focused private equity fund vehicles are Cayman Islands exempted limited partnerships ("**ELPs**"), which consist of at least one GP and investors who hold LP interests. ELPs are extremely familiar to Asian and North American sponsors and investors, and are viewed as attractive and fit for purpose, not least due to flexible underlying legislation and tax neutrality.

The Cayman Islands, along with many other jurisdictions, have been required by the OECD to introduce economic substance requirements. Framework legislation to meet the requirements, the International Tax Co-operation (Economic Substance) Law, 2018 (Substance Law), was introduced in December 2018 and this has been supplemented by regulations and guidance (the "**Cayman ES Law**").[10]

As a result, 2019 saw sponsors and managers taking advice on whether any changes or modifications were needed to their existing structures and/or fund documentation in order to comply with the new economic substance requirements.

If a "relevant entity" is carrying on a "relevant activity", the requirements for compliance include carrying on core income-generating activities in the Cayman Islands, being directed and managed in an appropriate manner in the Cayman Islands, and having an adequate physical presence and an adequate number of employees or other personnel with appropriate qualification in the Cayman Islands.

A more detailed discussion of the economic substance legislation is beyond the scope of this chapter, however some relevant headline points are:

- "investment funds" (as defined in the Cayman ES Law) *including vehicles through which they invest or operate* are excluded and are not viewed as "relevant entities" for the purposes of the Cayman ES Law;
- entities that are tax-resident outside of the Cayman Islands are carved out of the ES Law;[11] and
- "fund management business" (as defined in the Cayman ES Law) is a relevant activity, in relation to which relevant entities will be required to satisfy economic substance requirements in respect of gross income.

So while investment funds and their GPs would generally be excluded from the provisions of the Cayman ES Law, managers are now seeking advice in relation to whether Cayman-incorporated investment managers, investment advisor entities, portfolio companies or upper tier carry vehicles are subject to any requirements. There are a number of restructuring options available (some of which are more simple than others) in order ensure compliance with the Cayman ES Law; however, it is important to note that there is no universally correct approach, and managers will need to strike a balance between various competing onshore and offshore considerations.

Sponsors should continue to monitor the Cayman ES Law, and we anticipate that the year ahead will bring greater familiarity with the legislative requirements, and comfort around available solutions to existing structures.

Summary

The years 2017 and 2018 saw robust activity in respect of new launches, capital-raising and deals, although levels have declined throughout 2019.

There is plenty of dry powder in the region and, although it is becoming ever-harder to identify and win appropriate new investments, and many funds are still early in their lifecycles, there will soon be pressure on GPs to deploy that capital in order to generate returns for investors.

Fund finance in Asia-Pacific

Overview of the fund finance market

There is a healthy level of debt available for fund level financings in the Asia market. In recent years, Asia-based financial institutions have significantly ramped up the sizes of their teams as a direct response to the huge amounts of private capital being raised in the region, and non-bank lenders have also been entering the market. There has been significant growing interest and appetite among international, regional and local banks to offer a more diverse range of fund financing products.

Fund financings in the Asia market are typically done on a bilateral basis, but there have also been examples of financings completed on a club or syndicated lender basis, in cases where the size of the facility is too large for a single lender to underwrite on its own. This will likely become more common as larger funds are raised in the Asia market.

The majority of the fund financings in the Asia market so far have been traditional subscription line (or "capital call") facilities, where security is taken over the GP's rights to call undrawn capital from LPs. The high volume of new fund launches in 2017 enabled the traditional subscription financing product to quickly develop from being a bespoke relationship deal into a much more commoditised line. Terms and documentation are often derived from North American or European precedents, but certain local market adaptations have clearly emerged, e.g. the use of Cayman law to govern security over capital call rights, as opposed to using New York or English law.

However, in addition to these traditional subscription line financings, the market has also seen an uptick in the availability and use of more structured and bespoke facilities. These typically fall under the four categories below, although some lenders are able to offer tailor-made credit facilities for their fund clients:

- *Net Asset Value (or "NAV") Facilities*: These facilities are raised against "concentrated NAV" (i.e. a small pool of the underlying investments of the fund), with recourse to the cashflows and distributions from the fund's underlying investments (as opposed to recourse against the GP's rights to call undrawn capital from LPs). These facilities are helpful during the later stages of a fund's lifecycle when there may no longer be uncalled LP commitments to include in a lender's borrowing base.
- *Hybrid Facilities*: Hybrids involve a combination of capital call-style recourse to the GP's rights to uncalled LP commitments, and also NAV facility-style recourse to the underlying assets.

- *Management Fee and GP / Management Co-Invest Facilities*: These take a number of forms but typically involve lending to a GP or management company in its own capacity, with recourse to GP or management fee income, and may be supported by personal guarantees. These can be used to provide working capital to the GP or management company, pending receipt of GP profit share or management fee income. These facilities are also used to help fund capital calls made on the vehicle through which the GP or management team has invested (the latter being useful for larger funds where investors expect management to have significant skin in the game).
- *Preferred Equity Financings*: GPs have also been looking to raise finance at the fund level through preferred equity structures. Increasingly, lenders are helping preferred equity investors provide that equity funding through leverage to the investor, with security over the preferred equity investment.

There are a limited number of lenders in the market who have the appropriate internal resources to be able to offer the more structured fund finance facilities. For the lenders who are able to do so, these types of facilities offer more attractive pricing than subscription line facilities, which tend to be at lower pricing levels given the competition between lenders for that product. This is also reflective of the higher risk of these facilities, given that lenders need to make an assessment of the potential for cashflows/distributions resulting from the fund's underlying assets and investments.

As GPs look for additional ways to increase returns to investors and more lenders seek to diversify their fund finance loan portfolios beyond subscription line finance in order to continue to execute new deals, it will be interesting to monitor the extent to which these products get used.

Asian fund structures and fund documentation for fund facilities: Key issues

From a basic structuring and formation perspective, it is now much more common that new Asian fund documents contain provisions which specifically permit the fund (or a portfolio company) to incur subscription line finance debt, create security and grant guarantees. There is now often language that seeks to facilitate the taking of security over uncalled capital commitments and reduce the potential for further steps needing to be taken with their LPs in connection with any fund level financing. Making sure that a fund has the legal capacity to enter into the transaction and grant security forms the core of lender legal due diligence for this product. Parties are becoming more familiar with lender due diligence requirements, and there are now fewer examples of fund documents containing problematic restrictions in respect of basic capacity.

However, thinking ahead to the opportunity to put in place the more structured financings noted above, fund sponsors should consider ensuring that: (i) the GP entity and management company are set up as separate entities (this has not always been the case for local/regional funds); (ii) there is an SPV in any structure set up for a portfolio investment in respect of which share security can be granted and/or which can itself grant security to support any potential NAV financing; and (iii) there are no restrictions on assignments of rights to management fees, or any other rights to distributions by the fund or the GP.

In addition, when parties negotiate a subscription line facility, it may also be worth considering including a permission to grant second-ranking security over and recourse to undrawn LP commitments, to allow this to be provided to any hybrid/NAV facility lender in the future, to the extent that subscription line facility is still in place at that time.

Key legal due diligence points for funds and lenders in the Asia market

There are, of course, a number of points which both funds and their lenders will need to consider for any fund-level financing. However, we think funds and lenders in the Asia market will be particularly focused on the following legal due diligence issues:

- Do the fund documents facilitate different types of fund financing transactions other than subscription line financings (e.g. GP management fee financings)?
- What ability does the GP have to issue drawdown notices and use capital to repay newly incurred bank debt following expiration of a fund's commitment period?
- What are the circumstances in which investor commitments could be cancelled or reduced?
- What happens if a fund unilaterally releases or waives the commitments of its investors without lender consent and what contractual protections (if any) could be deployed to mitigate this risk?
- Are there restrictions around the transferability of LP interests (at least for those LPs who have been included in the borrowing base)?
- Will investor consent letters or other further deliverables be required from any LP to put in place the financing (e.g. acknowledgments or courier delivery receipts in respect of LP notices)? GPs are particularly sensitive in Asia to further interactions or detailed information requests being required with their investors. In some cases, GPs have even tried to resist providing copies of side letters to their lenders to avoid disclosing commercial terms agreed with investors.
- Is the permitted use of proceeds of the facility wide enough such that, in addition to being available to bridge capital calls to make investments, it can also be used to fund distributions to LPs as a bridge to receiving disposal proceeds, or to bridge any timing delay caused by currency conversions (e.g. when RMB proceeds are received onshore and will be subject to lengthy PRC regulatory approvals before they can be remitted offshore to the fund)?

Given current market conditions, we think it is essential that both lenders and GPs have a comprehensive understanding of these types of legal due diligence issues. This will permit a wider range of financing deals, and ensure that sufficient protections or flexibilities are included in the finance documents.

Outlook for 2020

Increasing competition and uncertainty brings opportunities

There is growing competition to raise funds and, at a time when there is a large amount of dry powder in the region, there is also a huge amount of competition over the best deals to deploy those funds. GPs will face the challenge to identify attractive new investments in what is now a relatively mature market, against the backdrop of uncertain market conditions. The performance of funds operating in the Asia market will be closely monitored by investors, who are increasingly looking to consolidate and reduce the number of their GP relationships.

This year has seen significant regional geo-political events, which have hindered new private equity downstream deal opportunities. Pressures caused by the US-China trade war have disrupted new mandates, rendering clients hesitant to commit to new deals in an uncertain economic landscape. In addition, Hong Kong's economy entered a technical recession following a contraction in Q3 of 2019 caused by months of socio-political unrest and public protest.

Looking ahead, it is also unclear what effect the upcoming US elections will have on the global and our regional economies in 2020. Election years typically result in somewhat stagnant and conservative US markets. It remains to be seen what the ripple effect will be on the Asia-Pacific markets.

Despite any uncertainties, private capital takes comfort from its reputation for outperforming during downturns. While the extent of any downturn is to be determined, it seems likely that, in the first instance, going into 2020, there will be a transitional period where participants react to market conditions and seek to identify new opportunities.

Although GPs may exercise caution during this period, wary that rushing to deploy capital early in a new fund's lifecycle could prove costly, we also see this as being a period where GPs can take advantage of opportunities brought to them by uncertain market conditions and increasing competition.

As GPs grow more mature and competition increases, GPs are diversifying their strategies in order to widen their nets and are becoming more specialised by sector or theme. There has been a notable trend towards infrastructure-focused strategies, aimed to target opportunities relating to regional infrastructure development needs (e.g. the Belt and Road Initiative) and any related funding gaps. There has also been a notable uptick in enquiries relating to debt-focused strategies, reflective of increasingly tough market conditions.

Increased focus on debt to manage liquidity and increase returns

The amount of existing dry powder, combined with the decline in the volume of new private equity fund launches, may result in a slower pipeline of new traditional subscription line financings as we head into 2020.

However, at the same time, there is increasing pressure on GPs to raise debt to manage liquidity and potentially help increase investor returns, especially in later life funds.

A new fund's primary concerns may be bridging capital calls or utilising leverage to increase liquidity and boost return on new investments – which can be served by the traditional subscription line facility. On the other hand, a later-life fund's commitment period may have expired and the GP not be able to draw capital commitments in order to repay newly incurred debt. A GP may also manage multiple funds with illiquid assets.

If available, bank debt can provide effective relief to these types of funds. Bank debt could consist of simple working capital facilities, NAV facilities, hybrid facilities or loans to the GP itself. Lenders will consider the liquidity of any remaining assets, the availability of remaining commitments, and will need to have a full understanding of the fund's business and cashflows. Until relatively recently, this has really only been the territory of a few bespoke lenders as well as direct lenders and credit funds.

We expect to see greater use of NAV, hybrid, GP management fee or other, more bespoke facilities. This would create new opportunities for lenders to diversify their books, expand fund relationships and offer potentially more lucrative financing products.

Another way in which investors and managers have both sought to manage their liquidity profiles or fund further growth has been via secondary market trading. Secondary fund market activity has grown in 2019, with deals worth US$42.1 billion completed globally in the first half of the year.[12] Although there is currently little precedent in Asia in respect of lenders financing large secondary market portfolio transactions, this is an area where we may see debt financings becoming more widely used in the future.

Summary

Current economic and market uncertainties, combined with increased competition and increasing demands from investors, will require participants to balance conservatism against a need to diversify their strategies, find new opportunities and achieve additional liquidity in order to generate higher returns to investors. At the same time, many of the more mature GPs will be looking to raise ever-larger funds which, in turn, will need increasingly larger debt facilities.

The fund finance market in Asia Pacific looks well placed to assist GPs throughout these processes and ensure they can manage liquidity throughout all phases of a fund's life cycle.

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11. Such entities will be required to produce evidence to the Tax Information Authority of the Cayman Islands substantiating the exemption claimed, such as a Tax Identification Number or tax residence certificate, as applicable.
12. *FT*, Private equity secondary deals soar (16 September 2019).

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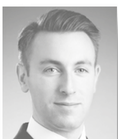

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Fund finance facilities: A cradle to grave timeline

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Introduction

This chapter looks at the various different types of fund finance which may be available to funds at the various different stages of a fund's life. The diagram opposite sets out in linear form the typical life cycle of a closed ended private equity fund, although the diagram would equally apply to closed ended funds of most asset classes, albeit possibly on a different time line.

As mentioned, we have picked a private equity fund as the fund on which to base this chapter. The other common asset classes – credit funds, real estate funds, infrastructure funds, secondary funds and fund of funds – are mentioned where relevant.

Start of fund life

The three-month period before first closing of a fund is characterised by management time spent on investor negotiations, coupled with the structuring and financing of pipeline transactions expected to complete shortly after closing. The fund will typically have a capital-raise period of one year following first close. At first close, undrawn commitments will be equal to total commitments. The first drawdown date following first close may depend on whether a transaction needs to be consummated shortly following first close, and the extent to which financing is in place to enable speedier execution of that transaction. The fund will also need to pay formation expenses, service provider costs and, potentially, the first quarter management fee to the general partner (where the management fee/general partner share is payable in advance) in addition to due diligence costs on pipeline deals.

Subscription line facilities

These fees and costs are funded by drawing investor commitments or by debt, which will most likely be made available by way of a subscription line facility, also frequently called a capital call facility. This type of facility will be made available to the fund as borrower in an amount calculated – in general terms – by reference to the amount of the undrawn commitments and the creditworthiness of investors. This calculation provides the borrowing base for the fund's debt, and it allows the fund to access debt during its investment phase, before it owns significant assets, by allowing it to use investor commitments as collateral for debt.

Whilst the amount of undrawn commitments is a purely empirical and straightforward question, the determination of investor creditworthiness – the other half of the borrowing

Fund and Fund Financing Life Cycle
Typical PE Fund

YEARS	Fund Stage	100% UCCs	Investments	Financing
-1	First Close Start of Investment Period			
0	Final Close Investment Period	100-90%	None	Sub line
	Investment Period	90-70%		
2.5	Investment Period	80-60%	Some (4-8)	Sub line/hybrid
	Investment Period	50-60%	Probably as many as going to have (eg 10-12)	NAV/hybrid
5	End of Investment Period Main Divestment phase	20/15%	10-12	NAV
	Divestment Phase	15%	8-10	NAV
7.5	Divestment Phase	15%	6-8	Concentrated NAV
	Divestment Phase	10%	4-6	Concentrated NAV
10	Original Fund terminal date Divestment Phase	5/10%	2-4	Very Concentrated NAV/Continuation
11	One Year Extension Divestment Phase	5/10%	2-4	Very Concentrated NAV/Continuation
12	One Year Extension Divestment Phase	5/10%	2-4	Continuation

base calculation – leads to more variation in the subscription line market. Typically, the lender will determine investor creditworthiness on a per-investor basis or by reference to the overall investor base of the fund. In the former case, a discount (called an 'advance rate') is applied to each investor's undrawn commitments, and that discount is inverse to that investor's creditworthiness.

Where an investor is not rated, or does not publish financial information which the lender can access and verify, the discount is total or very high, and the undrawn commitments are zero (or very low) for the borrowing base calculation. This per-investor approach to determining the borrowing base accordingly looks in reasonable detail at the creditworthiness of each investor on a reasonably granular basis and can be sensitive to investor-specific events. In the latter case – where the borrowing base is calculated by reference to the overall investor base of the fund – the lender applies a single advance rate against all of the investors, taking into consideration a blended metric of the creditworthiness of investors and the likelihood of investor defaults.

In this way, the investor base is critical at this stage of the fund's life, and the undrawn commitments and the bankability of the investor base will dictate the availability and quantum of finance. Accordingly, the subscription facility market tends not to distinguish significantly between the different types of funds – private equity, private debt, venture capital, etc. – because the facility is granted and sized principally by reference to the investor base. A private equity fund could quite easily have a subscription facility that looks broadly similar to that of a private debt fund. The fund assets do not drive the lending terms to any significant degree.

The key documentary variations in the subscription facility market are primarily driven by: (i) borrowing base methodology and other investor metrics as described above; and (ii) variations in fund structures, such as parallel funds and feeder funds (which could result in some degree of documentary complexity to ensure, for example, that the lender has access to the uncalled capital of the actual investors, rather than pass-through vehicles). Other variations emerge where lenders provide debt products which move away from the typical feature of a subscription line described above – i.e. a facility calculated by reference to the undrawn commitments of a diverse (or reasonably diverse) investor base. For example, some lenders are able to make available multi-fund facilities, which aggregate undrawn commitments across funds and provide a framework financing solution to managers, whilst other lenders provide facilities for single-investor funds (also known as "SMAs", or separately managed accounts) that invest alongside a manager's other funds.

Across the subscription facility market, however, facilities are fundamentally calculated by reference to undrawn commitments and investor creditworthiness, and it is this key feature which has contributed to the increasing popularity of subscription facilities amongst lenders in recent years, particularly in the European and (more recently) Asian markets. Lenders take risk not on fund assets, but on a clearly ascertainable and quantifiable amount which investors – often highly rated entities, such as pension funds and insurance companies – are contractually obliged to make available to the fund and which can be applied to repay the lenders.

Lenders typically take a secured position in relation to undrawn commitments in the form of security over the rights to issue drawdown notices to investors and security over the bank account to which commitments are funded by investors. In the event of an enforcement or work-out situation for lenders, which is rare in the subscription line market, the lenders are protected by this secured position against the contractual obligations of investors to fund their uncalled capital, and lenders are further protected in a default scenario by the discount mechanism described above, which should be largely insulated from asset value or market movement fluctuations. In an overall lending market affected by increasing volatility and ever-growing valuations and EBITDA-multiples, the subscription line market has proven ever more attractive to lenders.

Mid-way through the investment period

On final closing, the fund will have a fixed commitment level which will correlate to the size of the deals that the fund may undertake, subject to investment restrictions, whether based on deal size as a function of total commitments, geography or asset class. A typical private equity fund will terminate its investment period on the five-year anniversary of the final closing date (or the sixth-year anniversary of the first closing date). One would expect 40–50% of commitments to be deployed or earmarked for deployment in years 3-4.

Successor fund formation restrictions are usually relaxed when 70-80% of commitments have been drawn or earmarked for investment (or otherwise on termination of the investment period). Consequently, by year 4, the key executives of the general partner may begin thinking about the appropriate time to gear up for the next fund-raise within that strategy. The general partner will also focus on ensuring that commitments are deployed to a sufficient level before the close of the investment period, while being mindful of the extent to which follow-on investments may be desirable or required thereafter. The general partner will be on the lookout for exit opportunities, and consider divestment structures for current fund assets.

Hybrid facilities

At this stage, a subscription facility could very well continue to satisfy the fund's need for finance, but as investor capital is deployed, the borrowing base would start to reduce in line with undrawn commitments and could have the effect of restricting borrowings. The manager might consider moving to a Net Asset Value ('NAV') facility, which (as described below) would have a borrowing base shaped on the net asset value of the fund's assets.

Another option would be to obtain a hybrid facility, which combines the elements of a subscription facility and a NAV facility, with the borrowing base being calculated by reference to a combination of (1) undrawn investor commitments, and (2) the net asset value of the underlying assets acquired by the fund. A hybrid facility typically applies diversity and concentration limits to the asset value element of the borrowing base calculation in order to ensure that debt is not made available by reference to a small number of assets concentrated in a particular region or industry, and in this way, a hybrid facility frequently starts out with a borrowing base calculated on the basis of undrawn commitments only.

Whilst this combination of borrowing base contributors would seem a sensible way to increase access to finance, hybrid facilities remain less common – and less popular – than might be expected. This results from a combination of factors. It is difficult for some banks to combine subscription lines and NAV facilities, particularly where those product groups sit in different parts of the bank.

More significantly, managers continue to have doubts about the economics of a hybrid facility. Suspicion remains that the margin for a hybrid facility is not a 'pure' blend of that for a subscription facility and for a NAV facility, but rather results in the fund paying a margin that is higher than it should be during the initial period, where it relies principally on the uncalled commitments of highly rated investors, without sufficient compensation in the form of lower margin for the period when the hybrid facility relies principally on the underlying assets of the fund.

Also, for managers who have managed to raise multiple funds, and who have tried-and-tested subscription facility and NAV facility products agreed with lenders, the prospect of combining those products into a hybrid facility for the prospect of a slight degree of convenience or better pricing has not resulted in a significant move in the market toward hybrid facilities.

That being said, hybrid facilities have become a bigger element of the market for funding private debt funds, which reflects that the life-cycle of such funds can be shorter, and that the time it takes to deploy investor capital can be much shorter for private debt than private equity. These shorter time horizons make a hybrid facility more attractive. It simplifies the documentary process by only needing to negotiate and agree one facility agreement (and related documents), not two. It can reduce spend on bank fees and legal costs. And it can mitigate financing risk for the fund over its investment life.

A manager of a private debt fund is likely to take the view that a hybrid facility is more attractive than putting in place a subscription facility only in the first instance to find, maybe 12 months later, that the fund needs to move to an asset-backed NAV facility. The window for moving from one to the other could be very limited, and failing to execute a NAV facility in that period could risk either: (1) the fund not having access to sufficient bridge facilities to facilitate completions (which can be essential where a private debt fund is buying into private-equity-backed acquisition facilities which require "certain funds" on short time schedules); or (2) deploying investor capital too quickly without the ability for strategic short-term investment opportunities and the ability to reinvest capital commitments.

Termination of the investment period

On termination of the investment period, 70–80% of commitments should be drawn down or booked to service existing assets and costs. The fund will have acquired between 8 and 12 underlying assets, depending on its strategy. Following termination of the investment period, fund LPAs usually only permit drawdowns to complete investments which were secured before termination of the investment period and to meet liabilities (including fund financing and guarantees), taxes, indemnification expenses and so on. The fund limited partnership agreement typically enables 15–25% of commitments to be drawn down to make follow-on investments, which are intended to preserve or enhance the value of the fund's primary assets.

<u>NAV facilities</u>

NAV facilities are facilities made available to a fund with secured recourse to the portfolio of assets of the fund, and no recourse to the uncalled commitments of the investors of the fund. What that portfolio of assets will be will depend on the strategy of the fund in question. At one end of the asset class scale, a credit fund will have a pool of possibly several hundred loans and bonds. At the other end of the scale, a private equity fund will have a pool of what may be as little as a dozen private equity assets. The popular asset classes for NAV facilities are credit funds, secondary funds and fund of funds, but facilities in the real estate, infrastructure and private equity asset classes have increased over the last few years as well.

At this point, the different fund structures become important again. In the same way that for a subscription facility, the fund structure as it relates to investors is important (so bringing in parallel funds, feeder funds, etc.), for a NAV facility the fund structure as it relates to assets is important. Are the fund assets owed directly by the fund or through a series of holding companies – and if so, do those holding companies hold several assets or only one each?

In the case of a private equity fund, the fund will often form chains of three or four (or more) special purpose vehicles, the "top" SPV being owned by the fund and the "bottom" SPV being the entity which buys the private equity asset. The private equity fund will therefore have one chain of SPVs for every asset. In the case of a credit fund, however, the underlying loan assets are very often held by one or more holding companies, each of which holds a pool of loans. Real estate funds, infrastructure funds and secondary funds also all have varying asset structures.

The asset structure determines how the asset security is most efficiently taken. A typical credit fund structure is perhaps the most simple. Assuming the fund has a single holding company which it owns directly, and that holding company owns all the loans, the security package will normally be security from the fund over all the shares in the holding company, and security from the holding company over all its assets, which will include all the loans and all its bank accounts. This gives the lender the ability, on enforcement, either to sell the holding company through a straightforward share sale, taking with it all the underlying loans, or to sell the loans individually or in bundles. Plus, of course, it will have access to the bank accounts where proceeds from the underlying loans, whether of principal, interest or fees, are paid in the meantime.

A typical private equity fund is often the most complex in terms of the necessary security structure. Whilst not unheard of, it is not usual for private equity funds to use common holding companies through which they hold their assets, preferring instead chains of SPVs, each held directly by the fund as described above. This gives rise to two possible security structures. First, the fund can grant share security over each of the "topco" SPVs, giving rise (using our private equity fund example) to a dozen share charges. Each share charge needs to be granted under the jurisdiction of the relevant topco SPV; a Luxembourg share charge for a Luxembourg topco SPV, an English share charge for an English topco SPV, and so on. This would allow the lender on enforcement to sell each of the assets separately through individual sales of the topco SPVs, or a bundled-together sale of all 12 (or however many) topco SPVs at the same time, to the same purchaser.

Alternatively, the fund can do a restructuring exercise before the NAV facility is put in place, to insert one, or sometimes two, common holding companies between the fund and each of the topco SPVs. The security package would then be: (i) a share pledge over the shares in the new common holding company which now owns all the topco SPVs (the 'common asset holding company'), whether that company is a direct subsidiary of the fund or has the second common holding company between it and the fund; (ii) bank account security over the accounts of the common asset holding company and/or the bank accounts of the fund (and/or the second common holding company), depending on where distributions from the underlying assets are paid – it is often logistically easier to leave the bank accounts at fund level even though the assets move down to the common asset holding company; and (iii) all asset security from the common asset holding company.

This security structure would allow the lender to sell the shares in the common asset holding company on enforcement, taking with it all the underlying assets. On the face of it, this security structure would not allow the direct sale of the individual assets through sales of their respective topco SPVs, but this could be achieved on enforcement by taking control of the common asset holding company (rather than immediately selling it) and – through that control – selling the assets individually or in bundles.

The loan-to-value (LTV) covenant in NAV facilities is critical to lenders, and the constituent elements are usually heavily negotiated and very specific to the asset class concerned. Eligibility criteria, concentration limits and related "haircuts" are usual. The valuation methodology, frequency of valuations and the ability to challenge and require third party valuations, are also heavily negotiated.

A further feature of some NAV facilities, frequently seen for asset classes such as private equity, is a mandatory prepayment sweep of disposal proceeds if assets are sold. The sweep may not be 100% of net proceeds, and may not apply to all NAV facilities, even in the same asset class.

The lenders in the market who offer NAV facilities to funds overlap significantly with, but are not identical to, the lenders who offer subscription line facilities. And the NAV lenders vary from asset class to asset class, there being, as you would expect, more active lenders in the credit fund NAV facility market than in the private equity fund NAV facility market. Pricing, and LTV levels, are very different across the asset classes too, as in reality what was a broad single product at subscription line facility level, agnostic to asset classes, splinters into different NAV facility markets for each asset class. Pricing and LTV comparisons between asset classes are not that helpful as a result.

Mid-way through the liquidation period

The main focus following termination of the investment period is maximising exit opportunities for the underlying assets so that the general partner can generate a positive distribution curve and therefore carried interest. As the successor fund restriction will usually have fallen away, the general partner will also actively be considering its pipeline and raising capital for a follow-on fund. The fund may make follow-on investments during this phase to protect or enhance the value of the underlying assets. One would expect 80–90% of commitments to be drawn down as the fund life nears its close.

<u>Concentrated NAV facilities</u>

Continuing the theme of our private equity fund, as it moves through its divestment phase and successfully sells assets, it will reduce from having a pool of perhaps a dozen assets to a smaller pool of perhaps five or six assets. At this point, the original NAV lenders may wish to be repaid because the concentration risk with only five or six assets is too high for them, and new NAV lenders who are more comfortable with increased concentration risk will step in to provide a concentrated NAV facility. The small number of assets, which will continue to reduce as divestment continues, becomes a strong focus for the lender.

Valuations become more critical, and the lender will usually have stronger rights to challenge and require third party valuations, at the cost of the fund. A cash sweep for asset-distribution proceeds is more likely to be required, and more likely to be 100% or 75% of net proceeds rather than the lower percentages found for classic NAV facilities. The lender will have a more granular view of each of the assets, and may require full repayment upon any sale of the most valuable one or two assets. The lender will probably also require more asset-level reporting, and more frequent face-to-face meetings with the private equity executives in order to better understand and remain close to the asset disposal plans, process and progress.

End of fund life

Nearing termination of the fund's fixed term, typically 8–10 years following first closing, the general partner in most cases will be unable to draw down commitments from investors to fund further follow-on investments, and can probably draw those uncalled commitments solely to meet expenses and liabilities relating to the fund and its assets. Leading up to expiry of the fund term, the general partner will be considering whether to extend the life of the fund to maximise its ability to source exit opportunities and create value.

<u>Very concentrated NAV facilities</u>

At this point, the number of remaining assets is very low. NAV facilities at this time are much less available in the market, or at least not at a price and LTV attractive to the fund.

The facilities at this point broadly fall into two categories. It may be that all that is needed is a small working capital line to continue to fund the ongoing costs and expenses until the assets are sold. There will usually, at this end point in a fund's life, still be a small amount of uncalled capital which can, as indicated above, be called for these costs and expenses. Security over these uncalled commitments, when teamed with security over the underlying assets, can be sufficient for a facility with a very low LTV to be implemented.

The other type of facility at this point is where some LPs do not want the assets to be disposed of just because the fund life happens to be ending, whilst other LPs do want such a disposal. If a NAV lender can be found willing to provide a facility, that can be used to fund the final return of capital to the "want to leave" investors, whilst the "want to stay" investors can remain.

There are lenders that will provide these facilities, but they are typically relationship-driven lenders who will be very focused on the remaining assets. They will require considerable asset diligence, assuming they are not already familiar with the remaining assets, more akin in some respects to the diligence exercise required by a leveraged finance lender. They will want to understand in detail the rights of any remaining asset-level (acquisition finance) lenders, and the rights of any joint venture partners or minority equity holders.

Leveraged preferred equity facilities

It is at this point, when concentrated NAV Facilities become more difficult to implement, that another product seen in the market may make an appearance – a leveraged preferred equity facility. A preferred equity provider will provide an additional limited partnership interest to a fund in return for a preferred position, ahead of the "ordinary" limited partners, as and when further distributions from the remaining assets are received.

The position is akin to the position of a preferred shareholder in a company. It is possible for that preferred equity position itself to be leveraged, with security over that preferred equity position granted by the preferred equity provider to the lender. Whilst sometimes seen implemented at other stages of the life of a fund, leverage-preferred equity facilities can also make an appearance in place of the second form of concentrated NAV facility referred to above – i.e., when you have "want to leave" and "want to stay" investors.

Fund extensions

Most fund LPAs empower the general partner to extend the life of the fund by 12 months at its discretion, with a further 12-month extension available after that, either at its discretion or with the consent of the Limited Partner Advisory Committee. The decision whether to opt for the first extension will have been made before expiry of the term so during the first year, the general partner will be monitoring divestment opportunities and the activities of the portfolio companies to assess whether a further extension may be required.

If the general partner is of the view that opportunities cannot be maximised during the extension period, then it will seek to run a general partner-led secondary process. This can take the form of: (a) a tender offer of limited partner interests or of one or more of the fund's portfolio companies; or (b) a more complex secondary transaction such as a stapled secondary transaction, where investors in the fund are given the option to cash out their interests in the existing fund or elect to have their in-kind interests in the fund transferred to a new continuation fund, which may also be coupled with a refinancing, and new capital being injected into the continuation vehicle.

Continuation facilities

Facilities which are available at this late stage of a fund's life are very bespoke and provided by only a few lenders who, for relationship reasons, are comfortable with these facilities. In respect of the second option mentioned above, a stapled secondary transaction, a facility could be provided to the continuation fund, which could be a hybrid facility if the continuing investors have provided additional uncalled commitments, or a simple NAV facility based purely on the asset value of the assets transferred to the continuation fund. The proceeds of this type of facility are used to repay those investors who do not wish to participate in the continuation fund.

The terms of this kind of facility are essentially the same as any very concentrated NAV facility: much asset diligence or pre-existing familiarity for the lender; details of the proposed exit plans for the assets; mandatory prepayment on disposals; and low LTV.

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Australia

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Overview

The fund financing market in Australia continues to be buoyant in 2019. Private equity, infrastructure and real estate funds remain the main drivers of volume, with an increasing number of newly raised as well as existing private debt funds also capitalising on the market's additional liquidity and funding flexibility.

While there are no industry-standard data-reporting sources that track fund financing facilities in Australia, based on the transactions we have seen, and speaking to the major financiers active in the Australian market, the domestic market has experienced steady growth in the past two years. Based on anecdotal evidence from market participants, the size of the Australian market in fund financing for private equity, private debt, real estate and venture capital funds in Australia is estimated to be in the region of A$6.0bn to A$7.0bn. Adding infrastructure funds to that mix would increase the size to approximately A$8.5bn to A$9.8bn.

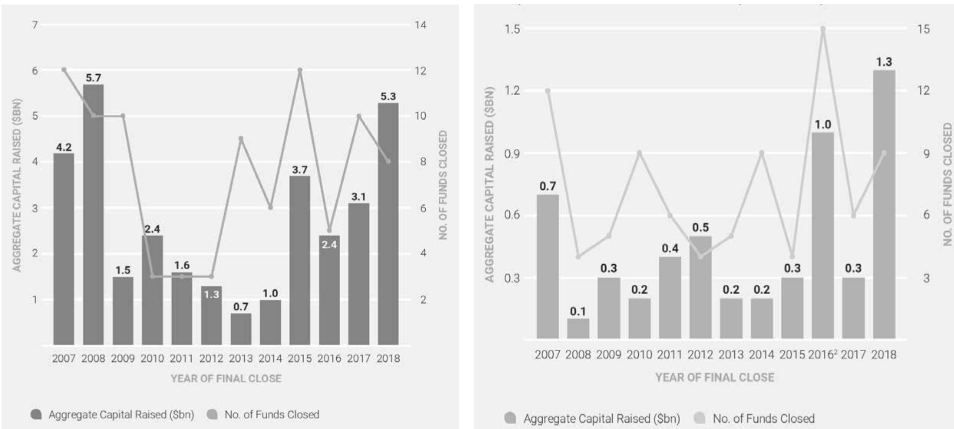
While the Australian domestic banks have remained active providers of fund financing, offshore commercial banks and investment banks have continued to grow their Asia-Pacific footprint into the Australian market. The media attention given to the Abraaj Group insolvency has seen an event of default of a subscription finance facility in the recent global fund finance market playing out publicly. This has resulted in certain knock-on effects on market practices in the assessment and implementation of a fund finance facility. Nevertheless, as the Abraaj case is based on its unique set of facts, and with the ability of the domestic fund finance market to maintain its track record of providing stable returns and having no known investor defaults, lenders' confidence in this asset class in Australia has not been dampened.

There has been some diversification in the market in terms of the type of facilities being offered, with some financiers and funds using subscription finance technology in structuring fund financings where the providers of capital are debt investors rather than equity investors, and some superannuation funds taking advantage of single-investor facilities. Nevertheless, capital call (or subscription finance) facilities and NAV-based facilities remain the dominant type of facilities used in Australia. Secured facilities continue to remain a relatively inexpensive means to obtain capital quickly for investment opportunities and working capital needs.

Sovereign wealth funds and superannuation funds are emerging as the significant investors in Australian funds, bringing new considerations for lenders' credit assessment and deal structuring. The increasingly stringent regulatory environment for traditional banks, both Australian and offshore, has fuelled direct lending activities of credit funds and superannuation funds, as well as further developing fund financing opportunities in the Asia-Pacific region.

The funds landscape in Australia

The Australian private equity and venture capital industry saw a continuation of significant fund activity over the course of 2018, with investment levels and fundraising remaining strong. Private equity and venture capital funds raised a record high of A$6.6bn in the 2018 calendar year.



Annual Australia-based Private Equity (left) and Venture Capital (right) fundraising 2017-18

Source: Australian Investment Counsel and Preqin, '2019 Yearbook – Australian Private Equity and Venture Capital Activity Report – May 2019'

Investments by the industry in 2018 increased significantly – which reflects a change from the softening trend seen in the market since 2016 – and aggregate buyout deal value increased from A$6.6bn in 2017 to A$12.5bn in 2018.[1] This strengthening trend looks set to continue, with A$10.1bn invested in the 2019 calendar year up until late June.[2]

Venture capital fundraising during the 2018 calendar year was A$1.3bn – a record year, and the first in which aggregate capital raised exceeded $1bn.[3] This eclipsed by some margin the A$300m raised in the 2017 calendar year.[4] Venture capital investment had a particularly strong year in 2018, with investment levels for the 2019 calendar year up until the end of September being close to A$608m.[5] Dry powder levels have also increased to A$11bn. As an indicator for the fundraising outlook for 2019, following several years of strong fundraising, the aggregate capital targeted by the private equity and venture capital industry is lower as at February 2019 (A$2.6bn) compared to the same point in both 2017 (A$5.3bn) and 2018 (A$6.1bn).[6]

The demand for infrastructure and the increased availability of debt financing, together with the high levels of dry powder available to fund managers, have led to increased competition across most asset classes, particularly infrastructure assets. Infrastructure is one of the fastest-growing asset classes globally, with target infrastructure allocations increasing significantly over recent years. In particular, public and private sector superannuation funds and sovereign wealth funds have demonstrated greater appetite for infrastructure over the past year, both by way of equity and private debt investments. During the first half of 2019, unlisted infrastructure funds raised approximately A$41.4bn, which closely mirrors activity in the corresponding half of 2018, when A$44.3bn was raised.[7]

The availability of capital, the chase for alpha by funds, and near-zero interest rates at central banks like Japan and Europe, has seen alternative assets becoming an attractive asset class globally, given such assets' ability to provide historically stable returns. While Australia's private debt market is still in its infancy compared to other regions, there has been a marked increase in the number of debt funds entering the market – both existing funds as well as newly established ones – whose sole mandate is to invest in debt assets. The Australian private debt market currently exceeds A$2.7tn and has been growing at a compound growth rate of 7.6% since 2003.[8] Private debt funds in Australia being tracked have raised approximately US$1.089bn over the last 10 years, and the estimated dry powder is US$328m.

Fund formation and finance

Fund formation and new developments

In regard to fund structure, Australian funds are predominantly set up as a unit trust or a series of stapled unit trusts. Typical limited partnership structures do not offer the same beneficial tax treatment afforded to a trust and are therefore a less popular funding structure in Australia. While common in Australia, a unit trust is not considered a standard investment vehicle in many other jurisdictions.

Australian funds may also be set up as venture capital limited partnerships (***VCLP***) under the *Venture Capital Act 2002 (Cth)* to take advantage of certain tax benefits, especially for foreign investors. However, VCLPs can only invest in Australian businesses with total assets of not more than A$250m by acquiring shares, options or units.[9] It is not uncommon for Australian mid-market private equity funds to be structured with a VCLP stapled with one or more special purpose trusts in order to provide greater flexibility for investment.

As mentioned in our previous articles, the Australian Government announced that it will introduce two CIVs as a tax-effective alternative to current Australian pooled investment trusts, the aim of which is to grow Australian's share of the global mobile capital. The new vehicles will be a corporate CIV (***CCIV***) (which has been modelled on the English and Welsh open-ended investment company (***OEIC***) and the Luxembourg SICAV) and a limited partnership CIV (***LP CIV***). The legislation in regards to the introduction of these vehicles remains in the consultation stages with the Federal Government.

It is expected that the availability of these new CIVs will significantly enhance the competitiveness of Australian funds by allowing fund managers to offer investment products using vehicles that are commonly used overseas and better understood by foreign investors than our current, trust-based funds.[10] Until the law is finalised, it remains to be seen what these new structures will entail and in turn, the ultimate uptake by investors of these new fund types.

Fund documentation

Unlike many offshore funds, it is not common for Australian fund documentation to include provisions that expressly contemplate fund financing facilities, including the grant of the required specific security over capital commitments, the ability to make capital calls by the fund to repay debt during and after the investment period, or mechanics to facilitate investors consenting to security being given by the fund. Typically, the fund documentation does contain a general permission for the fund to borrow, give guarantees and the ability to grant security. As the market is maturing, we have seen Australian fund documentation develop – albeit the process remains gradual – to import the technology utilised in offshore fund documents to cater specifically for capital call financing, particularly for new vintage funds raised by managers that have utilised these fund financing facilities in the past.

As mentioned above, a common fund structure in the Australian market is that of stapled fund entities. One focus for lenders is whether the trust deed or partnership agreement allows for cross-collateralisation of investor commitments in the stapled funds.

Fund document terms vary depending on the asset classes and investment strategy of the particular fund. Accordingly, it is essential to ensure that the credit and security terms are consistent with the fund document terms, and that the lender is able to properly enforce its securities. While investor-side letters are a common feature, financing provisions are seldom integrated in those documents.

Another key consideration when drafting the fund's governing documents is to ensure that investors explicitly allow the fund to pledge all capital commitments. There should also be express wording included whereby each investor acknowledges its obligation to make the capital contributions without any right of set-off, counter-claim or waiver. These provisions are fundamental to protect a lender. If this authorisation is not included in the partnership agreement/trust deed, lenders will generally require that investors deliver consent letters in connection with a fund financing. This is discussed in more detail in the section, 'Investor consent', below.

<u>Types of financings</u>

In the Australian market, fund financing facilities are more commonly provided on a bilateral or club basis rather than syndicated. Funds utilise fund financing facilities for two primary reasons. For those funds that have longer-term investments, such as infrastructure, property or private equity, the facility is used to provide certainty of funding during the asset-acquisition phase. Funds that have shorter-term investments or are more likely to have prepayments, such as mezzanine debt, prefer to use the facility to provide an internal rate of return boost for the fund. In terms of product diversification, capital call facilities and NAV facilities are the predominant product types used in Australia, with pockets of activity in relation to hybrid facilities, umbrella facilities and unsecured facilities. Interest in facilities to be provided to separate managed accounts (***SMA***), as well as general partner facilities, has begun to emerge in the Australian market.

Australian fund financing facilities are typically traditional capital call facilities, generally structured as senior-secured, revolving-loan facilities. It is common for fund governing documents to limit the use of borrowings to relatively short-term borrowings (90 to 364 days). Terms of facilities are generally structured in alignment with a fund's investment period, and are usually for less than three or four years. While term and revolving loans are the norm, lenders are also open to provide letters of credit and bank guarantee facilities to meet the financing and investment needs of the fund. These facilities are mostly committed, although some lenders may make uncommitted facilities available on an exceptions basis. The obvious driver for uncommitted facilities is that it means that commitment fees need not be payable. However, this needs to be balanced with the risk the fund bears for funding uncertainty.

Domestic lenders have also provided NAV-based financing to funds, which are secured against the underlying cash flow and distributions that flow up from the underlying portfolio investments or the equity interests of holding companies through which the fund may hold such investments. These types of facilities are attractive to funds, particularly private equity or special situations funds, where there is an urgent requirement for liquidity at the fund level, but no distributions from the portfolio imminent. They require the lender to "look down" for recourse against the underlying investments, rather than "looking up" to the investor commitments. The creditworthiness of the investors of the fund is less important than the value of the underlying assets. The returns for lenders are generally higher than the returns for traditional capital call facilities or asset-backed facilities. However, lenders providing these facilities may be structurally subordinated to other lenders that have provided finance that is secured directly against the underlying portfolio companies. These types of facilities may increase in popularity as the 'dry powder' of private equity and venture capital funds in Australia decreases, and as funds approach the end of their investment periods.

Hybrid facilities, where the facility is secured by both the uncalled capital commitments of the fund as well as the underlying portfolio assets of that fund, may be used by funds that have started to mature in terms of their investment lifecycle. Facilities provided to a SMA are provided on the back of the credit of the uncalled capital commitment of that investor in the fund through which the SMA's portfolio of asset is held. Given the dependence on the single investor commitment, among other things, a clean due diligence of that investor and its unconditional commitment is often mandated by lenders. In the case of a general partner facility, the facility is used to finance the general partner's commitment, as well as associated working capital expenses, into the fund.

As mentioned, hybrid, general partner and SMA facilities are less prevalent in Australia compared to the other, abovementioned facilities. These facilities are also bespoke in structure and, in the case of hybrid facilities and general partner facilities, are often provided by incumbent financiers that have previously provided the capital call facilities to those funds.

<u>Security arrangements</u>

The defining characteristic of the capital call facility is the security package, which comprises the fund granting security over:

- the rights to call the unfunded capital commitments of the fund's investors and to enforce the associated rights under the fund documents to call capital; and
- the deposit account into which the investors deposit their capital call proceeds.

Security is not typically taken over the underlying assets of the fund. The specific security is usually supported with an express power of attorney granted by the general partner of the fund in favour of the lender. This allows the lender to exercise capital call rights in a default scenario.

Where the fund is Australian or is otherwise subject to the *Corporations Act 2001* (Cth) (***Corporations Act***), the specific security may be accompanied by an all-assets security interest that operates as a 'featherweight' security to minimise moratorium risk on an administration of the fund. The introduction of the *Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Act 2017* (Cth) (the ***Ipso Facto Laws***), with effect from 1 July 2018, has resulted in a renewed focus on the need to consider the inclusion of this 'featherweight security'.

The Ipso Facto Laws amend the Corporations Act to, among other things, introduce a stay on the enforcement of certain rights that one party (***Enforcing Party***) may have against a counterparty under a contract, agreement or arrangement due to specified insolvency events (the ***Trigger Events***). Rights stayed include acceleration, termination and enforcement of security. Where the stay applies to a right, the Enforcing Party needs permission of the court or the relevant insolvency practitioner to enforce the relevant right. One of the notable exemptions from this stay is where the financier has security over all or substantially all of the assets of the borrower, and a 'featherweight' security will fall within this exemption.

Nevertheless, the security structure depends on the nature of fund and the credit requirements of the respective lender. For example, a recent loan facility for a large Australian infrastructure fund, utilising features of a capital call financing, was supported by an irrevocable power of attorney under which lenders had power to exercise capital call rights of the fund upon a default, rather than a security interest over those rights and accompanied by security over the collateral account into which call proceeds were deposited. This transaction is considered very bespoke, but is nonetheless a low-water mark in terms of the tolerance of lenders for minimum collateral requirements.

Security is typically granted by the fund and the trustee or general partner (as applicable), as they will hold the deposit account, the rights to call capital and related rights. Where the borrower is a portfolio special purpose vehicle of the fund, a guarantee from the head fund may also be required. In Australia, it is common for the general partner or trustee to delegate the power to call capital and other functions to a manager. If there is a delegation of the power to call capital to a manager, or a custodian arrangement is put in place, security is usually sought from the manager and custodian, as applicable.

The lender will need control over the deposit account to enable it to secure capital call proceeds upon a default. The deposit account may be required to be opened with the lender on day one of the facility, but this is not always mandated. Where the deposit account is held by another Authorised Deposit-taking Institution (***ADI***)[11] who is not the lender, an appropriate account control arrangement between the lender, the ADI and the account holder will be required, such as an account bank deed. Where the lender holds a security interest over an account maintained by another ADI, the security interest in that ADI account is perfected by registration of a financing statement on the Personal Property Securities Register (***PPSR***).

However, without an account control arrangement, any security interests which the ADI takes in respect of the account will have priority over the lender's security interest (even if perfected by registration on the PPSR), because the ADI is said to have perfected its interest by control over the account for the purposes of the *Personal Property Securities Act 2009* (Cth). Where the bank accounts are held outside of Australia, it is necessary to seek advice from foreign counsel regarding the fund documentation and security arrangement.

Investor consent

An investor consent letter serves three main purposes:

- The fund gives notice to the investor of the loan facility, the security over the trustee/general partner's rights to make a capital call against that investor and, upon a default, the ability of the lender to make such a call to the exclusion of the trustee/general partner.
- The fund directs the investor to pay any capital calls at the direction of the lender upon a default under the financing.
- The investor acknowledges such arrangements in favour of the lender, giving the lender privity of contract and, accordingly, the ability to have direct recourse to that investor.

The letter can also be the instrument under which the investor agrees to waive certain of their set-off rights and sovereign immunity rights. In some situations, funds may be sensitive about approaching investors to obtain such a letter because of the administrative burden. The investors may themselves be reluctant to provide such acknowledgment. In these situations, the lender needs to evaluate the reputation and creditworthiness of the underlying investor to see whether the uncalled capital commitments remain commercially 'bankable' despite the lack of a direct acknowledgment.

More sophisticated funds (particularly those established in the Cayman Islands and British Virgin Islands) have investor acknowledgments built into the fund documents, which avoids the need for separate investor consent letters. Australian fund documents generally do not contain such an acknowledgement. In Australia, as a minimum, notice of the assignment and security interest granted in favour of the lender should be given to the investors to satisfy the common law rule in *Dearle v Hall*,[12] which provides that where there are competing equitable interests, the person to first give notice to the debtor gets priority. The notice should contain a short statement confirming the name of the security document, its date, the parties to the document, and that the security comprises an assignment of the call rights and the related proceeds. The notice should explain to whom the obligations are owed, especially once there is an event of default under the loan facility. Depending on the governing law of the security document, the security perfection requirement of that jurisdiction should also be adhered to.

In Australia, investor consent letters are still obtained but have become less common, with a number of fund borrowers having successfully resisted these requirements, particularly where the relevant provisions are included in the fund documentation in a form acceptable to the lenders. In our experience, for funds where investor consent letters cannot be obtained, notices of the assignment and security interest may be given at the time of the grant of security or by way of notice in the next regular newsletter to the investors. However, the latter approach has become increasingly uncommon as a repercussion of the Abraaj case (see below in relation to developments after the Abraaj case). The form of this notice is agreed in advance with the lenders and the actual issue of such notice is monitored. However, as is always the case, each transaction is determined on its merits, and rarely does one deal replicate the next.

Key developments

Sovereign wealth funds and sovereign immunity

In the past five years, there has been a significant increase in sovereign wealth fund investors in funds, as well as the size of their investments. In 2018, the total assets of sovereign wealth funds globally was in excess of $7.45tn.[13] Given their prevalence and size of their investment, and with the maturing market and commonality of various sovereign wealth funds as investors across different funds, lenders have become more familiar and commercially comfortable with their quality of credit.

Sovereign immunity, which may protect a sovereign wealth fund or other foreign or domestic government body from enforcement action or shield them from liability in its entirety, has become a focus area for lenders. Whether an entity has the benefit of immunity is a matter of the local law where the sovereign wealth fund or government body is established, and a function of the ambit of the local law as to which matters the immunity applies. It is worth noting that commercial transactions of a sovereign entity tend to be an exception to the immunity coverage.

In Australia, the *Foreign States Immunities Act 1985* (Cth) provides that a foreign state is not immune with respect to a commercial transaction.[14] A commercial transaction is a commercial, trading, business, professional, industrial or like transaction into which the foreign state has entered, or a like activity in which the state has engaged. It is a broad concept and includes an agreement for a loan or some other transaction for, or in respect of, the provision of finance and a guarantee or indemnity in respect of a financial obligation. Therefore, entry into a fund finance facility will be considered a commercial transaction rather than a governmental action, so immunity will not apply.

In a default scenario, where a sovereign wealth fund has assets in Australia, if a lender has obtained a judgment overseas with respect to that entity, the judgment may be recognised under the *Foreign Judgments Act 1991* (Cth). However, this Act only applies to the superior courts in select countries, such as the United Kingdom, Cayman Islands and Switzerland, with a notable exception being the United States.[15] For excluded countries, the common law provides that the lender may enforce a judgment obtained in a competent court of a foreign country by bringing an action for a liquidated sum, relying on the foreign judgment as imposing an obligation to pay.

In our experience, where an investor has the benefit of sovereign immunity, there is generally no express waiver of such immunity. Rather, the investor typically expressly restates such immunity and requires the fund to acknowledge this. Where there is an investor consent letter provided in favour of a lender, a similar acknowledgment of sovereign immunity is typically required in the consent letter, with a further acknowledgment from the investor that, notwithstanding the immunity, the investor's obligations under the fund documents, including to make payment to the fund, apply. Lenders with longstanding relationships with the relevant investors may be willing to allocate borrowing base credit for their commitments based on prior dealings with them, but this is carefully analysed on a case-by-case basis and advance rates are generally discounted.

SPV investor structural issues and confidential investors

Some investors may choose to invest in a fund via a special purpose vehicle (***SPV***) rather than investing directly into that fund. Where an investor implements a SPV structure, one issue that the lenders face is to determine where the ultimate credit of the investor lies.

While lenders can obtain a level of comfort by performing due diligence on the SPV and the financial robustness of that SPV to assess whether that entity is sufficiently capitalised to meet capital calls, lenders will look for recourse to the ultimate investor. Under Australian law, lenders will encounter the legal obstacle of the requirement for privity of contract. In order to get direct recourse to the ultimate investor of that SPV, a contractual nexus between the ultimate investor and the lender will need to be established. In practice, lenders will often receive an acknowledgment from the ultimate investor in favour of the lender with regards to its liability in respect of the obligations of the SPV entity. It is usually a matter of commercial negotiation as to the level of assurance the ultimate investor is required to provide. In terms of the spectrum of comfort that an ultimate investor usually provides, it ranges from a direct acknowledgment that it guarantees the performance of the SPV's obligations, to letters of comfort from the ultimate investor that the SPV is its subsidiary and that it will use best efforts to ensure that the SPV has sufficient resources to meet its limited partnership agreement of fund document obligations.

Moreover, we have observed the emergence of confidentiality provisions in investor side letters that may restrict a fund from disclosing certain investor details, including the identity of that investor or the ultimate investor, to a lender. This has raised issues for lenders' ability in assessing the creditworthiness of that investor, and the bankability of the fund generally.

Notice of security and assignment post-Abraaj

In Australia, providing notice of the assignment and security interest granted in favour of the lender to the investors is part of the security package of a lender for a capital call financing. It is not uncommon for general partners to request that the provision of this notice be deferred to the next regular investors' update given by the fund; typically, this is the next quarterly update following the fund entering into a secured financing. This leaves a potential three-month gap between the close of the secured financing transaction and investors being given the notice.

Without commenting on the factual detail of the case, it has been alleged that the investment manager of Abraaj Private Equity Fund VI (***Abraaj Fund***) suspended operations and released its investors from their commitments in February 2019. We understand one key issue lenders had is whether the Abraaj investors received notice of the fund entering into the secured financing transaction prior to this release. Under Australian law, the period between when a secured financing transaction closes and the notice is issued to the investors can potentially expose lenders to a risk that their security may rank behind any prior equitable interests.

It is now considered best practice to require the fund to provide the notice to investors contemporaneously with financial close. In some cases, for financings that have already closed, financiers have required the fund to send a separate notice to the investors ahead of the next quarterly meeting. Additional protections, further restricting the ability to unilaterally amend or release an investor's obligations without the prior written consent of the lender, are also emerging.

<u>Superannuation funds</u>

Superannuation funds remain key candidates for development in the Australian fund finance field. At the end of the June 2019 quarter, the assets under management of Australian superannuation funds in aggregate were approximately A$2.87tn, growing by 6.2% in total superannuation assets.[16] Larger superannuation funds continue to grow in sophistication, evolving from being passive investors by investing through fund managers to becoming actively involved in direct investment in assets via co-investment structures or in their own capacity. In addition, like the pressures of other private capital funds, the pursuit of positive returns by superannuation fund managers has also seen superannuation funds becoming increasingly active in direct lending more generally, and not just in areas where it is necessary to 'plug the gap' in industries where typical lenders are pulling back.

It is important to note that there is a prohibition in the *Superannuation Industry (Supervision) Act 1993* (Cth) (the ***SIS Act***) that restricts the scope of the types of borrowings a superannuation fund may undertake and the granting of security over the fund's assets. Subject to certain exceptions, a trustee of a regulated superannuation fund must not borrow money, or maintain an existing borrowing of money.[17] By employing innovative funding structures that utilise the technology of fund financing methods, there is the potential to allow superannuation funds to facilitate their investments in Australia with fund finance facilities.

The Australian Prudential Regulatory Authority (***APRA***) has recently been granted new powers in relation to the regulation of superannuation funds. These new powers allow APRA to take action against the trustees of underperforming superannuation funds. This means that APRA can now proactively direct how superannuation funds deploy their capital.

The Treasury Laws Amendment (Improving Accountability and Member Outcomes in Superannuation Measures No 1) Act 2019 (the ***Superannuation Act***), which mostly came into effect from 6 April 2019, provides APRA with a broad and long sought-after directions power. It also gives APRA the power to take civil penalty action against trustees and their directors for breaching their obligations to members, including the duty to act in the best interests of members.

The Superannuation Act significantly strengthens APRA's ability to direct trustees towards improved outcomes for members, and to address underperformance at an early stage.

Acting in the best interest of members may even require underperforming funds to merge or exit the industry in some circumstances. This will likely result in significant changes and consolidation in the superannuation funds landscape in Australia.

Debt funds

The increase in non-bank direct lending activity in the Australian debt fund sector over the past 12 to 18 months is an exciting development. Private debt as an asset class is well entrenched overseas (particularly in Europe and North America), but it has traditionally not been popular in Australia among institutional investors. In Australia, the private debt market is traditionally dominated by the 'big four' domestic banks, but there is growing evidence that such dominance in this asset class is now being challenged.[18] The number of non-ADI lenders is growing, along with the volume of loans and a more diversified product offering. There are now over 100 non-ADI lenders in Australia with aggregate loans of approximately $150bn.[19]

This dominance of the 'big four' banks is being eroded for a number of reasons. The Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (the ***Royal Commission***) revealed a decade of poor bank behaviour and inappropriate lending practices that has led to an increased level of caution in the banking sector, with debt sponsors and borrowers seeking alternative sources of capital. Banks are also under increasing pressure from new prudential requirements to lift their capital adequacy and improve the quality of the capital they hold.

Recently, off the back of an APRA report in May 2019, the big four banks were required to increase their minimum capital requirements from between A$500m to A$1bn.[20] In 2018, APRA also increased the capital requirements for the big four banks by between four and five percentage points of risk-weighted assets. This naturally leaves a bigger gap (approximately A$50bn by 2023) for other debt providers to fill, which they are starting to explore.[21] As the growth of debt funds continue, so too will the demand for fund financing activities to fuel their liquidity requirements.

Separate managed accounts (SMA)

There has been a noticeable increase in interest to use separately managed accounts (***SMA***) as a way of investing, with this trend expected to continue. SMAs are a managed investment product held by an investor and overseen by an investment manager. The demand for SMAs is driven by the need of investors for investment solutions that are more tailored than those available via a sponsor's main commingled fund. In line with the proliferation of SMA activity, is the potential for a new market for financing opportunities for such investors. However, with the single investor concentration risk, the credit underwrite for such financings is bespoke, and very much dependent on the identity of the relevant investor. To date, lenders' appetite for financing SMAs in Australia has been subdued.

Aftermath of the Royal Commission – tempers or drivers for growth?

The year 2018 was a significant one for the financial services sector in Australia, with the Royal Commission established to inquire into the conduct of financial services entities to further ensure Australia's financial system is working efficiently and effectively.

While the Royal Commission mainly focused on the retail market, the role and power of ASIC and APRA in regulating the banking and superannuation industry was considered as part of the Final Report. The Final Report in relation to the Royal Commission recommended that court action should be the starting point for enforcement action and that infringement notices (which have traditionally been a common enforcement tool) should only be used for administrative failings, and rarely for large corporations.[22] Both ASIC and APRA have committed to act on the Royal Commission recommendations directed to them, and have publicly announced their planned actions for each recommendation and the matters referred to them for investigation.[23]

To complement the financial regulators' new-found mandate and zeal to litigate, the Government provided a record level of funding to both ASIC and APRA, which will enable the financial regulators to strengthen and intensify their enforcement and supervision activities. The Government has also committed to establishing a financial regulator oversight authority to ensure that ASIC's and APRA's effectiveness in delivering on their mandates is subject to consistent and ongoing independent assessment.[24]

The upshot of this is the potential for increased vigilance by banks and superannuation funds in how they conduct business, including their approach to lending and investing. To the extent the corollary of this is a possible dampening of market activity by those market participants, it will also present an opportunity for private capital funds to fill the void.

Shadow banking regulation – potential disruptor?

A continuing development in Australia in 2019 is APRA's growing interest in the shadow banking sector and its expanding purview to encompass shadow banking participants. APRA's prudential requirements (in particular, those relating to capital adequacy) apply only to Authorised Deposit-taking Institutions (***ADIs***), and this has resulted in those regulated lenders retreating from certain sectors, including residential property development. The shadow banking sector has been active in trying to bridge this funding gap.

While direct lending activities in Australia are still statistically much lower than in Europe and the US, the shadow banking sector has grown sizeably in the last two years, as detailed above. This has not escaped APRA's attention. In 2018, the *Treasury Laws Amendment (Banking Measures No 1) Act 2018* (the ***ADI Act***) was passed, granting APRA a reserve power to make rules in respect of the lending activities of non-ADI lenders. While the Government is of the view that non-ADI lenders are not materially contributing to risks at the moment, this reserve power is a new 'tool on the shelf' that APRA can use to manage risks should they emerge in the future.[25] The ADI Act also imposes a requirement on non-ADI lenders to register with, and provide data to, APRA to enable APRA to monitor non-ADI lending activity and determine when to use its reserve power.

At this stage, while still early, total debt financing for the non-ADI sector has remained steady overall, but grown rapidly in respect of housing credit despite the ADI Act. Any chilling effect that the ADI Act may be having on the direct lending industry is not yet clear.

The year ahead

We expect that the Australian fund financing market will continue its steady growth trajectory in 2020. We anticipate the drivers for growth will be from the new offshore lenders, testing the waters in the Australian market as part of the organic expansion of their global footprint, as well as new funds taking up these avenues of liquidity. Product diversification will continue, with facilities that employ a subscription financing technology but without the traditional equity investment structure, and more lenders looking at hybrid, general partner and SMA facilities as ways to build stronger relationships with their sponsors.

Lending to private equity, venture capital and infrastructure funds will continue to dominate the Australian fund financing market; however, real estate funds, debts funds and superannuation funds will remain the key potential growth areas. With the retreat of traditional banks in risk-weighted assets, the debt funds will thrive to bridge this funding gap and satiate the appetite of investors in increasing allocation to private debt assets.

We wait to see what the impact of the headwinds from regulatory changes in the banking and superannuation industry will be on the fund finance market. Until then, with Australia still being considered an investment haven with its favourable political and economic stability in comparison to other jurisdictions, we are optimistic that the demand for fund financing capabilities to support the ongoing investment mandate of funds in the region will remain robust.

* * *

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Belgium

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Overview

According to the Belgian Financial Sector Federation (FEBELFIN), in the first quarter of 2019, the Belgian fund sector grew by 1.4%, driven by increases in the prices of underlying assets. At the end of March 2019, the net assets of publicly marketed funds in Belgium reached €190.0 billion (https://www.febelfin.be/fr/journalistes/article/chiffres-du-secteur-des-opc-1er-trimestre-2019).[1]

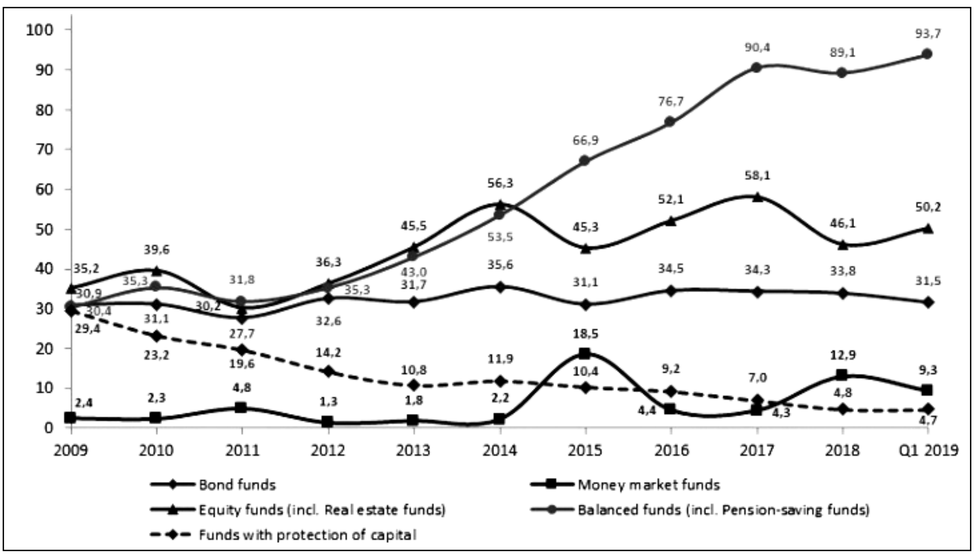

Fig.1 – Belgian funds mark during the last 10 years

In the group of funds investing mainly in fixed-income securities, the assets of bond funds marketed in Belgium fell by €2.3 billion, or 6.8%, during the first quarter of 2019, and thus represented an amount of €31.5 billion at the end of March 2019. Four-fifths of this change is due to falls in the prices of underlying assets.

The net assets of money market funds fell by €3.7 billion, or 28.3%, between January and March 2019.

In the group of funds investing mainly in variable income securities (such as equity funds, for example), and with the exception of capital protected funds, only upward trends were noted during the first quarter of 2019, mainly as a result of price increases recorded by the underlying assets of these funds.

The assets of equity funds in Belgium increased by €4.1 billion, or 8.8%, between January and March 2019. This increase is mainly due to net subscriptions (mainly as a result of technical interventions at portfolio level). At the end of March 2019, outstanding equity funds amounted to €50.2 billion.

The mixed funds category (including pension savings funds) increased by €4.5 billion, or 5.1%, in the first quarter of 2019.

At the end of March 2019, public funds under Belgian law represented total net assets under management of €155.5 billion. At the same time, pension savings funds represented €19.7 billion, or ⅛ of the public funds under Belgian law.

Since the Royal Decrees of 18 December 2007, tailor-made investment vehicles can be developed for institutional investors in the form of "institutional UCIs with a variable number of units". These institutional funds are non-public funds that must be reported to FPS Finance.

These institutional funds should not be confused with public funds with non-retail share classes, which are registered with the FSMA.

At the end of March 2019, the 141 institutional sub-funds under Belgian law represented net assets of €15.9 billion.

Private equity-backed vehicles in Belgium are usually financed through traditional secured term loan facilities, either on their own account or by private investors' capital. Belgian banks do not have a monopoly to grant loans to professional borrowers.

There are restrictions on cash borrowing, depending on the type of fund concerned. UCITS funds are strictly capped in the borrowed amounts, and restricted to specific purposes. Alternative collective investment funds (AIFs) are restricted in their borrowings due to their national legislation. Some AIFs may borrow at higher levels to leverage the funds' investments.

Fund formation and finance

The use of leverage in investment funds in the EU is regulated by the Alternative Investment Fund Managers Directive 2011/61/EU (the "AIFMD") dated 8 June 2011, UCITS Directive 2009/65/EC dated 13 July 2009 ("UCITS Directive"); and the CSR Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS CESR/10-788 dated 28 July 2010.

The AIFM and UCITS Directives impose regulatory requirements and processes on sound and effective risk management which must be consistent with the risk profiles and rules of the funds which are managed.

<u>The UCITS Directive</u>

The law of 3 August 2012 regarding collective investment undertakings compliant with the Directive 2009/65/EC and undertakings for investing in debt-claims, as amended,[2] and the Royal Decree of 12 November 2012 ("RD 2012") with respect to undertakings compliant with the Directive 2009/65/EC,[3] as amended,[3] implemented the UCITS Directive in Belgium.

A UCITS is allowed to borrow up to 10%[4] of the fund's NAV on a temporary basis and not for investment purposes but, for example, for liquidity purposes (article 139 RD 2012).

Belgian investment funds (UCITS/AIFs) have hardly any financial leverage, therefore the fund finance market is less developed than in some neighbouring countries. The liquidity risk resulting from a potential mismatch in the liquidity of an investment fund's assets and its redemption profile is considered the most important risk.[4] To mitigate this risk and to promote an effective liquidity risk-management process, the Financial Services and Markets Authority (FSMA) has drafted a proposal on legislative changes that would make additional liquidity management tools available to all Belgian public open-ended funds including swing pricing,[5] anti-dilution levies[6] and redemption gates.[7]

A Royal Decree of 15 October 2018 entered into force on 15 November 2018 introducing the possibility for collective investment undertakings to use additional instruments to manage their liquidity risk under certain conditions,[8] i.e.:

- *Swing pricing*: This is a mechanism that aims to eliminate the negative impact on the net investment value (NAV) of the UCITS or one of its compartments. Swing pricing is an accounting intervention in the calculation of the NAV. The NAV shall be increased or decreased by the swing factor on the date of the large net entries and exits. In the then subsequent calculation, the NAV, subject to the application of the swing pricing mechanism, shall return to the normal level.
- *Anti-dilution levy*: Like in swing pricing, this is a mechanism to eliminate the negative impact on the NAV of an UCI or one of its compartments, that is caused by the entry and exit of the participants in the UCITS. The anti-dilution levy shall be applied only after an explicit decision of the UCITS or the management company. In contrast to swing pricing, there is therefore no automatic application of this mechanism. The decision applies both to the level of the threshold and the additional costs, and the question as to whether or not to use the mechanism when the threshold is exceeded.
- *Redemption gates*: The UCITS or its management company can decide through this mechanism to only partially execute the orders of the outgoing participants if the predetermined threshold is exceeded. As the orders are partially executed, the calculation of the NAV itself is not suspended. By using the redemption gates, the UCITS or its management company is given more time to market the underlying assets in the event of large redemptions. This is a measure that is pre-eminently used in stress situations. This measure shall be introduced on top of the existing option to completely suspend entry and exit under certain circumstances. The information regarding the use of these measures must be included in the prospectus, the periodic reports and the articles of association or the management regulation.

A UCITS or a management company that wishes to make use of at least one of these three options must establish a clear policy in advance and explain the conditions under which these shall be applied. In its policy, it must pay special attention to conflicts of interest that may result from the use of these instruments.

<u>AIFMD</u>

The law of 19 April 2014[9] regarding AIFs and their managers ("Law of 19 April 2014"), as amended, implemented the AIFMD. Pursuant to article 93, paragraph 2 of the Royal Decree of 25 February 2017 regarding certain public AIFs and their management companies,[10] borrowing is only allowed up to 10% of the fund's NAV on a temporary basis.

The FSMA[11] examined the concept of leverage as defined in article 3, 58° of the Law of 19 April 2014, designating 'any method by which the AIFM increases the exposure of the AIF it manages, whether through borrowing cash or securities, through derivative positions or by any other means'. The FSMA accepts that loans made by an AIF's shareholders do not constitute leverage within the meaning of the law in cases where they are an economic substitute for the AIF's capital. In such cases, the manager cannot be considered to be increasing the exposure of the AIF as a result of the loan.

The FSMA therefore takes the view that loans meeting the conditions set out below do not constitute leverage:

- The loans are made by the AIF's shareholders, to the exclusion of any other person. The loans are inseparably linked to the shares held by the shareholders in question: if the shares are sold, the associated loan is also transferred. Moreover, each shareholder shall subscribe loans in proportion to its participation.
- The loans in question are fully subordinated to all other claims (other than similar shareholder loans), whatever their origin, and are not secured by any pledge of the AIF's assets.
- Interest payments may not be suspended by the AIF without incurring late payment charges (or another financial sanction).
- The maturity of the loans in question is no earlier than the AIF's maturity date. The loans cannot be repaid early, unless the AIF itself should decide otherwise, under conditions that ensure the capacity of the AIF to meet its short-and long-term obligations.

The Royal Decree of 15 October 2018 introduces the possibility for AIFs to use additional instruments to manage their liquidity risk under certain conditions. Please see *supra*, Re. UCITS, point 1.

Real estate vehicles

Under the Belgian REIT regime, a collective undertaking investing in real estate can either take the form of:

- a SICAFI/Vastgoedbevak (*société d'investissement en immobilier à capital fixe/ vastgoedbeleggingsvennootschap met vast kapitaal*), AIF;
- a FIIS/GVBF (*fonds d'investissement immobilier spécialisé/gespecialiseerde vastgoedbeleggingsfonds*) AIF; or
- a SIR/GVV (*société immobilière réglementée/gereglementeerde vastgoedvennootschap*), commonly referred to as BE-REIT, not an AIF.[12]

Whereas the SICAFI/Vastgoedbevak is an AIF, and subject to all the conditions of an AIF under the Law of 19 April 2014, a BE-REIT is exempt from the AIF legislation on the condition that it mainly engages in an operational activity instead of a straightforward investment activity. All Belgian SICAFI/Vastgoedbevaks were therefore converted into BE-REITs before the AIFMD entered into force in Belgium.

Three different BE-REIT regimes currently exist in Belgium, namely: (i) the stock-listed or retail REIT (BE-REIT); (ii) the non-stock listed institutional BE-REIT; and (iii) the non-stock listed social BE-REIT dedicated to investment in social housing. The BE-REIT includes participation in Public Private Partnerships ("PPS") directly or through joint ventures in the project company.

Belgian legislation requires that in a BE-REIT, the LTV ratio is limited to 65% of the consolidated assets. In case the BE-REIT has obtained a derogation to the risk diversification rule, the debt-to-asset ratio may not exceed 33%. Furthermore, the annual interest costs may not exceed 80% of the total annual operational and financial income. In order to guarantee a pro-active management, the BE-REIT must present a financial plan to the FSMA as soon as its consolidated debt-to-asset ratio exceeds 50%. A mortgage (or other collateral) is limited to 50% of the global fair value of the 'immovable property' and 75% of the value of each 'immovable property' mortgaged, subject to exceptions when it concerns the participation in PPP.

Security regime

The law of 11 July 2013 on security interests over movable assets entered into force on 1 January 2018.[13] A Royal Decree implementing the new law and establishing the rules regarding the use of the national online pledge register ("*pandregister/registre des gages*"), dated 14 September 2017,[14] entered into force at the same time as the new Belgian pledge law.

The regime excludes the following:

- financial instruments subject to the Belgian collateral law of 15 December 2004 on financial collateral arrangements implementing the directive on financial collateral arrangements 2002/47 EC dated 6 June 2002;[15]
- fungible financial instruments held in an account in a clearing system subject to the Royal Decree N°62 of 10 November 1967 on the deposit and clearing of fungible financial instruments;[16]
- receivables, unless they fall within the scope of an omnibus pledge (similar to a floating charge) by way of a registered pledge (e.g., a registered pledge over the business of the pledgor); and
- immovable assets by nature or by incorporation which may be mortgaged but not pledged.

Although the market in Belgium is less developed, the securities provided under a fund finance facility are similar to those existing in other countries, i.e.: (i) a pledge over the bank accounts; (ii) share pledges; and (iii) pledge over the undrawn commitments and receivables pledges. Side letters are still controversial and therefore there is no guarantee as to whether these shall be enforceable. Security interest may be granted in favour of an agent, or the representative of one or more creditors.

The insolvency law

In so far as the fund is constituted as a legal entity, the provisions of the insolvency law apply. The reformed Belgium insolvency law adopted on 11 August 2017[17] came into force on 1 May 2018. The law entitled Book XX of the Economic Law Code includes most of the 1997 bankruptcy law; the 2009 law on the continuity of enterprises which deals with the reorganisation of financially troubled enterprises; and the EU Regulation 2015/848 on insolvency proceedings (EIR Recast).

Among the changes strengthening out-of-court restructuring regimes for the protection of new capital, the most important change for secured lenders is that whereas previously, in reorganisation through a collective arrangement, extraordinary and secured creditors could not be obliged to write of any of their debts – even if approved by a double majority of the creditors – under the new law, secured creditors' claims shall only be protected for the lesser of: (i) the amount of their registered security; and (ii) the going-concern value of the secured assets if no registration has been effected. Where the value of the underlying collateral is less than the secured claim, the balance ranks as an ordinary unsecured claim.

Subject to the exceptions in the Belgian collateral law of 15 December 2004 under the old regime, the rights of the secured creditors may be suspended without their consent for up to 24 months, and in exceptional cases, up to 36 months, provided that the interest was paid as of the date of the filing to open judicial reorganisation procedures. Under the new law, this period is extended until the court ratification of the collective settlement agreement.

Key developments

<u>Reform of the Private *Privak* regime</u>

The Private *Privak* (*Pricaf*) is an AIF which invests exclusively in financial instruments issued by unlisted companies and combines the advantages of legal personality with a *de facto* tax transparency.

The latest reforms to the law of 19 April 2014 (the Law of 26 March 2018 strengthening economic growth and social cohesion[18]) allow investors to extend the life of a Private Privak (limited partnership structure) beyond the previous 12 years, if the articles of association allow, up to a maximum two terms each of a maximum of three years, if approved by a majority of 90% of the votes representing 50% of the share capital. It also abolished the restriction that prohibited a *Privak* from taking control in a portfolio company.

Different compartments can be created distinct from the Private *Privak*'s assets and liabilities/sub-funds. A compartment must have at least six non-related investors and must itself have been registered with the Minister of Finance. Compartments must keep separate books. A Private *Privak* and the compartments may be established and exist prior to registration, but cannot make any investments until the registration process is finalised. In case of a distress, the reform allows a 25% tax reduction of losses incurred, up to €25,000 per accounting year, as from 2019 for Private *Privak*s incorporated after 1 January 2018, and extends the lower dividend withholding tax rate of 15 or 20% to indirect investments such as those held through a Private *Privak*.

Minimum investment thresholds shall in the future be lowered from €100,000 to €25,000 according to the competent minister.

Pursuant to Opinion_2019_04 of the FSMA dated 22 October 2019,[19] it is preferable not to mention the target market in the prospectus of an issuer who is not subject to MiFID II, as this information is not drafted by the issuer, does not concern the issuer and may be considered misleading. The Prospectus Regulation does not contain information on the target market. Moreover, issuers who do not have the capacity of an investment company are not subject to product governance rules.

The year ahead

<u>Company law reform</u>

The Law of 23 March 2019 introducing a Code of Companies and Associations ("Company Code"[20]) is the most far-reaching reform of Belgian company law in the recent years. The Code applies to new companies and associations as of 1 May 2019 and will take effect gradually from that date. Existing legal entities may opt to be subject to the new regime as from 1 May 2019. Existing legal entities will be subject to the new Company Code from 1 January 2020.

The mandatory provisions will apply from that moment on (e.g. the rules on the distribution of profits in the SRL/BV (Private Limited Liability Company)), but for the other provisions, existing legal entities can wait until the next amendment to their articles of association to adapt to the Company Code, it being understood that they will have to comply fully with the Company Code from 1 January 2024. Existing legal entities with a legal form abolished by the Company Code are subject to the same ultimate deadline (1 January 2024) and are automatically converted into the nearest legal form remaining in the Company Code if the transformation has not taken place within the deadline.

The new Code, which applies as a *lex generalis* in the financial sector, enhances flexibility and simplification in relation to equity financing. It provides for substantial changes, amongst which are:

- A shift in the treatment of preferential subscription rights in case of a capital increase in cash, i.e.: (i) the identity of the beneficiaries of the suppression of the preferential subscription rights must be disclosed; (ii) the company's board of directors and auditor must produce comprehensive reports on the proposed transaction's impact on the current shareholders' situations, the issue of the shares as well as the justification; and (iii) the prohibition on beneficiaries of the capital increase who hold more than 10% of voting rights, from voting in the shareholders' meeting or through their representatives at the board meeting, deciding on the capital increase.
- The preferential subscription right, by which existing shareholders may subscribe in preference to new shares, is now exercised by class of shares (Articles 5:128 and 7:188 of the Code).
- The elimination of the minimum issue price (even below market price or below the intrinsic value of the shares) when a capital increase is reserved to investors specified in advance.
- New rules on the distribution of profits (including, amongst other things, a new 12-month liquidity requirement, in addition to the current net assets test).
- Amended rules on the appointment and removal of directors, mandatory management committee and specific competences for the management committee in credit institutions, modified rules on joint directors' liability, and possibly a liability cap for directors based upon the size of the company.
- New capital requirement rules and the possibility to incorporate companies without capital. An SRL/BV may issue convertible bonds (i.e. bonds that can be converted into shares in the future) and subscription rights (warrants). Thus, an SRL/BV has the possibility to issue anti-dilutive warrants (ratchets). Quasi-equity financing is made possible for SRL/BVs. The general shareholders' meeting or administrative body is competent to issue these warrants or its convertible bonds, according to the same procedure as the issue of shares.
- In addition, the potential tax consequences of the Base Erosion Profit Shift of the debt/equity ratios will need to be considered.
- As regards the financing of listed companies, the definition of "*pair comptable-fractiewaarde*" has been confirmed. This is the capital divided by the number of shares. However, there is a new possibility to issue shares below the accounting par value. There is no major change in the preferential right for listed companies. The practice can therefore continue. The subscription records have been abolished, as have the subscription forms.

<u>Brexit</u>

The Belgian law of 3 April 2019 on the withdrawal of the United Kingdom from the European Union provides,[21] among other things, that a Royal Decree can adopt more specific measures providing for continuity in the handling of contracts currently in place. The FSMA took measures and initiatives to prepare for the departure of the United Kingdom from the European Union. Guaranteeing continuity of contracts after Brexit has been the FSMA's chief concern.

European Banking Authority (EBA) guidelines of 31 October 2018 on management of non-performing and forborne exposures

The circular of the National Bank of Belgium (NBB/BNB) aims to implement the guidelines of the European Banking Authority (hereinafter referred to as "the EBA") of 31 October 2018 on management of non-performing and forborne exposures (NPEs).[22]

One of the objectives of the EBA guidelines is to specify sound risk-management practices for credit institutions for managing NPEs, forborne exposures and foreclosed assets. The guidelines also provide competent authorities with guidance on assessing credit institutions' risk management practices, policies, processes and procedures for managing NPEs and forborne exposures as part of the supervisory review and evaluation process (SREP).

The EBA guidelines shall apply as from 30 June 2019. For the first application of these guidelines, credit institutions should calculate their NPL ratios using 31 December 2018 as a reference date.

* * *

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3. Royal Decree of 12 November 2012 with respect to undertakings compliant with the Directive 2009/65/EC, *Official Gazette*, 30 November 2012.
4. *Update on Asset management and Shadow banking in Belgium*, FSMA and NBB, September 2018, p.15, 5.1.1.2.
5. Swing pricing has two forms. In the first form, the NAV of the fund adjusts up or down every calculation day, based on the direction of the net capital activity, regardless of the size of investor dealing. The second method is only invoked when the net capital activity is greater than a pre-determined threshold, which is usually set in terms of a percentage of basis point impact.
6. Anti-dilution levy is a single charge to the funds' NAV price. It is applied by fund management companies simply to protect existing investors from bearing the costs of buying or selling the underlying investments as a result of large inflows into or outflows from a fund.
7. Redemption gates are partial restrictions to investors' ability to redeem their capital, generally on a *pro rata* basis.
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Bermuda

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Overview

Bermuda is a major centre in the international offshore investment fund industry, with over US$200bn of fund assets domiciled in the jurisdiction. In addition to over 600 investment funds registered in and operating from Bermuda, there are also a significant number of unregulated investment funds, which are primarily closed-ended investment companies and limited partnerships that fall outside of the Investment Funds Act 2006, as amended (IFA). As closed-ended funds are not required to be registered with the Bermuda Monetary Authority (BMA), it is not possible to estimate with accuracy the number of such funds domiciled in Bermuda.

The Bermuda fund industry sees investment predominantly from North America and Europe, and therefore trends in the Bermuda fund finance market track the major onshore markets. Although there is no overall data reporting service for the local fund finance market, anecdotal reports from many of the major facility lenders, as well as Appleby practitioners, anticipate that there will continue to be substantial growth in the fund finance market, with increasing numbers of funds seeking subscription line or capital call facilities.

Bermuda as a jurisdiction is highly responsive to evolving market demands and over the past two years key stakeholders, including the Bermuda government, the financial services regulator (the BMA) and investment industry professionals have collaborated to make legislative changes that serve to cement Bermuda's position as one of the premier offshore jurisdictions for private equity funds. A review of the most significant changes from a private equity fund perspective is set out in the 'Key developments' section below.

Fund formation and finance

<u>Investment funds – overview</u>

The IFA governs the registration and authorisation of investment funds and contains certain requirements for the formation of investment funds, their operation and the offering of shares or interests of investment funds. An 'investment fund' is broadly defined under the IFA and means any arrangements with respect to property of any description, including money, the purpose or effect of which is to enable persons taking part in the arrangements to participate in or receive profits or income arising from the acquisition, holding, management or disposal of the property or sums paid out of such profits and income.

Investment funds are prohibited from operating in or from Bermuda unless they are authorised or registered under the IFA. Funds that are private in nature, such as master funds, are required to be registered with the BMA as Private Funds. A fund is considered to be private in nature, and thus a Private Fund, if it is open to 20 participants or less and the promotion, communication and offer to participate in the investment fund is restricted and not made to the general public.

Regulatory approval

The formation of companies, partnerships and limited liability companies (LLCs) is subject to the approval of the Registrar of Companies (Registrar) and the BMA (the Registrar and BMA being the principal regulatory bodies). The BMA is the principal body responsible for the regulation of investment funds, including those listed on the Bermuda Stock Exchange (BSX). The Registrar is responsible for the registration of companies, partnerships and LLCs and has powers pursuant to, *inter alia*, the Companies Act 1981 (Companies Act), the Partnership Act 1902, the Limited Partnership Act 1883, the Exempted Partnerships Act 1992, the Segregated Accounts Companies Act 2000 and the Limited Liability Company Act 2016. While the Registrar and the BMA do not regulate the formation of unit trust funds, a unit trust fund is required to apply to the BMA for authorisation or exemption under the IFA, and must also seek the permission of the BMA under the Exchange control regulations (Exchange Regulations) to issue units (as further defined and explained below).

Anti-money laundering (AML) and anti-terrorist financing (ATF)

The Bermuda AML and ATF framework requires that AML/ATF regulated financial institutions as well as independent professionals establish policies and procedures to forestall and prevent money laundering and terrorist financing. Such policies and procedures must cover:

(a) customer due diligence measures and ongoing monitoring;
(b) reporting;
(c) record keeping;
(d) internal control;
(e) risk assessment and management; and
(f) the monitoring and management of compliance with and the internal communication of such policies and procedures in order to prevent activities related to money laundering and terrorist financing.

The policies and procedures should be developed using a risk-based approach. The nature and extent of such policies and procedures will depend on a variety of factors, including the nature, scale and complexity of the business; the diversity of its operations, including geographical diversity; and its customer, product and activity profile.

Private equity funds

Closed-ended, private equity funds are typically formed as limited partnerships or companies incorporated with limited liability.

A Bermuda-exempted company (e.g., companies exempted from the provisions of Bermuda law that stipulate that at least 60% of the equity must be beneficially owned by Bermudians) incorporated with limited liability can be established with a single shareholder, any amount of authorised share capital, unrestricted objects, and the capacity and powers of a natural person.

In general terms, the Companies Act restricts an exempted company from carrying on business in Bermuda except to the extent that it has been granted a licence by the Minister of Finance. There are certain activities that are expressly excluded from the requirements of a licence , including doing business with other exempted companies in furtherance of the business of the exempted company that is being conducted outside Bermuda, and dealing in securities of exempted companies or partnerships.

Approval is sought from the BMA for the intended beneficial ownership of those with voting rights in the company. Any information provided to the BMA is treated in the strictest confidence (pursuant to Section 31 of the Bermuda Monetary Authority Act, 1969). Ordinarily, an incorporation can be accomplished within 24 to 48 hours. An exempted company can only commence business or issue shares after it has been organised and the requisite BMA consents have been obtained.

Investment funds

Historically, investment funds have typically been formed as mutual fund companies or limited partnerships, the optimal structure depending on a number of factors including where and to whom the investment opportunity is to be marketed, the nature of the investor base, and the identified portfolio of investment assets.

Mutual fund companies

A mutual fund company is a company incorporated with limited liability that is incorporated for the purpose of investing the monies of its members for their mutual benefit, having the power to redeem or purchase for cancellation its shares without reducing its authorised share capital, and stating in its memorandum of association that it is a mutual fund. In the case of a mutual fund company, the shares of which are to be sold in overseas markets, an exempted company is the appropriate vehicle. However, shares of a Bermuda mutual fund company, which is an exempted company, may also be offered inside Bermuda to both local and international investors.

Typically, a mutual fund company is incorporated with two share classes: ordinary voting shares (non-participating) held by the investment manager; and non-voting, participating, redeemable shares held by the investors.

The timeline for incorporation of a mutual fund company, after submission of the application to the BMA, is usually 24 to 48 hours. A mutual fund company may only commence business and issue shares after it has been organised and the consents under Bermuda's Exchange Regulations, the IFA (if required) and the AML/ATF framework (if required) have been obtained.

Limited partnerships

Investment funds may also be formed as exempted limited partnerships. A limited partnership consists of one or more general partners (which may be bodies corporate, or general or limited partnerships, formed under the laws of Bermuda or another jurisdiction) and one or more limited partners (namely investors) whose relationship is governed by a partnership agreement.

In Bermuda, partnerships (both general and limited partnerships) are not legal entities separate from their partners unless a specific election has been made by the partnership to have legal personality. Nevertheless, a partnership may in any event function as an 'entity', and may sue and be sued and carry on business in its own name. If an election is made by the partnership to have separate legal personality, such election is irrevocable and the partnership will continue regardless of whether all the partners die or are declared bankrupt or if there is a change in its constitution.

General partners are fully liable for partnership debts and obligations. In the case of limited partnerships, the general partners will have such general liability to third parties, while generally speaking, the liability of the limited partners is limited to the value of the money and any property that they contribute (or agree to contribute) to the limited partnership . It should be noted that the limited partners may forfeit their limited liability status in certain circumstances if they participate in the management of the partnership.

Limited Liability Companies

Limited liability companies or "LLCs" were introduced to the Bermuda regulatory landscape in 2016 as a result of the Limited Liability Companies Act 2016, as amended (LLC Act). An LLC is a hybrid legal structure allowing the contractual and operational flexibility of a partnership to be housed within a corporate entity. Like a Bermuda exempted company, an LLC has separate legal personality and the liability of its members is limited. Whilst members of a Bermuda company receive shares, members of a Bermuda LLC will each have an interest in a capital account in a similar way to partners in a partnership. Under the Bermuda LLC Act, parties can create bespoke vehicles, having the contractual freedom to set out in the LLC agreement the terms of operation and management of the LLC as well as expressly agreeing the allocation of profits and timing of distributions amongst its members. A Bermuda LLC may be managed by one or more members (a "managing member"), or a manager may be appointed who may or may not be entitled to share in the profits of the LLC.

Whilst the LLC vehicle may be utilised by clients in a broad range of sectors, the Bermuda LLC is an attractive structuring option for operators of investment funds and, in particular, closed-ended private equity funds, as the flexible corporate governance structure allows "managing members" to manage the fund (in a similar way to a general partner) but without unlimited liability for such members in respect of the fund's losses. At the moment, it is not yet clear what the lender collateral package will look like in respect of LLC funds, although arguably the use of LLCs, as opposed to partnerships, may serve to simplify the security package, as security would only have to be granted by the LLC itself and not its manager.

Security package in fund financings

A key consideration in any fund financing transaction (whether it be a capital call facility, subscription facility or equity bridge facility) is the collateral package which the lender can secure. Typically, security will be granted over the rights to call for contributions from investors, with the security interest in uncalled capital commitments perfected by the delivery of a notice of the assignment of such capital commitments to the investors, where the document granting the security is governed by Bermuda law. Where the security document is not governed by Bermuda law, local counsel should be engaged to determine any perfection requirements. Additionally, the lender will want security over the account into which investors' capital contributions are funded.

There is no Bermuda law requirement that the collateral account be a local one (although of course, the local banks are very familiar with such requirements, should it be preferable to secure a local account).

Bermuda law does not stipulate that the security package must be governed by Bermuda law, and most often we see the security agreements mirroring the governing law of the applicable credit facility. Bermuda as a jurisdiction is very familiar with New York law as the preferred governing law for US facilities, and English law for European facilities. Of primary concern therefore, from an offshore perspective, is to review the validity and priority of the offshore-based security.

Bermuda recognises the concept of a security agent and there are no restrictions under Bermuda law on the enforcement of rights or security interests solely because those rights or security interests are held by an agent. An agent is treated in the same way as any other secured party and is subject to any applicable Bermuda law. It should also be noted that there are no Bermuda law restrictions on granting security to foreign lenders and that it is not necessary under Bermuda law for a security agent to be registered, licensed or otherwise qualified in Bermuda in order to enforce any of its rights.

There are no restrictions under Bermuda law on a company or partnership making payments to a foreign lender under a security document, guarantee or loan agreement, and exempted companies and partnerships are designated by the BMA as "non-resident" for exchange control purposes, which means that they are free to deal in any currency of their choosing, other than "resident" Bermuda dollars.

The Stamp Duties (International Businesses Relief) Act 1990 abolished stamp duty on most documents executed by exempted undertakings (including exempted companies and partnerships, and this also applies to LLCs).

Following execution of the security document, lenders will want to ensure that their security package is appropriately registered. Charges over the assets of Bermuda companies in Bermuda (except charges over real property in Bermuda or ships or aircraft registered in Bermuda) which are granted by or to companies incorporated outside of Bermuda, are capable of being registered in Bermuda in the office of the Registrar, pursuant to the provisions of Part V of the Companies Act. Registration under the Companies Act is not compulsory and does not affect the validity or enforceability of a charge, and there is no time limit within which registration of a charge must be effected. However, in the event that questions of priority fall to be determined by reference to Bermuda law, any charge registered pursuant to the Companies Act will take priority over any other charge which is registered subsequently in regard to the same assets, and over all other charges created over such assets after 1 July 1983, which are not registered.

Partnerships which have elected to have separate legal personality can also register with the Registrar and thereby ensure priority in a similar way to the regime for companies. In the event that a Bermuda partnership has not elected to have separate legal personality but has a Bermuda company as its general partner, the charge can be registered against the general partner acting in its capacity as general partner of the partnership.

Key developments

Economic Substance

The Economic Substance Amendment Act 2019 (Amendment Act) became operative on 28 June 2019. The Amendment Act creates an exemption for entities that are resident for tax purposes in a jurisdiction outside of Bermuda (provided such jurisdiction is not on the EU's list of non-cooperative jurisdictions for tax purposes). This important development will place Bermuda on a level playing field with other jurisdictions that are subject to the EU's economic substance requirements.

Information received by the Registrar from an entity to support its non-resident status will be provided to the foreign competent authority of the jurisdiction where the holding entity, the ultimate parent entity, the owner or the beneficial owner of the non-resident entity is incorporated, formed and registered or resident.

The Registrar released Draft Economic Substance Requirements – General Principles (Draft Guidance Notes) on 26 June 2019 for industry consultation. The Draft Guidance Notes will assist entities in determining whether they are within scope of the economic substance requirements and, where entities are in scope, provide guidance on how to satisfy these requirements. Additional sector-specific guidance notes will be released by the Registrar in due course. The Draft Guidance Notes state that the Registrar is in the process of building an e-registration system to accept and manage the economic substance declarations, and it is anticipated that the e-registration system will launch in the second quarter of 2020.

The legislative framework in Bermuda in respect of economic substance is likely to continue to evolve in the near to medium future and this evolution is likely to continue to affect Bermuda funds.

Beneficial Ownership Regime

Bermuda has recently adopted legislation to implement international standards in order to enhance transparency while combating money laundering and terrorist financing. The standards which the legislation implements were initially adopted by the Financial Action Task Force (FATF), with the Organisation for Economic Co-operation and Development incorporating key FATF requirements into their proposals. The Bermuda beneficial ownership regime has built in key exemptions for open-ended investment funds and for closed-ended investment vehicles managed or administered by a person licensed under the Investment Business Act, 2003 or the Investment Funds Act, 2006 or registered, authorised or licensed by a foreign regulator recognised by the BMA.

Register of Directors

In keeping with the global trend towards increased transparency, it is now a requirement under the Companies Act that the Register of Directors of every Bermuda company be lodged with the Registrar, where it will be publicly available for inspection. The Register of Directors must contain the following information with respect to each director of a Bermuda company: (i) if an individual, his/her present first name, surname and address; or (ii) if a company, its name and the address of its registered office. Whilst there is a requirement to disclose the identity of the directors, there is no requirement for such directors to be registered or licensed with a governing body or to satisfy any additional disclosure or regulatory requirements.

Anti-money laundering and anti-terrorist financing

The Bermuda Government and BMA are committed to ensuring that Bermuda's anti--money laundering and anti-terrorist financing (AML/ATF) requirements are aligned with the highest international standards, and legislative amendments have recently been implemented to further strengthen the regulatory regime in Bermuda. These include extending the scope of those entities which fall within the definition of an "AML/ATF Regulated Financial Institution", and enhancing the registration requirements for such entities where such entities are not otherwise licensed, registered or authorised by the BMA.

The year ahead

We are seeing an increase in the number of tailored investment structures and single investor vehicles being utilised in Bermuda. These "fund of one" structures are especially popular with funds of funds (FoF), in which the investor, in this case the FoF, is the sole investor in a specific vehicle or fund. These structures allow the FoF to create a bespoke investment rather than investing in a target fund as an ordinary limited partner. As "fund of one" structures continue to grow in popularity, we anticipate that the subscription credit market will also look to expand its offering to facilitate lending to these types of structures.

Another innovative legal structure which Bermuda offers, and where there is increasing interest, is the segregated accounts company. Under the provisions of the Segregated Accounts Companies Act 2000, a mutual fund company may be registered as a segregated accounts company, enabling it to create different share classes, each representing a segregated portfolio of assets. Accordingly, where a multi-class structure is desired with a separation of liability between classes, it is not necessary to incorporate multiple companies in an umbrella form. Instead, a single segregated accounts company may be incorporated, with segregated accounts representing each share class. Such accounts enjoy a statutory division of liability, effectively ring-fencing each segregated account from the general liabilities of the company, and from other segregated accounts. Bermuda segregated accounts can invest in other segregated accounts in the same company, creating a master/feeder structure, making it possible to invest and redeem without the capital leaving the company and creating a capital transfer.

Bermuda will continue its commitment to developing new and innovative products, and we will continue to see a 'collaborative effort' by regulators, government and industry professionals to ensure Bermuda continues to provide innovative fund products and maintains its position as a leader in the offshore funds world.

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Canada

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General industry overview

Though still not as mature as the corresponding markets in the United States and the UK, the subscription credit facility (commonly referred to in Canada as a "**capital call financing**") continues to evolve from its relationship-based, demand-bridge loan roots. Generally speaking, the market for this product has seen an uptick in terms of lenders (both Canadian and foreign banks) and borrowers (particularly in the venture capital space), and the product continues to evolve to meet an increasing number of requirements and/or demands in the Canadian market. For the funds that seek out financings of this nature, capital call facilities have proven to be an efficient tool to provide for, among other things, a more predictable capital call schedule, payment of normal-course operating expenses, more flexible timing of fund investments, long-term leverage not previously available at the fund level, smoother capital call processes, cross-leverage between funds and enhanced internal rates of return.

Subscription financing in Canada

Acquisition finance transactions aside (these are generally provided at a subsidiary company level at the time of an acquisition), capital call financings continue to be the most common form of credit made available to private equity funds, and are on the rise for venture capital funds, in Canada. In their purest form, capital call financings are not secured by the general assets of the fund (or those of its operating or project level subsidiaries) but rather, as the name suggests, by the unfunded capital commitments of the investors in the fund. As is the case in other, larger markets (where capital call financings are more common due to the depth and breadth of the private equity markets), lenders on these capital call financings generally focus on, and follow a comprehensive due diligence regimen in order to confirm, the underlying credit strength of the investors and their legal obligation to fund capital commitments pursuant to the applicable fund documents.

Like other jurisdictions, the core collateral package on a typical capital call financing in Canada includes: (i) a pledge of the unfunded capital commitments of the investors in the fund; (ii) an assignment of the fund's right to make a call on such capital commitments and the right to enforce payment of the capital commitments once called (including a covenant to ensure all payments are made into certain bank accounts); and (iii) a pledge of such bank accounts into which the capital commitment proceeds are to be deposited. Unlike certain other jurisdictions, however, and notwithstanding that the market in Canada has evolved significantly, material differences in approach still exist from lender to lender and by fund type (private equity *vs* venture capital) with respect to certain of the remaining characteristics of the structure.

What makes Canada different?

In Canada it is not uncommon (particularly for mid-market or small funds) for lenders to provide capital call financing facilities based on varying security packages, varying covenant packages and varying reliance on capital call diligence. Though we are cautious not to generalise (we acknowledge that a number of factors contribute to the structure and security package on any financing), we believe this reflects, at least partially, the fact that a certain segment of the capital call financing market in Canada is still heavily relationship-based, particularly in the burgeoning venture capital fund space. We have set out below some of the key differences or attributes of a capital call financing in Canada.

Account control agreements – Unlike the United States, the common law jurisdictions in Canada do not require an account control agreement (or any other form of control) to perfect a security interest over bank accounts. Perfection of a security interest over a bank account happens by way of registration pursuant to the applicable provincial Personal Property Security Act. Furthermore, most structures in Canada include deposit accounts with the applicable lender or agent. Consequently, on a purely domestic transaction, (Canadian lender(s) and a Canadian borrower with bank accounts in Canada only), lenders do not generally require account control agreements. Account control agreements can provide other benefits and foreign lenders (accustomed to taking them in their home jurisdiction) often require them, but many of those benefits can be addressed in the other loan documents.

Limited partner acknowledgments – The requirement for limited partner acknowledgments varies greatly from transaction to transaction in Canada. We see transactions structures with: (i) no such requirement; (ii) limited requirements where only certain investors are required to provide acknowledgments; (iii) a requirement for every investor to provide an acknowledgment of a limited nature; and (iv) a requirement for every investor to provide a comprehensive acknowledgment.

We are starting to see a fifth requirement: that notice of the capital call facility and the security relating thereto be provided to each limited partner, notwithstanding that such notice is not otherwise required by the applicable limited partnership agreement. It is important to note that certain large institutional investors have a significant influence on the fund documents and limitations may be imposed on the managers to prevent them from approaching investors for acknowledgments (and certain diligence materials like financial statements) in connection with third party financings. This can lead to significant issues where the fund documents do not otherwise contain capital call-friendly provisions regarding, among other things, authorisation to enter into such facilities, setoff, waiver of certain defences, and the assignment of the capital call commitments.

Included and excluded investors – A limited number of capital call financings in Canada do not contain "included investor" and "excluded investor" concepts. Instead, the borrowing base will include all investors, and does so on an equal basis. Given the typical reliance on the strength of the investor capital call commitments, it might seem particularly strange to treat all investors equally, but this particular approach is generally paired with other attributes (a lower margin rate, small deal size, 90-120 day, demand-bridge loan, a general security agreement ("GSA"), etc.) which mitigate overall risk. The more common approach in Canada aligns with what you might expect to see in other jurisdictions: a strong focus on the investors of the fund, including detailed investor eligibility criteria in the credit facility; and a list of ongoing exclusion events that operate to remove an investor from the borrowing base during the life of the facility. Certain credit facilities in Canada also include multiple margining rates.

Diligence – As can be expected in a jurisdiction where a meaningful portion of the capital call financings are relationship-based, we still see a broad range of approaches to diligence in Canada. Our general advice on any capital call financing is to follow a comprehensive and regimented review of the fund documents, including, among other things, the offering materials, limited partnership agreements, subscriptions agreements and side letters. In certain circumstances, lenders still obtain comfort based on a limited review of certain key issues: authorisation re. borrowing and assignment of the capital call commitments; limited partner acknowledgments; investment periods; defaulting investors provisions; capital call periods; and use of capital calls to repay loans. Other lenders take a more comprehensive approach and request the same of their counsel.

To be clear, there's nothing particularly special about the structure of a Canadian capital call financing (versus a capital call financing in the United States or the UK, for example) that allows for or encourages a more limited approach to diligence. Furthermore, given the make-up of the fund market in Canada (like many jurisdictions, it includes a broad range of funds in terms of size, fund formation experience and capital call financing experience), a comprehensive and regimented approach is warranted in almost all cases – even where cost sensitivities, relationship, timing, additional GSA security or other factors might suggest otherwise.

Notwithstanding that many funds in Canada are extremely sophisticated and are both proactive (in their fund formation documentation) and protective (with respect to what they accept in subscription agreements and side letters), we still experience situations where the diligence leads to: (i) amendments to the fund formation documents; and/or (ii) a request for acknowledgments from fund investors where acknowledgments were not originally contemplated. This is never the intended purpose of the diligence process, and we are very mindful of the investor/fund relationship, but we raise these examples to highlight the importance of the diligence process on these transactions.

General Security Agreements – The GSA operates to grant a security interest in all of the personal property of a fund. In certain circumstances, lenders in Canada still require a GSA in connection with a capital call financing. This, of course, reflects a divergence from the premise that the lender is focused solely on the investors and the legal obligation of such investors to provide capital contributions once called upon, pursuant to the fund documents. For some funds (particularly those accustomed to capital call financing structures in the United States), this is of material concern. In certain instances, after accounting for the fund's future acquisition financings with third party lenders, the overall benefit of the GSA is limited and can result in the need for future intercreditor agreements and/or waiver letters with such third party lenders. Furthermore, certain of the risks addressed by the GSA can be addressed in the credit agreement and the other loan documents through the use of more stringent operating and reporting related covenants. After taking into account where the general global market has been heading for a number of years, we expect GSAs to be used less frequently in connection with capital call financings in Canada.

Mature market structures – Though the market in Canada continues to evolve, we acknowledge that Canada still trails more established markets such as the United States and the UK. As previously mentioned, the depth and breadth of the fund markets in those jurisdictions are far greater than Canada's. Consequently, the capital call finance markets in those jurisdictions have evolved at a quicker pace. That said, and notwithstanding that single borrower, demand-bridge loan structures are still prevalent in Canada, we also see certain lenders becoming comfortable with (or at least considering) more sophisticated fund structures involving committed facilities, umbrella facilities, multiple funds (feeders, AIVs and parallel funds, etc.), a more singular focus on the investors and the capital call rights in the fund documents and, in limited circumstances, cascading security and/or mixed asset/hybrid borrowing bases. We are also starting to see structures that involve leverage for the managers and the principals.

Multiple fund structures – Certain multiple fund structures have become more common in Canada. Most lenders are now comfortable lending into funds with borrowing bases that involve multiple levels of funds (including, for example, feeder funds in the Cayman Islands for international investors) on closing, and/or allow for multiple levels of funds to be used going forward. The key to these arrangements is a strong understanding of the fund documents in connection with, among other things: the mechanics of how each fund operates on its own and with the other funds in the structure; what each fund can or cannot be jointly liable to pay; the comfort of lenders with the manager and general partners and how the capital call rights may be impacted by the use of additional funds.

Cascading security – Though not as common in Canada as they may be in other jurisdictions, cascading security packages are a viable option in Canada and have been implemented by certain lenders (for example, where certain feeder funds cannot be directly liable to the lender for tax or other reasons). As described in greater detail in other chapters of this text, this structure relies on multiple levels of pledges and security to ultimately put the lender in a position similar to the position it would have otherwise been in, had each of the funds guaranteed and provided security packages directly to the lender. As is the case in other jurisdictions, lenders in Canada generally try to avoid cascading security packages and prefer to rely on direct guarantee and assignment structures.

Hybrid borrowing bases – Again, these are not as common in Canada as they might be in more mature capital call finance markets. These facilities combine standard capital call borrowing bases (based on investor capital commitments) with asset-based borrowing bases for other asset classes (for example, real estate assets held in the fund's subsidiaries) under one credit agreement. These structures generally involve coordination among multiple groups within a particular lender organisation and we have seen fairly limited use and/or consideration of hybrid borrowing bases in the Canadian market. That said, where the desire for such a structure exists, there are no issues (from a purely legal perspective) to structuring these facilities in a manner that properly protects the lender's interests.

Enforcement

Typical steps to enforcement in a Subscription Credit Facility – Though there may be slight variations in enforcement depending on whether the lender has obtained a GSA, proceedings will be identical so far as the capital call enforcement is concerned. Therefore, in this section our intention is to focus on that latter aspect of enforcement.

(a) <u>Notice</u>

Enforcement in Canada will generally require the lender to give the debtor notice of the default under the loan agreement and a reasonable amount of time to cure the default, before any enforcement action can be taken. This notice period is usually 10 days although, in some cases, the courts have extended the length of time for which notice is required. In cases of urgency (e.g. fraud), an application to the court can be made to waive or abridge the 10-day period. Once this default notice period expires, the lender would then be in a position to enforce its security interest. Where the lender has the typical capital call security package, the lender would not have to send notice to all creditors of the fund, only the investors.

(b) Enforcement

Where the lender has the typical capital call security package, enforcement will involve taking possession of the fund's deposit account(s), and advising the fund and its investors that the lender is enforcing its security interest and exercising its capital call rights pursuant to the pledge (and any power of attorney granted thereunder) of the investors' unfunded capital commitments. The notice to investors would direct them to deposit their unfunded capital contributions into the debtor's deposit account, of which the lender would have taken possession.

Ability to appoint a receiver – Where appropriate, a lender in Canada may choose to apply to a court to appoint a receiver for the purpose of enforcing the lender's security interest in the specific collateral. This results in additional professional costs but provides court protection for the lender's enforcement. It may also ensure that the investors in the fund are obliged to comply with any capital call requirements that the court-appointed officer may assert pursuant to the fund formation documents. This may be beneficial where limited partner acknowledgments have not been obtained, or the fund-formation documents do not make it express that the capital call rights can be assigned as part of any permitted financing. In such a scenario, the receiver would be exercising the rights of the fund to call on the capital commitments of the investors.

Insolvency – The foregoing analysis is not impacted should the fund become subject to insolvency proceedings, either voluntarily or involuntarily. The rights and remedies available to the lender in any type of insolvency proceeding are not altered regardless of the type of security package.

Insolvency proceedings in Canada can be either voluntary or involuntary. If the fund owes CAD$5 million or more, then the fund can initiate proceedings for protection under the *Companies' Creditors Arrangement Act*, R.S.C. 1985, c. C-36 ("CCAA"), or it can opt to reorganise under the *Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B-3 ("BIA"). The BIA has no minimum debt requirement. In either case, the commencement of proceedings results in an initial 30-day stay of enforcement proceedings against both secured and unsecured creditors. A stay of proceedings could prevent exercise of the assignment rights, and the lender may have to apply to the court to seek permission to enforce. It is uncertain how a court in Canada would address the competing interests. There is one notable BIA exception: if the lender has delivered a notice of intention to enforce its security more than 10 days before the BIA proceeding commenced, then the stay will not apply to that lender under that statute (but would still apply under the CCAA).

The future of capital call financing in Canada

The Canadian market with respect to capital call financings continues to evolve towards more complex capital call financing structures that are comparable to those prevalent in other global markets. However, the evolution to more sophisticated and more standardised lending practices is hampered to some degree by the paucity of large fund players in the Canadian fund market compared to those of the United States or the UK. Additionally, new lenders (some of them foreign) and new borrowers continue to enter the market in Canada. The result is a bifurcation between the more pure capital call financings provided by certain lenders to the larger or more experienced funds at one end of the spectrum, and the more traditional, smaller, relationship-based, demand-bridge facilities being provided at the other end of the spectrum.

We continue to witness positive momentum and an increasing awareness of the potential of this market. Almost all lenders now have dedicated sponsor coverage teams that review, promote, sell, lead or participate in capital call financings within the Canadian market. Furthermore, the size and number of venture capital funds seems to be steadily increasing, thereby creating further demand for this product – and that, in our view, generally bodes well for the market here in Canada.

* * *

Note

At this time, we do not have access to year-end industry statistics.

* * *

Acknowledgment

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Cayman Islands

Simon Raftopoulos & Anna-Lise Wisdom
Appleby

Overview

The Subscription Credit and Fund Finance markets have continued to grow steadily into the third quarter of 2019 in the Cayman Islands. Growth in this area over the past few years has been driven in part by expansion of the product into a broader range of fund types, increasing take-up by fund sponsors who have not traditionally used the product in their fund families, record levels of fundraising and, most recently, an increasing number of net asset value and hybrid facility closings.

At the same time, established banks continue to increase their book of business, even as a number of new lenders have entered the capital call lending space. Given that strong credit performance remains the norm in this market, the relatively low risk profile of the product continues to make it attractive for lenders.

The Cayman Islands continues to be a pre-eminent offshore jurisdiction for the establishment of private equity funds, particularly for North American fund managers, and the exempted limited partnership (**ELP**) continues to be the private equity fund vehicle of choice. According to figures published by the Cayman Islands Registry of Exempted Limited Partnerships, as at the end of 2018, the number of active ELPs in the jurisdiction had risen from 22,346 to 26,011. 3,665 ELPs were registered in the Cayman Islands in 2018, and 2,274 ELPs have been registered in the Cayman Islands as at June 2019.

No doubt buoyed by the familiarity of US counsel and fund managers with Delaware LLCs, the use of the Cayman limited liability company (**Cayman LLC**) as a business vehicle has steadily increased since its introduction in July 2016. According to figures published by the Cayman Islands Companies Registry, there were 1,876 Cayman LLCs registered in the Cayman Islands as at March 2019, representing a 73% increase over the corresponding period in 2018.

The success of the Cayman LLC can, at least in part, be attributed to the decision by legislators, in collaboration with the private sector, to introduce a vehicle that is similar to the Delaware LLC. Familiarity with this type of vehicle facilitates usage and offers the benefit of operational consistencies across the onshore and offshore segments of fund structures. Cayman LLCs are most commonly used as joint venture vehicles, carried interest vehicles, downstream blockers, and investment management vehicles. The authors are also aware that a handful of Cayman LLCs have been used as investor-facing fund vehicles, including by Asian-based fund managers.

Successful public and private sector discussion and collaboration are but a few of the factors contributing to Cayman's market-leading position in this space. Others include: (i) historical familiarity with the jurisdiction by investors and fund sponsors; (ii) the increasing convergence of hedge fund and private equity sectors, as more fund managers offer and operate both products from the same platform; and (iii) Cayman law's English common law roots, supplemented, as necessary, by local legislation, which ensures that Cayman Islands funds are recognised as internationally accepted vehicles.

Globally, Preqin's Q3 2019 Fundraising report reflects a collective fundraising effort by private equity funds of US$103 billion of capital in Q3 2019 ending September. Although this represents a 12% decrease on Q3 2018, the figures for Q3 2018 reflect the second-strongest Q3 fundraising in the last six years. According to Preqin, the 10 largest funds that closed in Q3 2019, including a couple of mega-funds, secured a combined $56 billion, representing 50% of the total capital raised. This reflects a continuing trend whereby the more established general partners continue to account for the largest proportion of aggregate capital raised by funds closed.

North America-focused funds have continued to dominate fundraising. As of the end of Q3 2019, there were 3,118 private equity funds in the market, targeting $782 billion in institutional capital, of which more than 40%, or $126.2 billion, was raised by North America-focused funds. This geographical emphasis on the North American market corresponds with activity in the fund finance space, where Appleby's Cayman office continues to see a steady progression of instructions in the subscription credit facility market from referrers in North America, involving traditional players and new entrants to the market. Indeed, Appleby's Cayman office continues to be a market leader in this area, where it continues to represent the largest global banks on a variety of financing structures.

Fund formation and finance

Lending to Cayman Islands funds

Cayman Islands private equity funds have historically been registered as ELPs under the Exempted Limited Partnership Law, as amended (**ELP Law**). The Cayman LLC, registered under the Limited Liability Companies Law, as amended (**LLC Law**), is a hybrid form of business vehicle, merging certain characteristics of a Cayman Islands exempted company and an ELP.

Though registered pursuant to the ELP Law, an ELP is not a separate legal entity. Rather, an ELP reflects a contractual agreement between the partners, where the general partner is vested with certain duties and powers with respect to the business and its assets. Any rights and obligations of the general partner and the limited partners are therefore contractual in nature and will be governed by the provisions of the limited partnership agreement and any subscription agreements (and/or side letters) signed by the limited partners. The ELP's rights and property of every description, including all choses in action and any right to make capital calls and to receive the proceeds thereof, are held by the general partner in trust as an asset of the ELP. A Cayman LLC, on the other hand, is a body corporate with separate legal personality and limited liability. It can therefore hold such property and assets and incur obligations and liabilities in its own name.

The legal treatment of an ELP and the corresponding role of the general partner has a number of implications for lenders (**Lenders**) offering subscription credit facilities to Cayman Islands vehicles when structuring the related security package. Limited partners of an ELP will usually commit in the partnership agreement and/or subscription agreement to fund investments or to repay fund expenses when called upon to do so by the general partner from time to time. This contractual obligation of a limited partner to fund its capital, to the extent that it has not already been called (**Uncalled Capital**), and the corresponding right of the ELP to call for Uncalled Capital (**Capital Call Rights**) are the backbone of the subscription credit facility.

Given that these rights, or choses in action, are contractual in nature, the appropriate form of security over such rights is an assignment by way of security. As discussed above, legal title to such assets ultimately vests in the general partner of the ELP and, being contractual in nature, such rights are exercisable by the general partner for the benefit of the ELP.

Consequently, the proper parties to any grant of security are the general partner as well as the ELP (acting through the general partner), as the ultimate beneficiary of such assets. Where the obligor in a subscription-secured credit facility is a Cayman LLC, however, legal title to Uncalled Capital and to Capital Call Rights should vest in the Cayman LLC itself, with the manager having such power and authority as set out in the LLC agreement to make calls for Uncalled Capital and to receive capital contributions from the members in accordance with the terms of their subscription agreements.

Accordingly, where a Cayman LLC is the obligor, the security package could be simplified in that only one entity – the manager on behalf of the Cayman LLC – need be a party to the relevant security agreements. The LLC Law allows considerable flexibility in the structuring, governance and administration of the Cayman LLC, as it defers in many instances to the LLC agreement. Members of a Cayman LLC will therefore have relative freedom to introduce features typically associated with ELPs such as capital accounts, capital commitments and capital calls, provided that the provisions of the LLC agreement do not contravene the LLC Law or any other laws of the Cayman Islands. Each member of the Cayman LLC will also typically enter into a subscription agreement, setting out the terms on which it agrees to be a member, and to fund its capital commitment to the Cayman LLC.

In all instances, the optimal security package would incorporate an express irrevocable power of attorney in favour of the Lender to exercise effectively the general partner's or the Cayman LLC's Capital Call Rights following the occurrence of an event of default.

In addition, the security package will typically include the grant of a security interest over a designated bank account under the control of the Lender. Although the security over Capital Call Rights can be granted under a Cayman law document, it is increasingly common for such security to be granted under a New York or English law-governed security agreement. Assuming that the grant of security is permitted under the Cayman law-governed limited partnership agreement or the LLC Agreement, Cayman courts would recognise the grant of security even if such security were granted under a foreign law-governed security agreement. However, in such a situation, the Lender will need to ensure that the local law opinion covers not only the assignability of the Capital Call Rights, as a matter of Cayman law, but also the recognition of the security assignment, the choice of foreign law to govern the same, and the steps taken to establish priority as a matter of Cayman law.

The terms of the limited partnership agreement or the LLC Agreement play an integral role in the structuring of the collateral package and must be reviewed in detail in order to ensure a number of key elements are present, including but not limited to: (i) the ability of the ELP or the Cayman LLC to incur indebtedness and enter into the transaction; (ii) the ability to grant security over (x) the Uncalled Capital, (y) the right to make and enforce capital calls, and (z) the related contributions; (iii) the ability to apply the capital contributions towards the secured obligations; and (iv) acknowledgment by the limited partners or the members of the Cayman LLC of the security assignment and their obligation to fund their capital commitments.

Perfection of security

With the exception of land located in the Cayman Islands, vessels flagged in the Cayman Islands, Cayman Islands-registered aircraft and interests of limited partners in an ELP, generally no perfection steps are required in Cayman and, further, there is no general register of security interests in the Cayman Islands accessible to the public.

Perfection over the Capital Call Rights is achieved through the delivery of written notice of the grant of security (**Notice**) to the ELP's limited partners or the members of the Cayman LLC. According to conflicts-of-laws principles, the priority of two competing security interests in a chose in action is determined by the law governing that chose in action. Where a security interest is granted over Capital Call Rights set forth in a Cayman law-governed limited partnership agreement or LLC Agreement, priority of the security interest as against any competing security interest will therefore be determined in accordance with Cayman Islands law. As a matter of Cayman Islands law, where successive assignments of a chose in action are concerned, priority as between creditors is determined based on the English court decision in *Dearle v Hall* (1828) 3 Russ 1, according to the order in which written notice is given to a third-party obligor (i.e. the limited partners or the members of a Cayman LLC). Priority is not established in accordance with the time of creation of the relevant security interests. A delay in the delivery of the Notice will therefore open up the Lender to the possibility that the Cayman LLC, or a general partner on behalf of the ELP, may (quite unintentionally) grant a competing security interest or an absolute assignment over Capital Call Rights to a subsequent assignee. Provided that Notice of the second assignment is given to the limited partners or to the members of the Cayman LLC ahead of Notice of the first assignment, the subsequent assignee will rank for repayment ahead of the first assignee.

Equity holders in Cayman Islands vehicles are increasingly aware of subscription facilities. Indeed, sponsors and lenders alike agree that investors should expect transparency insofar as the use of subscription lines by fund managers is concerned. Familiarity with the product means that there is now much less resistance by such vehicles to giving Notice to their equity holders. In addition, a general "tightening up" by lenders of certain aspects of their facilities, has led to less flexibility around timing for delivery of Notices, with these typically being circulated to the equity holders either immediately upon execution of the security documents, in order to ensure priority is achieved at closing of the subscription credit facility, or within three to five business days of closing, depending on the commercial agreement between the parties.

Given the importance of actual delivery of the Notice to equity holders, evidence of the Notice having been received also assumes some importance. With advances in the technology of delivery of notices and reports to investors, such as posting to secure web portals and other similar platforms, the discussion of the appropriate evidence of delivery of such notices becomes crucial, and is best discussed in the early stages of negotiation of the facility to avoid inefficiencies on closing. If partnership agreements or LLC Agreements are drafted to take into account the technology of how notices are actually delivered to equity holders, this may prove helpful to the discussion.

Where partnership agreements or LLC Agreements include provisions that specify the circumstances in which Notices delivered in accordance with their terms are "deemed" to have been received by the equity holders, a Lender might take some comfort in proof of delivery of the Notices in accordance with the provisions of such partnership agreement or LLC Agreement, rather than proof of receipt by way of a signed acknowledgment by the equity holders. In all cases, the recommendation would be that the general partner, or an authorised person on behalf of the Cayman LLC, sign and deliver the Notices to the equity holders in accordance with the provisions of the limited partnership agreement or the LLC Agreement governing service of Notices on the equity holders, with a copy delivered to the Lender.

Apart from establishing priority, delivery of a Notice to equity holders of an assignment of Capital Call Rights has other distinct advantages, three of which are discussed below.

It prevents equity holders from obtaining good discharge for their obligations to fund their Uncalled Capital in any manner other than as specifically indicated in the Notice. Once notice of the assignment has been delivered to each equity holder, indicating that equity holders are to make all payments with respect to Uncalled Capital into a designated Lender controlled account, the equity holders will not be in a position to discharge their obligations to make such payments in any other manner.

It prevents set-offs from arising after the date of service of such Notice. This rationale is based on the common law principle that set-off works between the same parties in the same right. If there is notice to one party of the assignment of a right to a third party (i.e. a Lender), set-off will no longer operate in the same manner. However, the service of notice on equity holders does not have the same effect with respect to claims which might have arisen prior to the date of service of the Notice. Most limited partnership agreements, LLC Agreements and/or the accompanying subscription documents will now incorporate express waivers on the part of equity holders confirming that they will not rely on any right of set-off in order to reduce their obligations to fund their Uncalled Capital. Usefully, these contractual waivers survive the insolvency of the ELP, as the insolvency provisions of the Cayman Islands Companies Law (which apply to ELPs by virtue of Section 36 of the Cayman Islands ELP Law and to Cayman LLCs by virtue of Section 36 of the LLC Law) expressly provide that the collection in and application of property on the insolvency of a company (or partnership, as the case may be) is without prejudice to and after taking into account, and giving effect to, any contractual rights of set-off or netting of claims between the entity and any persons, and subject to any agreement between the entity and any persons to waive or limit the same.

This serves as an important informational tool insofar as equity holders are concerned. Once an equity holder has taken delivery of the Notice, it becomes more difficult for such holder to challenge the enforceability of a call made pursuant to the facility in question, based on a lack of knowledge or awareness of the existence of the same. Although there is no public registry relating to the grant of such security in Cayman, there is a statutory requirement for Cayman Islands exempted companies and Cayman LLCs to enter particulars of all mortgages and charges created over their assets (wherever located) in a register of mortgages and charges maintained at their registered office. Importantly, the statute does not aim to impose perfection requirements, and failure to enter such particulars will not invalidate the security. However, exempted companies and Cayman LLCs are expected to comply with the requirement, and failure to do so will expose such companies to a statutory penalty.

While there is no corresponding requirement for a Cayman Islands ELP to maintain a register of mortgages and charges with respect to charges over its assets, where the general partner of an ELP is incorporated as a Cayman Islands exempted company or a Cayman LLC and such general partner has granted security in its own right, the general partner will be subject to the statutory requirement discussed above. In the context of a subscription credit facility secured by an ELP's Capital Call Rights, given that legal title to the ELP's assets will be held by the general partner, details of security granted by the general partner in its own right and on behalf of the ELP should therefore be recorded in the register of mortgages and charges of the general partner. In practice, this puts any person inspecting such register on notice as to the existence of the security.

Key developments

<u>Beneficial Ownership Regime</u>

Cayman Islands companies and Cayman LLCs are now required to maintain registers of beneficial ownership at their registered offices, pursuant to legislation that came into force on 1 July 2017 (the **Beneficial Ownership Regime**). As a result, barring any applicable exemptions, in-scope companies must take "reasonable steps" to identify individuals qualifying as "beneficial owners" or corporate vehicles qualifying as "relevant legal entities". Beneficial owners are defined as those individuals who hold: (i) directly or indirectly, more than 25% of the shares, Cayman LLC interests or voting rights in the company; or (ii) the right to appoint or remove a majority of the board of directors or managers of the company. If no individual meets these conditions, the Beneficial Ownership Regime looks to those persons who directly or indirectly exercise significant influence or control over the company through direct or indirect ownership or interests. Generally, "relevant legal entities" are intermediate holding companies registered in the Cayman Islands through which beneficial owners hold their registrable interests.

Recent amendments to the Beneficial Ownership Regime, among other things, add new exemptions for companies which are (or which are subsidiaries of one or more legal entities which are): (a) regulated in an AML-equivalent jurisdiction; (b) the general partner of a special purpose vehicle, private equity fund, collective investment scheme or investment fund which is registered or holds a licence under a regulatory law; or (c) holding, directly, a legal or beneficial interest in the shares of an entity licensed under the Banks and Trust Companies Law, the Companies Management Law, the Insurance Law, the Mutual Funds Law or the Securities Investment Business Law. A further key amendment is that any company that claims an exemption from the Beneficial Ownership Regime must provide its corporate service provider with written confirmation of the exemption.

The Beneficial Ownership Regime extends the Cayman Islands' commitment to help combat tax evasion, terrorist financing, money laundering and other serious and organised crimes, by providing greater transparency on beneficial owners.

The potential significance of the Beneficial Ownership Regime for lenders in a fund financing transaction lies in the remedy available to a company in the case of non-compliance by an equity holder with a request for beneficial ownership information. If a company does not receive such information within one month of requesting it, it may issue a "restrictions notice" in respect of the relevant interest held by the equity holder. Until such notice is withdrawn by the company or ceased by court order, any transfer or agreement to transfer the interest is void, no rights are exercisable in respect of the interest, no shares may be issued or additional rights granted in respect of the interest or in pursuance of an offer made to the interest holder, and no payment may be made from the company in respect of the interest, whether in respect of capital or otherwise. Further, other than in a liquidation, an agreement to transfer a right to be issued any shares in respect of the relevant interest or a right to receive payment in respect of the interest will be void.

Given that: (i) the Beneficial Ownership Regime currently applies only to companies and to Cayman LLCs (and not to ELPs) and only where an exemption from the Beneficial Ownership Regime is not applicable; (ii) regulated investment funds and funds (including private equity funds) having a manager or administrator who is regulated in Cayman or in a jurisdiction approved by the Cayman Islands' Anti-Money Laundering Steering Group remain outside the scope of the Beneficial Ownership Regime; and (iii) a restrictions notice may not be served in respect of an interest that is subject to the security interest of an arm's length security holder, the enforceability of an unaffiliated lender's security package in subscription financing transactions should remain relatively unaffected by the Beneficial Ownership Regime.

Economic Substance

The Cayman Islands introduced the International Tax Co-Operation (Economic Substance) Law, 2018 (**ES Law**) in January 2019. The ES Law requires certain entities incorporated or registered in the Cayman Islands, and carrying on "relevant activities", to have "adequate substance" in the Cayman Islands. The ES Law applies to "relevant entities" that conduct any "relevant activity". Such entities must establish "adequate substance" in the Cayman Islands, and will be subject to administrative penalties and, ultimately, strike-off for failure to comply.

Relevant entities include: (i) Cayman companies (including exempted companies and limited liability companies); (ii) limited liability partnerships; and (iii) non-Cayman companies that are registered in Cayman (which would include a foreign company that acts as a GP of a Cayman ELP), but *exclude* (x) investment funds, and (y) entities that are tax resident outside of the Cayman Islands. Exempted limited partnerships are currently out of scope. While all "relevant entities" are required to declare their ES Law status in their annual filing, only those entities that are carrying on "relevant activities" are required to comply with economic substance requirements.

There are nine relevant activities under the ES Law, the most relevant for these purposes being "holding company business" and "fund management business".

We anticipate that Cayman corporate blocker entities or corporate vehicles that are not classified as investment funds and not otherwise tax-resident outside of the Cayman Islands will be subject to the ES Law. A corporate vehicle carrying on "holding company business", which is defined as "pure equity holding business" – i.e., only holding equity participations in other entities and only earning dividends and capital gains – is in scope, but is subject to a reduced economic substance test. In practice, this should be met by its ongoing compliance with existing statutory obligations. Compliance by other corporate vehicles should, however, be initially assessed by lenders' counsel, and all corporate vehicles should be monitored on an ongoing basis for continued compliance with the ES Law.

A foreign corporate GP registered in the Cayman Islands would be considered a "relevant entity" but would not likely be carrying out a "relevant activity" such as "fund management business" (except in unusual situations). As such, while it would need to declare its status in its annual filing, it would not be required to actually comply with economic substance requirements.

The year ahead

Despite uncertainties in the global markets, the forecast for private equity fundraising over the next few years is optimistic, and Cayman will remain relevant for North American-focused funds, in particular. As the industry matures, the demand for fund finance solutions throughout the lifespan of the fund will likely increase. This demand will be satisfied by an increasing number of sophisticated lenders willing to offer attractive and diverse financing options – which include not only subscription facilities, but the more bespoke net asset value and hybrid facilities.

Worthy of note, as lenders jostle to offer competitive options to funds and their sponsors, is the emergence of North American-based debt advisors in the space. The potential impact of this, on a market that has thrived on strong collaborative relationships between Lenders and fund sponsors alike, remains to be seen, but we suspect that evolution and innovation will always be a feature of the industry. The market will continue to evolve and is poised for continued growth in 2020 and beyond.

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England & Wales

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What makes a fund finance transaction "English"?

There are a number of features of a fund finance transaction that can give it a significant nexus to England & Wales, including:

- the facility agreement being governed by English law;
- a lender or the arranger being incorporated in, operating from, or leading the transaction from England & Wales;
- the fund manager or fund vehicle being formed, incorporated in or operating from England & Wales (usually as an English limited partnership); or
- one or more investors being domiciled in England & Wales.

In practice, it is the first of these two factors that most clearly defines a fund finance transaction as "English", and it is the market of transactions with those two features that this chapter chiefly focuses on. However, these transactions are rarely domestic in nature. The location of the fund manager and investors varies significantly from transaction to transaction, and the fund vehicles used in these transactions are often domiciled in other jurisdictions, as explained in more detail below. Fund financiers operating from other jurisdictions (such as continental Europe and Asia) also use English law to govern some of their facilities, and so commentary below on English contractual matters is also potentially relevant to fund finance transactions that are not in other respects strictly "English".

When and why did the English fund finance market develop?

Outside North America, England & Wales is the most mature fund finance market, having its genesis in the early 2000s. The main drivers for its initial development were:

- a growing need and desire for fund-level liquidity from (principally) private equity managers; and
- the close relationship between the small group of financial institutions that first began to provide these types of products and the end-user PE managers (sometimes in an investor capacity), giving them access to fund-level information essential for the assessment of the credit quality of the collateral underpinning the financing.

Whilst many very large transactions were being carried out at this time (generally bilaterally), the size of the market was comparatively small as a result of:

- a limited number of financial institutions offering this type of product and offering it as a relationship-enhancing product in conjunction with more traditional credit lines, such as portfolio company leverage; and

- a limited number of fund managers being considered an appropriate user of this type of financing – typically top-quartile European and global private markets managers with high-quality, diversified investor bases and underlying assets, and proven track records.

How has the English fund finance market changed since the early 2000s?

Fast forward to the end of 2019 and the English fund finance market has grown both in depth and breadth exponentially. Notwithstanding the continuing political and economic uncertainty characterising much of the last few years, in 2019 our team in London advised on new transactions totalling in excess of £30bn and, whilst there is no publicly available data for the English fund finance market, we believe the size of the English fund finance market to be in excess of £125bn.

In the past year, a significant number of these transactions have comprised non-subscription line facilities with hybrid, NAV-based (across all asset classes including primary PE), and GP-led financings, with a standout transaction for our team advising on a back-levered preferred equity transaction as further described in our earlier chapter on the secondaries market. The number of entrants into the fund finance market has increased by a staggering 48% as we've seen a growing trend in non-bank lenders in the fund finance space.

The main drivers of this growth have been:

- an increasing number of financial institutions, insurance companies and asset managers with capital to deploy looking to these products to deliver attractive risk-adjusted returns and, in the case of financial institutions, to facilitate a wider and deeper relationship with private markets fund managers;
- the attractiveness of the "low default" record of these transactions, with only one notable exception in 2018 in respect of the Abraaj group demise;
- as the products have become better understood and more widely used and recognised, a greater willingness and appetite to make these products available to managers across all asset classes and sizes and jurisdictions across Europe (including Germany, Spain and Italy) where English law generally remains the governing law of the financing;
- an increase in the prevalence of different types of fund finance products, as alluded to above, including an increase in the number of GP/Exec financings, umbrella and co-invest facilities and SMA financings; and
- as allocations to the private markets increase with dry powder sitting at over $2.2tn globally, the desire of fund managers to use fund finance products to facilitate the use of that capital as efficiently as possible. The efficient and intelligent use of fund finance facilities can provide this competitive edge.

A top-down analysis

The three most important shapers of the English fund finance market are:

- *Investor sentiment.* With prevailing low (albeit rising) interest rates, the private markets continue to play a crucial role in the investment strategies of institutional investors given the historically high levels of returns generated by alternative assets and several consecutive years of high distribution levels. Although at the time of writing this article, fund-raising figures for Q1-Q3 2019 are down on 2018, fund-raising is expected to match 2018, with 2019 being another successful year for fundraising globally. Similar to previous years, the fundraising market was again dominated by fewer and larger funds, as investors continued to concentrate their relationships in fewer managers, which in turn continued the bifurcation in the market in terms of capital-raising between the larger managers and the mid/small-cap managers. The 10 largest funds together raised more than 50% of the total capital raised in Q3 alone.

- *The asset manager's perspective.* The robust levels of fundraising have surpassed many managers' expectations, with more funds reaching final close in the period Q1-Q3 and many exceeding their targets yet again. However, this brings with it significant pressure to deploy record levels of capital and deliver high returns, in a competitive market where entry prices for assets are high and managers must continuously differentiate themselves.
- *Debt focus.* There are approximately 46 providers of fund finance products in the English market. However, a number of those lenders have tended to occupy different niches within it, so the market overall is not particularly deep, although increasingly widening. The factors which have tended to differentiate lenders historically are:
  - **Sector:** e.g., venture, infrastructure, buy-out;
  - **Geography:** reflecting the preferred geographic focus of the lender;
  - **Cross-selling opportunities:** the potential to provide ancillary products including depositary services;
  - **Facility complexity/pricing returns and revenue levels:** some lenders favour more complex products and the returns that accompany them;
  - **Balance sheet capacity/facility size:** as private markets managers' requirements for the size, duration and type of facilities increases, lenders that previously have been able to meet all of the manager's financing needs now need to bring in other lenders to meet this high level of demand. Conversely, there are a number of newer entrants in the market with large balance sheets that are using this capacity as a market differentiator;
  - **Risk/capital limits:** this has resulted in some lenders focusing on key clients only and/or preferring to offer uncommitted facilities; and/or
  - **LP diversity:** some banks require greater LP/underlying asset diversity than others, although we have seen a trend of lenders moving to advance against increasingly concentrated LP bases and asset portfolios.

The number of lenders offering these facilities has increased significantly over recent years; as fund finance products have become more mainstream, the yields continue to be attractive compared to other debt products. These returns, coupled with some of the ancillary business opportunities that are available, continue to make fund finance in its various guises a compelling product for lenders. Nevertheless, with many lenders still tending to have their own niche, the lender market is a Venn diagram of appetite which can limit the numbers of lenders with the ability and desire to participate in any particular facility.

Following the general trend in debt capital markets products and fuelled by increasing levels of competition, we continue to see pricing on some subscription lines, and NAV-backed facilities in the private credit and secondaries space tighten. This has reduced the appetite of some lenders to provide this type of product, and is resulting in an increased focus on ancillary business and/or a move towards more bespoke fund financings. Yet despite the number of new entrants to the market in the past three years, it is interesting that the number of lenders with credit appetite to provide wholly or partially asset-backed fund finance products is significantly less than is the case for LP-backed facilities.

Fund finance structures

Historically, subscription credit facilities advanced against diversified LP pools have been the most prevalent type of facility in the English fund finance market. However in the past eight years and particularly in the last three years, we have seen a significant increase in other types of fund finance products – mainly NAV-backed (whether hybrid or pure NAV-based), GP/Manager/exec financings, SMA financings, financings of GP-led transactions and umbrella facilities in their various guises. This has been driven in part by the increasing levels of competition in the subscription credit facility market, driving lenders to seek better returns, and private markets managers to be more creative in their usage of debt products at fund level. We have seen a number of trends emerge with each of these types of products in the English fund finance market as follows:

- *Secured or unsecured.* Prior to the global financial crisis, many subscription line facilities in the English market were provided on an unsecured uncommitted basis with a security power of attorney often being the only piece of (quasi-) security taken by the lenders. The rationale for this was:
  - the market at this point comprised only very high-quality experienced private markets managers with whom lenders had close institutional relationships;
  - importantly, the terms of the facilities precluded any other indebtedness within any fund vehicle sitting between the lender and the lender's ultimate source of repayment, i.e., the contractually committed and uncalled capital of the investors and very often, the underlying assets of the fund as well;
  - these facilities were niche bespoke products at that time and, whilst the fund documentation expressly contemplated the fund having the power to borrow, the security package that is now widely accepted as a staple part of these transactions was often not expressly contemplated;
  - these transactions were accompanied by a legal opinion from the fund's counsel confirming that the lender's claims under the finance documents ranked ahead of the claims of the investors (being the only other potential "creditors" of the fund); and
  - utilisation of these facilities was largely short-term, so the periods during which lenders were on risk was generally less than one year.

  As the market has grown and developed, with funds using fund finance products no longer having these relationships or features, so the emphasis on security has become greater, such that we now rarely see unsecured lines.
- *Umbrella facilities.* Designed to be a one-stop financing solution for private markets managers, these facilities can be used across a number of different funds (or entities within a fund structure) managed by the same manager (or, indeed, executives within a manager) at any time. We continue to see an uptick in volume of these types of facilities, as managers have become more creative and reliant on fund finance products and lenders look to differentiate themselves by offering bespoke financing solutions.
- *Defaults.* Whilst we continue to see fund finance as an industry with a very low default profile, the defaults associated with the Abraaj collapse continue to be a talking point in the market, with lenders taking a stricter view on a number of positions that had previously become more relaxed in the run-up to the Abraaj collapse. The Abraaj cases provided the only real opportunity the fund finance market has had to scrutinise our documentation and provisions in limited partnership agreements

which had previously not been regarded as relevant, for example, jurisdiction clauses and how the language in these clauses can impact a lender's recovery. Whilst the specific features of the circumstances underlying these defaults allow it to be distinguished to a large extent in the fund finance market, it has allowed us to take a much-needed pause for thought. The market has developed at a rapid rate against a backdrop of low default and zero enforcement numbers, and these deals have not been tested in the same way as other types of facilities until now. Our view is that this is actually a welcome development in our market, offering us the opportunity to consider risks which may not have been immediately apparent with these types of facilities previously, and thus to approach the documentation with these risks in mind. As a result, we believe many areas of the facility and fund documentation should be revisited in the wake of these facilities.

- *Committed versus uncommitted.* Historically, many subscription line facilities were structured on an uncommitted basis, enabling lenders to benefit from favourable regulatory capital treatment under UK regulation. Private markets managers using these facilities had done so on a regular basis for many years, and took comfort from their experience with the lenders providing them over this time that they would not be withdrawn without serious cause. The size of these facilities ran into the hundreds of millions, if not billions, and the savings made by private markets managers on commitment fees were considerable, particularly given that historically, these facilities tended not to be heavily drawn. We still see a number of uncommitted transactions (or transactions with an uncommitted element) in the English market, but as the market has opened up to new entrants, some managers have become less confident with uncommitted lines, and many banks no longer have the ability to provide uncommitted lines.
- *Side letters.* As a result of fund finance facilities becoming better understood and more widely used across the private markets, the use of debt by fund managers has become a focal point for investors when negotiating the limited partnership agreement and side letters, and we are seeing more provisions in those documents which relate to, restrict and otherwise impact on a manager's use of these lines. We are increasingly seeing restrictions around who can serve drawdown notices on investors, and restrictions on the amount that can be called from investors by lenders providing subscription lines, including some provisions which may seem innocuous but which may have a material impact on a lender's recovery.
- *Increase in volume of hybrid and NAV facilities.* We have seen an increasing number of managers looking to both restructure their existing facilities and structure new facilities, in each case on a hybrid or NAV-only basis, allowing the manager to use the line through and beyond the fund's investment period. Although there are far fewer lenders with credit appetite to lend against the underlying assets of a fund – particularly outside of credit and secondaries – we are seeing an uptick in lenders either getting comfortable with this type of recourse or specifically targeting these more lucrative transactions, particularly in the primary PE space, where we expect to see a continued increase in volume, as the market is opened up by top-tier managers using these lines. True hybrids, i.e., where a lender is taking equal credit risk on the investor commitments and the underlying assets, continue to be a more difficult proposition, with few true hybrids being done in the market.
- *Single account financing.* Single account vehicle financings continue to increase as private markets managers respond to investor demand to invest significant amounts

of capital through segregated accounts, and we are seeing a widening of the lender universe, getting comfortable with lending against highly concentrated LP bases.

- *Secondaries market.* The secondaries market has been one of the big success stories of the private markets over the past few years and this year has been no exception. In our earlier chapter, *The secondaries market: The rise of GP-led and preferred equity solutions*, we looked at the two biggest trends in the secondaries market – GP-led and preferred equity transactions – and how these are shaping the market. The secondaries market has evolved quickly in terms of capital-raising, deal volume and transaction complexity and innovation. This has given rise to a myriad of financing opportunities for lenders and fund managers.
- *GP/manager support facilities.* Whilst the increase in volume in these types of facilities has not been as material as other types of fund finance products, we are finding GPs and managers using these products more creatively, with many of the GP lines we have done this year involving umbrella frameworks, allowing execs to draw directly on these facilities, with lenders having little or no recourse to the management fee.
- *Open-ended structures.* We have advised on an increasing number of subscription lines where the end-user is a quasi-open-ended fund. Whether or not it is possible to work a subscription line around this type of structure will depend on the particular structure and documentation of the fund. On the whole, we have been able to navigate through the issues these types of vehicles give rise to in the context of a subscription financing, but early identification of issues is key.

Fund domicile in English law fund financings

Whilst Guernsey, Jersey and the Cayman Islands continue to be popular when it comes to fund domiciliation in English law fund financings, over the past six years we have seen funds domiciled in Luxembourg (particularly in the credit fund space) and Ireland feature increasingly.

Comparatively few English fund finance transactions involve English-domiciled funds. This is at least in part because, until relatively recently, the law governing English limited partnerships was antiquated with the key statutes, the English Limited Partnership Act 1907 and the Partnership Act 1890, having changed little since they were originally introduced.

However, on 6 April 2017, the Legislative Reform (Private Fund Limited Partnership) Order 2017 came into force, with the specific purpose of making English limited partnerships more attractive to private equity, venture capital funds and other private funds. In particular, it introduced the concept of "private fund limited partnership". Some of the usual rules, restrictions and administrative burdens that previously applied to all limited partnerships and their limited partners do not now apply to these "PFLPs".

Following other jurisdictions, such as Cayman and Guernsey, the Legislative Reform Order also seeks to add certainty for investors by introducing a non-exhaustive white-list of activities that a limited partner can undertake without "taking part in the management of the business" and thereby losing its limited liability status, which is likely to be helpful particularly for single-account structures. Despite these efforts, we have not seen any material increase in the number of funds choosing to domicile in England & Wales over the past 12 months, perhaps because English limited partnerships still do not provide all of the advantages of limited partnerships in some other jurisdictions.

With the rise of these non-traditional jurisdictions over the past few years, we have seen an increasing number of different types of vehicles being used as fund-raising vehicles – particularly corporate structures – which can present challenges in terms of putting a subscription or hybrid line in place. The challenges depend on the structure, jurisdiction and terms of the fund documents, but include addressing and providing the lender with control over any additional steps that need to be taken in order to complete the call-down process on investors.

The outlook for 2020 – some crystal ball gazing…

At the time of writing this chapter, the market saw the Conservatives win a clear majority in the December 2019 election, breaking the political deadlock of the last few years, which now means that the Prime Minister should be in a position to transition the UK out of the European Union. Whilst this has provided some relief to the markets that we appear now to be on course for an orderly departure from the EU and a withdrawal agreement signed imminently, there is still no trade deal with the EU, which may continue to hamper appetite for UK assets. For now, however, the short-term economic outlook is improved and the markets have initially responded favourably – a clear majority for the government placing it in a better position to do what it needs to do to "get on with Brexit".

It is interesting that despite the continued political and economic uncertainty we have again seen this year, there has been no decline in the number of English fund finance transactions, and in fact we have seen a significant increase in deal volume. This is not to say that the fund finance industry is immune to a politically and economically challenging environment, but whether we are in a time of record fundraising or a downturn, fund finance plays a pivotal role in creating liquidity in all types of situations for managers, and we expect to see demand for these products continue to grow, particularly on the NAV-based lending side.

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Samantha Hutchinson advises both financial institutions and private markets managers on the full range of fund finance products across all asset classes. She has advised on some of the largest subscription and leverage deals in the market, including a €7bn secondary financing for a leading primary PE manager, a €105m back-levered preferred equity financing, a €150m GP financing to a leading primary PA manager, as well as numerous secondary and GP-led financings. In the last 12 months she has advised on over 55 new fund financings, exceeding $23bn in value. Sam has been advising financial institutions and private markets managers for over 17 years, and her practice covers the full range of fund lending products, delivered via a number of different structures including framework and umbrella facilities.

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Jeremy Cross is a vastly experienced loan finance lawyer with particular experience in funds finance and real estate finance as well as more general experience in acquisition, leverage and general corporate finance.

Jeremy acts for lenders, borrowers and sponsors on a wide range of domestic and international financing transactions. His clients include the Royal Bank of Scotland, Lloyds Banking Group, Barclays Bank, Wells Fargo and National Australia Bank along with a number of other banks, non-bank financial institutions and funds.

Chambers UK lists Jeremy as a leader in the field of Banking & Finance, described as "a highly intelligent and commercial figure". *The Legal 500* has recommended the "very commercial [Jeremy Cross]". He is also recommended in Bank Lending, noted as "very commercial and has the ability to explain in simple language often difficult concepts". Jeremy was included among the "Hot 100"' Lawyers by *The Lawyer* in 2013.

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Nathan Parker is a Partner in the Finance Group in Cadwalader's London office. Nathan has worked in the City for over a decade on a large range of financing transactions and has represented leading private equity sponsors, funds and their portfolio companies in connection with their financing of cross border leveraged buyouts, restructurings and holdco and other structured indebtedness. He frequently works on new money investments and direct lending transactions in the restructuring and special situations context as well as fund financing transactions for both borrowers and lenders. Prior to joining Cadwalader, Nathan worked in the acquisition finance and fund finance practices in Debevoise & Plimpton's London office.

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Overview[1]

French private equity players, members of France Invest (the French private equity and venture capital association), raised €18.7bn in 2018 and €8bn in the first half of 2019.

In the first half of 2019, fundraisings increased significantly (+21% compared to the first half of 2018). This performance was boosted by fundraisings of more than €1bn. These amounts were raised through only 91 vehicles compared to 95 in the first half of 2018, suggesting a significant concentration of capital.

On 12 September 2019, Ardian announced that it had raised $2.5 billion for its latest co-investment fund, Ardian Co-Investment Fund V. The fund attracted more than 190 investors across Europe, the US and Asia, more than three times the size of Ardian Co-Investment's previous investor base. It also doubles the $1.2 billion raised for Ardian's fourth-generation fund in 2015.[2] Antin Infrastructure Partners raised more than €2.5bn in 2019, with a first closing for its fund IV as it heads towards target of €5–€6bn, which demonstrated that the French private equity market has world class players.[3]

Foreign investors represent 48% of the funds raised in 2018 and 49% of the funds raised in the first half of 2019, compared to an annual average of 40% over the period 2009–2018, which is a positive sign of the attractiveness of the French private equity and venture capital market. The financing of French funds, in the first half of 2019, came mainly from funds of funds (20%), insurance companies (19%), pension funds (14%), public sector (13%), sovereign funds (13%) and individuals and family offices (10%), with a very strong upturn in terms of public sector (+87% compared with the first half of 2018) and sovereign funds (+81% compared with the first half of 2018).

Dominique Gaillard, Chairman of France Invest, emphasises that: "*During the first semester of 2019, the two main indicators of French private equity activity, which are cash raised that will be invested in the next five years in companies and investments in start-ups and SMEs, are progressing strongly. This development reflects a favourable environment driven by government reforms, which is quite noticeable to long-term foreign investors who have subscribed to 50% of the funds raised this semester. Although start-up financing continues to progress, the State's announcement in mid-September 2019 of the €5 billion engagement from French institutional investors will be a welcome boost for French tech companies with high growth potential*."[4]

While equity bridge financings have been available on the market since the early 2000s in the United States and the United Kingdom, French funds for professional investors only started using bridge loans five years ago. However, they quickly integrated them, understanding that this is a competitiveness issue for the French asset management industry. Encouraged, among other things, by low interest rates, the growth of the private equity market and the needs of the fund managers and investors, equity bridge financings are increasingly popular in the French market.

There is no publicly available data for the French fund finance market or indeed, any fund finance market given the private and confidential nature of these types of transactions, although Preqin started publishing this year (on the Preqin Pro platform) information regarding equity bridge financings. At this stage, the information is limited to a binary 'yes/no' as to whether each fund that agrees to disclose this information uses equity bridge facilities or not.[5]

We set out below the deals which have been published in the past years. We note that in 2014, Natixis set up an equity bridge financing in an amount of €350,000,000 for funds managed by Antin Infrastructure. In June 2014, PAI Partners put in place equity bridge facilities of €600,000,000 granted by Lloyds Bank for its funds PAI EUROPE VI, refinanced in July 2016 by a second equity bridge financing of €960,000,000 granted by Crédit Agricole Corporate and Investment Banking and BNP Paribas Fortis SA/NV. In April 2016, Crédit Agricole Corporate and Investment Banking granted an equity bridge financing in an amount of €300,000,000 to Apax France IX. In 2016, Astorg Partners put in place an equity bridge financing made available to Astorg VI, managed by Astorg Assets Management.

Equity bridge facilities are being offered by an increasing number of financial institutions and are now playing an important role in a number of French private equity transactions. Financial institutions are also offering these facilities in order to develop stronger relationships with principals of the funds.

French funds overview

A French Alternative Investment Fund reserved for professional investors ("**Professional Funds**") is most of the time structured as a:

- FPCI (*Fonds Professionnel de Capital Investissement*) ("**FPCI**"), which can be established as a mutual fund or as an investment company with variable capital;
- FPS (*Fonds Professionnel Spécialisé*) ("**FPS**"), which can be established as a mutual fund or as an investment company with variable capital; or
- SLP (*Société de Libre Partenariat*) ("**SLP**"), which is an FPS, comparable to the English limited partnership or the Luxembourg *société en commandite spéciale* (SCSp).

A mutual fund does not have legal personality, whereas an investment company with variable capital or an SLP has legal personality.

Professional Funds are subject to the provisions of the Alternative Investment Fund Managers Directive 2011/61/EU (the "**AIFMD**") as implemented in France, and related EU Delegated Regulations. Professional Funds are not authorised by the French Regulator ("**AMF**"), but only subject to declarative obligations to the AMF within the month following their constitution. The legal documents of such Professional Funds can be drafted in French or in any other commonly used language in the financial sector (usually English).

Changes in French law

Article R. 214-206 of the French Monetary and Financial Code has been amended further to Decree n°2019-1172 of 14 November 2019, to increase the borrowing limit of a FPCI from 10% to 30% of its assets, which should have an impact on the current practice where, before such Decree, borrowings were made at the level of a special purpose vehicle set up by the FPCI, with the FPCI granting to the lenders a guarantee (*cautionnement*) of the obligations of such special purpose vehicle. The establishment of a special purpose vehicle should, therefore, in most cases, no longer be necessary since most of the funds borrow under an equity bridge financing less than 30% of their assets and, consequently, a FPCI will be able to borrow directly without the need to set up a special purpose vehicle.

Structuring of the financing

In France, an equity bridge facility will usually be structured via a committed term facility (which can be "replenished" upon repayment of each loan), but the facility also sometimes includes an uncommitted line, such uncommitted line reducing the costs of the facility for the lender in terms of regulatory capital. In order to avoid the management company being considered to be using leverage for the purposes of Commission Delegated Regulation n°231/2013 of 19 December 2012, "supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision", loans should be temporary in nature and should relate to and be fully covered by capital commitments from investors, and revolving credit facilities should not be considered, being temporary in nature.[6] It is usually considered in France that loans with a maximum duration of 364 days should be considered as temporary, provided that they relate to and are fully covered by, capital commitments from investors. Depending upon the activity of the fund, the facility can be utilised only by way of loans, or by way of loans and letters of credit.

Finally, depending upon the size of the facility, such facility is either syndicated or bilateral.

French law security package

Usually, the lenders under the facility agreement will benefit from: (i) a pledge over the bank account of the fund into which the investors pay their capital calls (and possibly, over certain other bank accounts of the fund); (ii) a pledge over certain bank accounts of the special purpose vehicle (if any); and (iii) the right to draw down investors' undrawn commitments if: (a) there is a payment default or an acceleration; and (b) the management company has not sent drawdown notices to such investors or the management company has sent drawdown notices to such investors but such investors have failed to pay the amounts due and payable under the facility agreement.

Certain transactions are also secured by way of pledge over the undrawn commitments of the investors. However, under most of the transactions, the lenders have relied on a third party drawdown right granted by the investors in the by-laws of the fund, called *stipulation pour autrui* or, to a lesser extent, on a power of attorney granted by the management company in order to call the investors, both the power of attorney and the *stipulation pour autrui* being exercisable upon the occurrence of the two enforcement events listed in the above paragraph.

Under French law, a power of attorney can always be revoked by the donor, even if stated to be irrevocable, subject to damages being due by the donor to the beneficiary of the power of attorney.

A *stipulation pour autrui*, as used in France in equity bridge financings, is an undertaking made by the investors (at the request of the fund), directly in the by-laws of the fund, pursuant to which each investor agrees to pay, at the request of the lenders, its undrawn commitments into the collection account of the fund, opened usually with its French depositary, up to the amount owed by each investor to the fund pursuant to its subscription agreement. Under a typical equity bridge financing, such collection account is pledged to the benefit of the lenders.

Since at the time the by-laws are signed, the names of the lenders are unknown, such *stipulation pour autrui* cannot refer to the names of such lenders. However, the lenders can rely on the terms of the *stipulation pour autrui*, notwithstanding the fact that their names are not specifically indicated in the by-laws of the fund, since such *stipulation pour autrui* is like a third party right which benefits any future lenders. At the time the *stipulation pour autrui* has been accepted by the lenders, it cannot be revoked by the fund. Such acceptance is typically made by way of a simple one-page acceptance letter executed by the lenders on the date of signing of the facility agreement.

A *stipulation pour autrui* is not a security *in rem* as such and does not grant any preference right to the lender, which means that if another creditor of the fund wants to seize the undrawn commitments of the investors, or if the fund has granted a pledge over such undrawn commitments (even if this would be done in breach of the negative pledge provisions of the facility agreement or in breach of the limits to indebtedness inserted in such facility agreement), such seizure would prevail at the time it is carried out and the pledge would prevail at the time it is notified to the investors or enforced.

In the absence of pledge, lenders on the French market have obtained comfort via: (i) the specific nature of the funds, dedicated to investments, which means that, in principle, a fund should not have other financial indebtedness and therefore, should not have other competing debt creditors with respect to such indebtedness; (ii) the negative pledge clause inserted in the facility agreement; and (iii) the fact that the by-laws of the funds usually provide that the investors' commitments shall be paid on the collection account of the fund opened with its depositary (which would, in practice, render such pledge less attractive).

From what we have seen, lenders have also taken a view on the quality of the investors and the potential side business which could be generated as a result of entering into an equity bridge financing with such fund. A lender may avoid this risk by taking security *in rem* in respect of the undrawn commitments of the investors. However, as noted, as a matter of French market practice, if lenders benefit from such a *stipulation pour autrui*, we have not seen pledges being granted to such lenders over the undrawn commitments of the investors, although we are seeing certain lenders considering such possibility.

A pledge of receivables can be enforced by notification to the investors, asking them to pay the pledgee. A pledge can also be enforced by contractual attribution of the claim which has been pledged, without the need to go to court. Such pledge could, in theory, also be enforced by way of judicial attribution but, due to the existence of the two above enforcement methods, such judicial method, in practice, is never used. There are no judicial expenses related to an enforcement by way of notification or contractual attribution. Depending upon the law applicable to the by-laws and the location of the investors, formalities may be required in order for the pledge to be enforceable – as detailed, among other places, in the Regulation (EC) n°593/2008 of the European Parliament and of the Council of 17 June 2008 on the law applicable to contractual obligations (Rome I) and in French case law.

French insolvency issues

Neither a FPCI, a FIPS nor a SLP can be subject to insolvency, to the extent the FPCI or the FIPS is established as a mutual fund. For such FPCI and such FIPS, this is due to the fact that they do not have legal personality, since they are co-ownerships of assets. For the

SLP, the French Monetary and Financial Code has specifically provided that the French insolvency proceedings regime does not apply to SLPs.[7] Since the French insolvency proceedings regime does not apply to such French funds, the enforcement regime of the above-mentioned security interests is not affected by the French rules applicable to insolvency proceedings (Book VI of the French Commercial Code) and enforcement is very much based on the principle of "first come, first served".

However, under article 1343-5 of the French Civil Code, a borrower may ask a judge for a grace period which the judge may or may not grant, for a maximum period of two years. The criteria where a borrower can apply for a grace period will be decided on a case-by-case basis by the judge. Article 1343-5 of the French Civil Code is very general and the judge will mainly decide on the basis of the situation of the borrower and the needs of the lender. The judge can decide that the rescheduled amount owed by the borrower will bear interest. The judge can also provide that such grace period will be subject to the accomplishment by the borrower of certain acts which may facilitate or secure the payment of the debt. Article 1343-5 of the French Civil Code cannot be excluded from the scope of the security or disapplied, since it is a mandatory provision of French law. In practice, however, we are not aware of any instances of a judge having granted such grace period in a fund finance context.

Contrary to a FPCI, a FIPS or a SLP, the management company of a French fund can be subject to insolvency proceedings. Although insolvency of the management company would have an impact on the power of attorney referred to above, the insolvency of the management company would not have an impact on a *stipulation pour autrui*.

Key developments

Equity bridge financings have traditionally been viewed as presenting a low risk for lenders. The only significant default that has been largely publicised, has been that of Dubai-based Abraaj Group. In 2018, it acquired a business with a subscription line from a French bank just prior to its default.

Abraaj's default was caused by the manager's deceit towards investors, the misuse of funds and the release of the investors.[8] Although this is very rare and unusual situation, lenders who operate in the fund finance sphere in France have sought to strengthen their contractual positions following this default, in particular, by requesting early disclosure to the investors of the existence of the facility, of the drawdown right and of the security interests securing such facility.

French law does not require notices to be sent to the investors in order (i) to perfect the *stipulation pour autrui,* or (ii) for the *stipulation pour autrui* to be invoked against the investors. Typically, lenders require the management company to mention, in the first quarterly report after the closing date (and sometimes, in each quarterly report in order to deal with new investors), the existence of the facility, the drawdown right and the security interests.

The knowledge by the investors of the equity bridge financing, the drawdown right and the security interests, allows in particular:

- to ensure that the investors will cooperate in case of enforcement and will respond to the drawdown notices received from the lenders or their agent, without being able to argue that they were not aware of the existence of the financing (although such argument should, in practice, not be accepted by a French court); and

- in the event of a release by the fund of its investors (as in the case of Abraaj) and therefore, in the situation where the investor undrawn commitment would be reduced to zero, to establish that the investors knew about the fraud and to have the release declared unenforceable (*inopposable*) *vis-à-vis* the lenders via an "*action paulienne*".[9]

It is now much more common for the lenders to request a notification of all existing investors at the closing of the facility, and of all new investors after the closing date (at the latest on the date on which each new investor becomes an investor in the fund), thus avoiding leaving a three-month window during which the investors could be released from their commitment without being aware of the equity bridge financing, even if this would be done in breach of the various undertakings and covenants of the facility agreement.

It is worth noting that the guidelines on equity bridge facilities published by the Institutional Limited Partners Association (ILPA),[10] which have been widely discussed (including in previous editions of this publication and by the Fund Finance Association[11]), include extensive recommendations covering disclosure and encouraging greater transparency from management companies.

The year ahead

With management companies and investors becoming more knowledgeable with equity bridge financings, the equity bridge finance market is expanding. Equity bridge financings are now used by all types of funds, from small to large cap, whether positioned in the infrastructure, real estate, secondaries or in the private equity sector, and with transactions where collateral is over the assets of the funds and not only over the undrawn commitments of the investors.

* * *

Endnotes

1. These data are based on a report entitled "*activité des acteurs français du capital-investissement 1er semestre 2019*" from France Invest and Grant Thornton, which can be accessed at https://www.franceinvest.eu/communique/activite-au-1er-semestre-2019-du-capital-investissement-francais. We state the law as at 25 November 2019.
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Guernsey

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Overview

Guernsey is a leading funds domicile with more than 50 years' proven track record as an international financial centre, and as such is increasingly recognised by fund sponsors and promoters as a leading centre for the formation, administration and cross-border distribution of investment business such as private equity, alternative investments, property funds, hedge funds and funds of hedge funds. As at the end of June 2019, there were over 1,000 funds domiciled in Guernsey, with the overall value of institutional and retail funds under management and administration in Guernsey standing at £295.9 billion.

There are a range of factors contributing to Guernsey's leading position in this space, including: (i) over 800 years of independent self-governance as a Crown Dependency of the United Kingdom; (ii) an AA-/A-1+ credit rating from Standard & Poor's representing Guernsey's very strong capacity to meet its financial commitments; (iii) historical familiarity with the jurisdiction by investors and fund sponsors; and (iv) the increasing dominance of the private equity sector in the funds market.

In addition, Guernsey law, which is derived from a combination of English common law, Norman customary law and local legislation, ensures that Guernsey funds are recognised as internationally accepted and well recognised vehicles for all kinds of fund-related activity.

Collaboration between the Guernsey government and the private sector also ensures that Guernsey laws keep pace with market evolution and demand. New products are being introduced to the market regularly to keep Guernsey at the forefront of the international funds market; previous products include manager-led products (MLPs) and private investment funds (PIFs).

The growth in this area shows a strong correlation with the fund finance space, where Appleby's Guernsey office continues to see steady growth year on year in the subscription credit facility market. Indeed, Appleby's Guernsey office continues to be a market leader in this area, representing the majority of the largest global banks on a variety of different financing structures.

An increase in fund size across the globe has meant higher commitments being expected of general partners, and this in turn has given rise to market demand for general partner support facilities over and above the standard subscription lines. These facilities tend to bring with them more bespoke security packages, tailored depending on the make-up of each individual general partner and the fund it manages.

Fund formation and finance

Lending to Guernsey funds

Guernsey private equity funds have typically been registered as limited partnerships under the Limited Partnerships (Guernsey) Law, 1995, as amended (**LP Law**). Though registered pursuant to the LP Law, a limited partnership is not generally a separate legal entity (although it can elect to have separate legal personality from its partners at the time of registration).

A limited partnership reflects a formal legal arrangement between one or more general partners of the limited partnership and one or more limited partners of the partnership. A general partner of a Guernsey limited partnership (**LP**) is liable for all of the debts and obligations of a LP and is vested with certain duties and powers with respect to the business of the LP. On the other hand, limited partners contribute or agree to contribute specific sums to the capital of the LP only, and have no liability for any of the debts or liabilities of the LP beyond this amount so long as they refrain from taking part in its management.

Any rights and obligations of the general partner and the limited partners are governed by the limited partnership agreement and any subscription agreements or side letters entered into by the limited partners, and are therefore contractual in nature. The LP's rights and property of every description, including any right to make capital calls and to receive the proceeds thereof, are held by the general partner in trust as an asset of the LP (and this remains the case even if a LP elects to have separate legal personality).

The typical security package

This contractual arrangement and ownership structure largely dictates the structure of the security package available to lenders offering subscription credit and general partner support facilities to Guernsey vehicles. As previously mentioned, limited partners of a LP will usually commit in the partnership agreement and/or subscription agreement to fund investments or to repay fund expenses when called upon to do so by the general partner from time to time. It is this contractual obligation of a limited partner to make these capital contributions, to the extent that they have not already been called (**Uncalled Capital**), and the corresponding right of the general partner on behalf of a limited partnership to call for Uncalled Capital (**Capital Call Rights**) that is at the core of the typical subscription credit facility security package. Given that these rights are contractual in nature and will be governed by the laws of Guernsey, the appropriate form of security over such rights is an assignment of title in the form of a security interest agreement in accordance with section 1(6) of the Security Interests (Guernsey) Law, 1993, as amended (the **Security Law**).

As legal title to the assets of the LP ultimately vests in the general partner, the Capital Call Rights are exercisable by the general partner for the benefit of the LP. As such, the proper parties to any grant of security over the LP's assets (and in particular, the Capital Call Rights) must be the general partner as well as the limited partnership (acting through the general partner). The security package must be in strict compliance with the requirements of the Security Law and, ideally, should incorporate an express irrevocable power of attorney in favour of the secured party, entitling the secured party to exercise the general partner's Capital Call Rights following the occurrence of an event of default.

It should not be assumed that the assignment of Capital Call Rights is necessarily permitted under the limited partnership agreement governing the LP (although it is common enough that the requisite changes to an agreement to permit such security are fairly uncontroversial). The terms of the limited partnership agreement can have a fundamental effect on the structuring of the collateral package and must be reviewed in detail in order to ensure a number of key elements, including but not limited to:

- the ability of the LP to incur indebtedness and enter into the transaction;
- that security may be granted over (a) the Uncalled Capital, (b) the right to make and enforce capital calls, (c) the related contributions, and (d) the general partner's share; and
- that Uncalled Capital may be applied (when called) towards the secured obligations.

In general partner support facilities, security is also taken under this section of the Security Law, with the collateral consisting of less well-known receivables than Uncalled Capital, such as general partner investor distributions.

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

In order to be effective and comply with the Security Law, any security over a contractual right must satisfy two limbs (the **Two Limbs**): firstly, the secured party must have title to the collateral assigned to it under a security interest agreement; and secondly, express notice in writing of that assignment must be served on the person from whom the assignor would have been able to claim the collateral (for example, in the case of Capital Call Rights, the limited partners).

On this basis, the serving of notice under the Security Law is a matter not just of the perfection of the security; the service of notice is crucial to the creation of the security interest, and without it no security interest exists. Attention must therefore be given to the sometimes tricky issue of the service of notice on limited partners who may otherwise be unaware of the financing arrangements proposed for the LP in which they invest; funds are often reluctant to serve notice promptly following the signing of the security interest agreement, and it can be important to educate lenders and fund managers as to the implications of not doing so.

Where a security interest is granted over Guernsey Capital Call Rights, priority of the security interest over any competing security interest will therefore be determined in accordance with Guernsey law and, given that a valid security interest is only created once both of the Two Limbs have been satisfied, priority may not be established in accordance with the time of execution of the relevant security interest agreements. A delay in the delivery of the Notice will therefore open up the secured party to the possibility that a general partner, on behalf of the Guernsey LP, may (quite unintentionally) grant a competing security interest or an absolute assignment over Capital Call Rights to a subsequent assignee. If both security interest agreements have been executed, provided that notice of the second assignment is provided to the limited partners ahead of notice of the first assignment, the second assignee will rank for repayment ahead of the first assignee.

Limited partners are increasingly aware of subscription facilities and familiarity with the product means that there is now, generally, less resistance by Guernsey LPs to giving notice to limited partners. This has led to notices typically being circulated to the limited partners immediately upon execution of the security documents in order to ensure that security is created and priority is achieved at closing of the subscription credit facility.

Given the importance of actual delivery of the notice to the limited partners, evidence of the notice having been received also assumes some importance. In general, where the limited partners are not part of the same borrower group, it is unlikely that any form of acknowledgment of the notice will be received. It is increasingly common for Guernsey limited partnership agreements to build in provisions that specify the circumstances in which notices delivered in accordance with their terms are "deemed" to have been received by the limited partners. Where a limited partnership agreement contains such provisions, lenders can take some comfort in proof of delivery of any notice in accordance with the provisions of the partnership agreement (rather than proof of receipt by way of a signed acknowledgment by the limited partners, which is the ideal).

In all cases, the recommendation would be that the general partner sign and deliver the notice to the limited partners in accordance with the provisions of the limited partnership agreement governing service of notices on the limited partners, with a copy delivered to the secured party. Where no such provisions are included regarding the service of notice and deemed delivery, it is important to obtain proof of delivery to limited partners (such as receipt of copies of courier delivery slips).

We have also seen an increasing prevalence of limited partners, within the terms of the limited partnership agreement, appointing an agent specifically to receive notice of this nature on their behalf (and indeed, sometimes, to also acknowledge receipt of the notice on their behalf). Wording of this nature should be examined with caution to ensure compliance with the requirements of the Security Law. Increasingly, local market practice is to have the agent sign an acknowledgment to the notice of assignment, containing a specific confirmation that they (the agent) will send the notice on to the limited partners in satisfaction of the requirements of the Security Law (although, see below under 'Key developments').

In addition to facilitating the creation of a security interest, delivery of a Notice to a Guernsey limited partnership's limited partners of an assignment of Capital Call Rights has other distinct advantages. Two of the more important advantages of delivery of the Notice include preventing: (i) the limited partners from obtaining good discharge for their obligations to fund their Uncalled Capital in any manner other than as specifically indicated in the notice; and (ii) set-off arising after the date of service of such notice (on the basis of the common law principle that set-off works between the same parties in the same right).

Other elements of a typical security package

The typical security package will also include the grant of a security interest over a designated bank account under the control of the Lenders into which any capital call proceeds must be paid. Although the security interest agreement over Capital Call Rights in a Guernsey LP must be granted under a Guernsey law security interest agreement which complies with the requirements of the Security Law, security over such designated bank accounts should usually be governed by the law of the jurisdiction in which the account itself is situated.

Whilst Guernsey is a popular choice for the accounts of both Guernsey and non-Guernsey private equity funds due to the well-established and regulated status of the jurisdiction, it is equally common for such accounts to be sited in the United Kingdom or United States and, in such instances, it would be usual for such security to be granted under a New York or English law governed security agreement. If the account is Guernsey situate, security should be taken in compliance with the requirements of the Security Law and take the form of a security interest agreement. Assuming that the secured party is not also the account bank, then notice is once again a key factor, and time should be factored in to deal with the requirements of individual account banks who maintain the accounts which are the subject of the security.

Less typical security elements

Other, less typical security packages may include security directly from the limited partners over their interests in the limited partnerships themselves and, particularly in relation to hybrid facilities and funds nearing the end of their life cycle, security is often taken over underlying assets of the fund, as this is where the fund's value lies. In Guernsey these might include shares in Guernsey registered subsidiary companies, units in Guernsey unit trusts, and/or contract rights arising under Guernsey law contracts. In respect of these asset types, security is taken by way of a Guernsey law security interest agreement and the formalities to finalise the creation of the security are as follows:

- Shares – notice of the assignment is given to the company whose shares are secured, possession is taken of the share certificates (together with blank stock transfer forms) and the register of members is annotated to reflect the security interest.
- Units – notice of the assignment is given to the trustee of the unit trust whose units are secured, possession is taken of the unit certificates (together with blank unit transfer forms) and the register of unit holders is annotated to reflect the security interest.
- Contract rights – notice of the assignment is given to the contract counterparty and acknowledgment obtained.

Registration requirements

With the exception of land located in the Bailiwick of Guernsey, vessels flagged in Guernsey and Guernsey-registered aircraft, there are no registration steps required in Guernsey and there is no general register of security interests in Guernsey accessible to the public. There is similarly no statutory requirement that a Guernsey entity keeps a private register of security interests.

Other products

The protection afforded to investors in funds proposed by the Alternative Investment Fund Managers Directive (**AIFMD**) has been at the forefront of the minds of the entire Guernsey funds industry and has seen increased emphasis on the substance of both funds and fund managers, in particular.

Guernsey has worked hard to ensure that from the outset its regulatory infrastructure is suitable to enable the distribution of Guernsey-domiciled funds to both EU and Non-EU countries. In July 2016, the European Securities and Markets Authority announced its recommendation that Guernsey be included in the first round for the granting of a third country passport for the purposes of AIFMD. Guernsey is still one of only five non-EU jurisdictions to be given such an assessment and the recommendation (subject to relevant approvals at an EU level) will enhance Guernsey's position as a gateway to the European funds market. It is anticipated that, Brexit notwithstanding, this enviable position will further strengthen Guernsey's position in the offshore market in the EMEA time zones and make Guernsey a first point of call for the purposes of structuring funds distributing to both EU and non-EU markets.

Guernsey publicly stated its intent to participate in the OECD's Base Erosion and Profit Shifting (**BEPS**) Project as an Associate in March 2016 and remains committed to the collective aim to reach a globally fair and modern international tax system. Accordingly it has signed a Multilateral Agreement to exchange tax information. The Multilateral

Competent Authority Agreement provides for automatic exchange of information in accordance with country-by-country reporting by large multinational enterprises. BEPS refers to tax planning strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low- or no-tax jurisdictions where there is little economic activity, resulting in little or no overall corporate tax being paid.

Manager Led Product (MLP)

In May 2016, the Guernsey Financial Services Commission (**GFSC**) launched the MLP. The MLP is aimed at alternative investment fund managers (**AIFMs**) seeking to market into one or more EU Member States under national private placement regimes.

Under the MLP regime, all regulatory standards are borne by the AIFM and, by virtue of the AIFM's sponsorship, no alternative investment fund or underlying licensee will have rules imposed on it. The MLP regime avoids duplicating regulatory requirements over several entities. Further, derogation requests acceptable to the host country will be considered by the GFSC. The GFSC will be able to register a fund and license an underlying licensee within 24 hours of notification.

The regime is intended to be used by AIFMs seeking to market an AIF into an EU member state under its national private placement regime. In addition, it is anticipated that the MLP regime will assist Guernsey AIFMs in utilising the EU AIFMD third country passport (once available) in order to market in the EU. For that reason, the MLP regime anticipates that the AIFM will opt into the Guernsey AIFMD Rules – which replicate the rules of the EU AIFMD.

Until the EU AIFMD third country passport has been extended to Guernsey, it is unlikely that a Guernsey AIFM would wish voluntarily to submit to the additional regulatory burden of Guernsey's AIFMD Rules. For that reason, the GFSC has indicated that significant derogations from the MLP regime requirements may be available.

The GFSC intends to extend Guernsey's suite of MLPs to include a similar offering for marketing outside the European Union.

Private Investment Fund (PIF)

In November 2016, the GFSC introduced a PIF regime which provides fund managers with greater flexibility and simplicity. The PIF, which was developed in response to market demand by the GFSC in consultation with the island's funds industry, recognises that certain investment funds are characterised by a relationship between management and investors that is closer than that of a typical agent. The PIF dispenses with the formal requirement for information particulars such as a prospectus in recognition of that relationship, significantly reducing the cost and processing time of launching of a fund.

The PIF, which can be either closed or open-ended, should contain no more than 50 legal or natural persons holding an economic interest in the fund. A key strength of the product is that, where an appropriate agent is acting for a wider group of stakeholders such as a discretionary investment manager or a trustee or manager of an occupational pension scheme, that agent may be considered as one investor. While there is a limit imposed on the number of investors in the PIF, no attempt has been made to limit the number of investors to whom the PIF might be marketed – a feature not available under comparable regimes.

The PIF is predicated on a close relationship between investors and the licensed manager, who will be responsible for providing warranties on the ability of the investors to assume loss. Under the new rules, both the PIF and its manager benefit from an application process that can be completed in one business day. The two processes may be completed in tandem by the GFSC, ensuring a short regulatory timescale.

Key developments

As a result of certain judicial cases in the last year, we have seen a tightening of legal structures, with increased scrutiny of the way in which security in fund finance transactions is created, or perfected, in foreign jurisdictions.

From a Guernsey perspective, as noted above, service of a notice of assignment under the Security Law is fundamental to the creation of a Guernsey security interest, and so due service on the counterparty must occur contemporaneously with, if not before, completion occurring.

Where we have seen key developments in the market is in lenders' internal policy requirements for the service of such notices of assignment. The internal policies often contain little-to-no room for flexibility in the mode of service, regardless of the terms of the partnership agreement, so as to minimise the risk of a counterparty challenging the security on the grounds of non-receipt.

Such a clear movement in internal thinking has given rise to multiple market discussions around the mode of service of notices to bigger funds with larger pools of limited partners; discussions which will no doubt continue to develop over the coming year.

The year ahead

Foreseeing the year ahead would require the ability to read a crystal ball! The fallout from Brexit (whatever form it takes) is extremely hard to predict accurately.

The Guernsey market continues to see sophisticated lenders providing increasingly complex and tailored solutions to the funds market, with loans being made to the full cast of players in the funds market including funds, secondary funds (against their limited partnership interests, to finance the acquisition of limited partnership positions and release capital to investors), limited partners and general partners (to help finance GP and fund commitments). As the funds industry continues to flourish, so will the fund finance industry; the market shows all the signs of continuing to expand in 2020.

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Hong Kong

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An overview of the Hong Kong fund landscape

When referring to "funds", a distinction must be drawn between public, open-ended funds and private, close-ended funds.

Public, open-ended funds are regulated in Hong Kong by the Securities and Futures Commission (**SFC**). As at 31 December 2018, there were over 775 public, open-ended funds domiciled in Hong Kong with a net asset value of $1,081 billion (US$138 billion), representing a decrease of 13% compared with the preceding 12-month period.[1] Despite the decreased net asset value in 2018, it is expected that this number, and the value of investments, will continue to grow in the mid to long term as the Hong Kong government and regulatory authorities continue to pursue a number of initiatives in a drive to promote Hong Kong as a full-service international asset-management centre and preferred fund domicile.

The SFC has continued expanding the mutual recognition of funds scheme (**MRF Scheme**), which allows for securities of public funds domiciled in Hong Kong to be offered directly to investors in recognised markets (and *vice versa*). As of the time of writing, mutual recognition arrangements exist with the People's Republic of China (the **PRC**, which for the purposes of this chapter, excludes Hong Kong, Macau and Taiwan), Switzerland, France, the United Kingdom, Luxembourg and the Netherlands. Since the introduction of the open ended fund company (**OFC**) in Hong Kong (which is discussed further in this chapter), the SFC has also secured eligibility for SFC-authorised OFCs under the MRF Scheme with those jurisdictions. It is expected that this list will grow as the SFC continues to hold discussions around similar arrangements with other jurisdictions.[2]

The private fund space paints a rather different picture. While there are roughly 239 fund managers based in Hong Kong today,[3] the majority of the private funds are domiciled overseas.[4] This is largely due to uncertainties surrounding the treatment of limited partnerships in Hong Kong, pursuant to its antiquated Limited Partnership Ordinance, which was introduced in 1912. Following the introduction of the OFC regime in 2018, the Hong Kong Government is now consulting on a proposal to establish a limited partnership regime for use by investment funds in Hong Kong.

Further, on 1 April 2019, amendments to the Inland Revenue Ordinance came into effect establishing a unified fund exemption regime allowing all privately offered onshore and offshore funds operating in Hong Kong, regardless of their structure, their size or the purpose that they serve, to enjoy profits tax exemption for their transactions in specified assets (including in investments in both overseas and local private companies) subject to meeting certain conditions. It is anticipated that an increasing number of private funds will choose to domicile in Hong Kong as the Hong Kong Government continues to strengthen

Hong Kong as a premier international asset and wealth management centre in the Asia-Pacific region and increase the attractiveness of Hong Kong as a preferred jurisdiction for fund domicile.

As fund finance activity is very much concentrated in the private funds domain, the remainder of this chapter will focus more on the private fund market in Hong Kong, and the proposals that are expected to propel Hong Kong into a prominent position in the global funds market.

What is a "Hong Kong" fund and what is "Hong Kong" fund financing?

As noted above, it is rare for private funds to be domiciled in Hong Kong, and so when a reference is made to a "Hong Kong" fund it is, to a large extent, referring to funds administered out of Hong Kong or managed by a fund manager based in Hong Kong. Similarly, we would classify a fund financing as a "Hong Kong" financing if it is provided by a lender operating from Hong Kong and/or the fund obtaining the financing is administered or managed out of Hong Kong. In practice, the reality is that Hong Kong fund financing typically involves various parties across a number of jurisdictions (especially as we see more financing provided on a club rather than on a bilateral basis).

The private equity funds market in Hong Kong and the PRC

The PRC continues to dominate with the largest number of private equity and venture capital investors within Asia, representing 32% of total investors in the Asia-Pacific region as compared to a diminutive 9% of investors from Hong Kong.[5] As far as fundraising is concerned, in 2017, approximately 303 funds were closed by managers in the PRC and 31 funds closed in the rest of Greater China (being the PRC, Hong Kong, Macau and Taiwan), representing a record $90 billion of aggregate capital value raised. Compare that with the data this year (up until September), of approximately 39 funds closed by managers located in the PRC, and with nine funds closed in the rest of Greater China (unfortunately, data was not available from our source regarding the investor profile, the type of fund structures included in this calculation or the aggregate capital value raised in 2018).[6]

If the wider market is taken into account as well, the number of funds closed each year in the Asia-Pacific region has continued to decline since its peak in 2015. In 2018, over 200 funds focused on the Asia-Pacific region were closed, raising approximately US$60 billion as compared to 2015, when 836 funds were closed, raising approximately US$89 billion.[7] This trend is perhaps due to increasingly large funds being raised and closed in the market, recent examples of which include: PAG Asia Capital securing US$6 billion, well in excess of its goal of US$4.5 billion;[8] and Bain Capital's Asia IV fund raising US$4.65 billion in six months, also exceeding its US$4.5 billion target.[9]

In September 2018, Hillhouse Capital, an investor in leading PRC-based technology firms including Tencent and Baidu, raised a record US$10.6 billion for its latest fund, Hillhouse Capital Fund IV, focusing amongst others, on technology and healthcare in Asia.[10] These record-sized funds entering the Asia-Pacific market build on trends we have noted in past years. Also worth noting are some of the largest private equity and venture capital fund managers based in Greater China over the last 10 years, which include SINO-IC Capital (headquartered in the PRC) having raised US$22.6 billion, and Inventis Investment Holdings (China) (headquartered in Hong Kong) having raised US$12.2 billion.[11]

While there is speculation that the reported contraction in the number of fund closures may be related to more stringent Chinese policy on the transparency of wealth management products and reduction of financial risk,[12] there are also reports that China has begun a campaign to ease regulatory restrictions on foreign investment as it continues to open up the market.[13] The impact of such easing of restrictions remains to be seen, given the current climate of on-going trade tensions with the US.[14]

In terms of deal value, as a combined force, Greater China continues to attract significant volumes of capital, with deal value rising to US$94 billion in 2018,[15] as illustrated in the chart below. It should be noted, however, that despite increasing investments, Asia-Pacific funds, including that of Greater China, are still sitting on significant amounts of dry powder (i.e. committed but unspent capital), which is discussed further in the next section.[16]

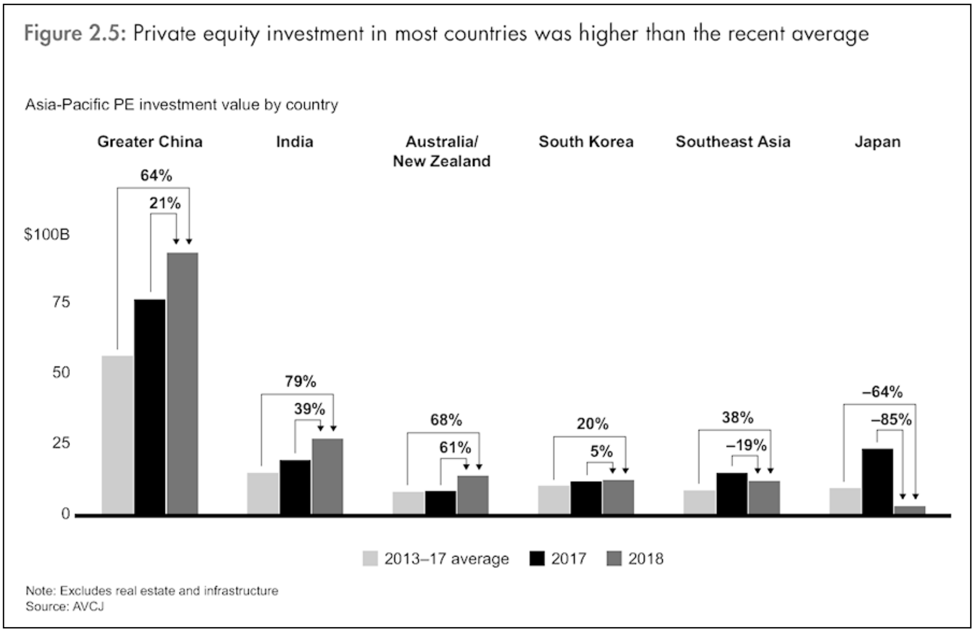

Figure 2.5: Private equity investment in most countries was higher than the recent average

Source: Asia-Private Equity Report 2019, Bain & Company, March 2019[17]

Factors affecting the market

Although 2017 was generally seen as representing a resurgence for Asia-Pacific private equity,[18] fundraising activity has experienced an overall slight reduction in the Asia-Pacific region over the last few years. This is partly due to a stagnant exit environment: where managers feel unable to divest their holdings, they are less likely to make new investments and are consequently less profitable and make fewer distributions to their investors. When not seeing significant return on their capital contributions, investors are deterred from committing further capital, which serves to exacerbate the cycle. Indeed, at the end of December 2018, Asian-based fund managers were holding a record US$317 billion of dry powder, considerably higher than the figure of $267 billion in 2017, which is equivalent to three years of future supply at the current pace of investment.[19]

The fundraising market in the PRC, in particular, is further hampered by a limited number of managers performing at the highest level with a consistent track record and sector expertise, especially in the increasingly desirable technology, healthcare and education sectors. This is especially disadvantageous in the current exit environment, where it is essential that fund managers are able to show that they have good management skills and an ability to negotiate favourable exit rights in order to attract investors.

In April and May 2018, the PRC revived the once-suspended Qualified Domestic Institutional Investor (**QDII**) and RMB Qualified Domestic Institutional Investor (**RQDII**) regimes, respectively. In brief, QDII/RQDII is a scheme established to allow qualified domestic financial institutions to invest in securities and bonds in offshore capital markets. Specifically, RQDII allows qualified domestic financial institutions to invest in overseas RMB denominated products using their own RMB funds or funds from other domestic institutional or individual investors. In this revival of the RQDII regime, tighter controls have been put in place (e.g. strengthening the initial and ongoing filing requirements on the background information of investors, custodian bank, funding source and scale, investment plan, repatriation, and the outstanding position outside the PRC under the RQDII regime), and it has been stressed once again that RMB funds repatriated outside of the PRC under the RQDII regime may not be converted into foreign currencies.

Both regimes were unofficially suspended in 2015 – reportedly, amongst other reasons, to reduce capital outflow; this may have had an impact on the funds market, but the impact of the resumption of these regimes remains to be seen. Going forward, the PRC regulator has stated that it would conduct macro-prudential supervision over RQDII investments, taking into consideration factors such as the repatriation of RMB funds, liquidity of the offshore RMB market, and the development of RMB denominated investment instruments outside the PRC.

Generally, given the limited channels through which onshore capital can be repatriated outside the PRC, it is not surprising to see a lot of private funds based in Asia (including those managed in Hong Kong) having an investor base which is dominated by offshore investors. Despite regulatory relaxations in recent years in the PRC, there are still limited opportunities for onshore investors to commit onshore capital directly to offshore private funds.

Fund formation in Hong Kong

Funds: Currently, the vast majority of Asia Pacific-focused funds are set up as limited partnerships in jurisdictions such as the Cayman Islands, where the limited partnership is considered tax-neutral and treated as a "flow-through" structure, which is particularly advantageous since investors are usually based internationally.

Fund structures: The introduction of the OFC structure in 2018 has also brought Hong Kong in line with other sophisticated investor markets such as the United Kingdom (whose equivalent structure is known as the "open-ended investment company"). The OFC structure allows funds to take on a limited liability corporate structure, with the flexibility to vary their share capital to meet shareholder subscription and redemption requests. Sub-funds allowing for segregated liability within an overall umbrella OFC may also be established. OFCs have requirements such as: (i) mandatory delegation of investment management functions to an investment manager in Hong Kong; (ii) mandatory entrustment of scheme property to an eligible custodian; and (iii) disclosure requirements.

OFCs can either be set up as public or private vehicles. Public OFCs are authorised and regulated in accordance with the existing authorisation regime for SFC-authorised funds. On the other hand, private OFCs, while not being quite as limited as public OFCs in terms of investment scope, must still have 90% of their gross asset value invested in: (i) asset types the management of which would constitute a Type 9 (asset management) regulated activity; and/or (ii) cash, bank deposits, certificates of deposits, foreign currencies and foreign exchange contracts. As of the time of writing, the SFC has approved two private OFCs.

As mentioned above, Hong Kong's existing Limited Partnership Ordinance does not create an attractive legal framework for private equity funds because of its limitations in important areas such as capital contribution and distribution of profits. In order to address these limitations, the Hong Kong Government is now consulting the public on the introduction of a new limited partnership regime for funds (**LPF**); in devising the LPF regime, overseas experience from jurisdictions such as the Cayman Islands, Delaware, Ireland and Luxembourg were considered.

Under the proposed LPF regime, the LPF will be a contractual arrangement between a general partner and limited partner(s) constituting a fund established for the purpose of managing investments on behalf of the limited partner(s); the general partner of a LPF will have unlimited liability for all the debts and obligations of the LPF, and the limited partner(s) will not be liable for such debts and obligations beyond the agreed contribution (unless the relevant limited partner has exercised substantive control of the LPF outside of the scope of the prescribed safe harbour activities).

In addition, the general partner will be required to appoint an investment manager to carry out the day-to-day investment management functions. To meet the needs of the fund industry, provisions allowing for flexibility in capital contribution, distribution of profits, contractual flexibility and a winding-up mechanism are intended to be introduced under the LPF regime. It is hoped that the LPF will put Hong Kong on par with other jurisdictions such as the Cayman Islands and Luxembourg in offering fund managers an attractive option for fund domicile in Asia.

Investment managers: Any entity that holds responsibility for managing investments in Hong Kong must hold a Type 9 (asset management) licence with the SFC, regardless of whether the fund itself is incorporated onshore or offshore; as mentioned above, OFCs must have an investment manager with a Type 9 licence. The SFC revised the Fund Manager Code of Conduct in 2018, which Type 9 intermediaries are subject to, in order to bring Hong Kong in line with international regulatory developments in asset management regulation.

It is worth noting that, in instances where the main commercial substance of a fund is located in another jurisdiction, the investment manager would most likely be domiciled in that jurisdiction and subject to any local regulatory requirements. In order to manage the Hong Kong aspects of that fund, the investment manager would then appoint an investment advisor in Hong Kong. Such advisor would be subject to the same licensing requirements as described above, and would manage the local aspects of the fund only.

Investors: While fund investors in North America and Europe are mostly pension funds and foundations, Asian-based fund investors are predominantly banks, corporates, insurance companies and investment companies.[20] As private wealth increases across the Asia-Pacific region, an increasing number of high-net-worth individuals and family offices are also investing in funds.

A distinction should also be drawn between those investors that are committed to investing in the Asia-Pacific region as part of their long-term investment strategy, and opportunistic investors that invest in the region only where they see real windows of opportunity that may afford positive returns. When the market is not at its peak, it is those opportunistic investors that may be most significantly deterred from investing in the region.

Hong Kong fund financing

Capital call (subscription) financing: Although currently not as prevalent as in the United States and Europe, subscription financing has become significantly more common in the

Hong Kong market in recent years. Traditionally, subscription financing was used as a bridging loan to allow investment managers to close deals in a tighter timeframe than would be possible by calling capital from investors (as amounts can often be drawn down under a subscription facility within a matter of days, while notice periods for calling capital from investors can extend into a number of weeks). Due to low interest rates, funds are now using subscription facilities more frequently and more extensively for longer-term borrowings than the original bridging financings they were intended for. In recent years, the subscription facility market has significantly increased in size as more funds are attracted by the flexibility and liquidity, and lenders are attracted by strong credit profiles and historically low delinquency rates.

In Hong Kong, as is the case in the United States, Europe and Australia, security under a subscription facility is two-fold: firstly, an assignment of the general partner's right to make capital calls on the limited partners' unfunded capital commitments; and, secondly, a fixed charge over the collection account into which the proceeds of such capital calls are paid. The assignment interest can be a legal or equitable assignment but market practice in Hong Kong is generally to give notice of the assignment to the limited partners (and use reasonable endeavours to obtain an acknowledgment) in order to evidence a legal assignment (and in this respect, the law in Hong Kong relating to charges and assignments follows the same principles as English law).

As suggested above, the market indicates that there may be an increased appetite for larger-sized fundraising in the Asia-Pacific region and, since the market for subscription facilities generally tracks that of fundraising of the larger-sized private funds, the prevalence of these facilities may continue to increase in the next few years, particularly if the PRC relaxes its restrictions on outbound investment over time. With the proposed legal and regulatory developments in Hong Kong, it is hoped that much of this activity will be concentrated in Hong Kong, affording local investors a far broader access to funds, which will help to further encourage financing by local funds.

While international banks (many with a strong track record in fund financing in the United States, Europe and Australia) still dominate the market in Hong Kong, regional banks based in Hong Kong and other parts of Asia are also starting to become increasingly involved in subscription financings. Given their extensive network in the region, they are much better placed than a lot of their offshore counterparts in assessing the credit of funds with a large regional investor base, and have a greater appetite for country-specific risk.

Umbrella financing: A number of funds choose to set up as an umbrella fund: a single legal entity with a number of separate sub-funds that each operate as an individual fund. For investors, this provides the benefit of economies of scale and, for the investment manager, it is more efficient, as the same terms and conditions tend to apply to each of the sub-funds and to the umbrella fund, reducing administrative time and costs. A subscription facility may be provided either to the umbrella or to any one or more of the sub-funds against the usual security package. Umbrella financings are becoming increasingly common in the Hong Kong market, as a number of Asia-domiciled funds are choosing to establish themselves using this structure.

General partner financing: Although not particularly common to date, we have seen an increasing number of enquiries in the last 12 months with regard to general partner financings, where financing is provided to the general partner of a fund in order to fund its working capital needs and, sometimes, its own commitment. Under these facilities, security is taken by way of an assignment of all of the general partner's partnership interests in the fund (including, for example, its right to receive management fees, performance fees, carried interest and any other related income) in addition to a fixed charge over the relevant collection accounts. This structure is the same in Hong Kong as it is in the United States, Europe and Australia, where these types of financings are much more common in the respective markets.

Alternative models: As the Hong Kong market becomes increasingly sophisticated, both lenders and borrowers are beginning to ask more questions of alternative financing structures that may be more suited to their requirements. Mature funds, which have already called all or a significant portion of their investors' capital commitments; funds that do not permit traditional subscription financing or single investment; sub-funds looking to obtain financing without recourse to the master fund (amongst others), may, for example, benefit from a net asset value-based (**NAV**) financing. Instead of being backed by the uncalled capital commitments of the fund's investors, NAV facilities are backed by the underlying cashflow and distributions that flow up from the fund's underlying investments via security interests over the portfolio assets.

While NAV financings are becoming relatively common in the United States, market participants are only just beginning to explore this product in Hong Kong.

Another alternative option is the hybrid facility, which offers maximum flexibility to both lenders and borrower funds. These are particularly useful for funds, as they provide financing with a long maturity, utilising a traditional subscription financing structure in the early stages and switching to an NAV-based structure later in the life of the fund, after a certain proportion of commitments have been drawn from investors. This affords lenders recourse to both the undrawn commitments of the fund and the fund's underlying assets, while borrowers are presented with a more flexible solution that may suit their investment needs over time.

Other key developments

ILPA guidance: As mentioned above, a subscription financing allows a fund to delay calling capital which, in addition to being used as a tool to manage the timing of capital calls, can also be used to boost a fund's internal rate of return by returning capital to investors earlier in the investment cycle, which it is argued can be used to artificially inflate performance. While many investors do favour subscription facilities due to the decreased number of capital calls, others are more hesitant because of the additional expenses and this perceived ability to manipulate the internal rate of return. This led the Institutional Limited Partners Association (**ILPA**), following consultations with various interested parties, to issue best practice recommendations in respect of subscription financings in June 2017. Generally, these recommendations focused on increased transparency and disclosure to investors.

In the Asia-Pacific region in particular, where investors may be less sophisticated and familiar with the subscription financing product, the market view is that this guidance may lead to increased discussions and interest from investors, helping the investors to better understand subscription facilities, and in turn perhaps enabling them to better utilise the product. Over time, we are also tending to see new funds established with limited partnership agreements that are much more favourable to, and expressly permit, subscription financings and related security interests, cross-collateralisation between funds and alternative investment vehicles, and more flexible financing terms including longer-dated facilities. We have also seen an increase in fund financings (both on a bilateral and syndicated basis) being documented on a fully or partially uncommitted basis this year.

Regulatory environment in the PRC: Since summer 2016, the Asset Management Association of China (AMAC) has opened the private fund market up to foreign asset managers. As at August 2019, there were 22 Sino-foreign joint-venture (JV) securities investment fund management companies (FMCs) with licences granted by AMAC, including Fidelity International and UBS Asset Management. Such a licence enables them to market funds to qualified domestic companies and high-net-worth individuals in the PRC.

In April 2018, AMAC announced that foreign fund practitioners will be able to sit for the industry's qualifying examination in English, as part of AMAC's attempt to allow more foreign practitioners in the market.[21] It will be interesting to see whether and to what extent the increasing number of global asset managers obtaining licences from AMAC, coupled with the relaxation of industry rules, will alter the fund landscape in Hong Kong, particularly as a large number of asset managers are based here.

Looking forwards

As the Hong Kong Government pushes forward measures and reforms to strengthen Hong Kong's position as a leading international fund centre, we continue to see encouraging signs in the form of expanding mutual recognition of funds, the introduction of the OFC, the establishment of the unified fund exemption regime, and the proposal for a new LPF framework. With a large number of global asset managers already having found their homes in Hong Kong, this jurisdiction will no doubt continue to be a key player in the private funds market in Asia.

As lenders, funds and investors in Hong Kong develop a more mature understanding and appreciation of the funds market and attempt to transfer more sophisticated products and tailor-made solutions from the United States and Europe (such as NAV and hybrid financings), we have no doubt that Hong Kong and Greater China will see an intriguing evolution in the years ahead.

* * *

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Ireland

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Overview of the Irish funds industry

Overview of the Irish regulated funds market

Ireland is regarded as a key strategic location by the world's investment funds industry. Investment funds established in Ireland are sold in 90 countries across Europe, the Americas, Asia, Africa and the Middle East. A total of 986 fund promotors have funds domiciled and/or serviced from Ireland.

As of June 2019, there were 7,500 Irish domiciled funds (including sub-funds) with net assets of over €2.71 trillion. While the majority of these fund assets are held in UCITS, Irish-domiciled alternative investment funds ("**AIFs**") had in excess of €681 billion in net assets as of June 2019 (representing an increase of 12% from June 2018). Ireland is also the largest hedge fund administration centre in the world.

Given the scale of the funds industry in Ireland and the global reach of its distribution network, it is not surprising that the vast majority of the investment in these regulated investment funds comes from non-Irish, predominantly institutional, investors.

Regulatory framework

The Central Bank of Ireland ("**Central Bank**") is responsible for the authorisation and supervision of regulated financial service providers in Ireland, including regulated investment funds and investment managers. The powers delegated to the Central Bank are set out in the laws and regulations applicable to the relevant financial services sector. In addition, the Central Bank issues guidance in relation to various aspects of the authorisation and ongoing requirements applicable to financial service providers and investment fund products in Ireland.

Common fund structures

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

Regulated structures

There are four main types of regulated fund structure in Ireland (as described below): (i) variable capital investment companies ("**Investment Companies**"); (ii) Irish collective asset management vehicles (or "**ICAVs**"); (iii) unit trusts; and (iv) common contractual funds (or "**CCFs**"). Each of these regulated fund structures may be established as UCITS pursuant to the European Communities (Undertakings for Collective Investment in Transferable Securities) Regulations, 2011, as amended (the "**UCITS Regulations**") or as AIFs pursuant to the EU (Alternative Investment Fund Managers) Regulations 2013 (the

"**AIFMD Regulations**"). An AIF may also be established as a regulated investment limited partnership (pursuant to the Investment Limited Partnership Act 1994). These structures may be organised in the form of umbrella schemes with segregated liability between compartments ("**sub-funds**").

- *Investment Companies*

  An Investment Company is established as a public limited company under the Irish Companies Acts 2014. They have a separate legal identity and there is no recourse to the shareholders. There is a requirement to spread risk if the fund is established as an Investment Company. It is typically the board of directors of the Investment Company which will approve any decision to borrow, grant security or enter into derivatives, although it will be important in each case to review the Investment Company's constitutional documents, including its memorandum and articles of association, prospectus and/or supplement thereto, and any management agreements that have the authority to execute the necessary agreements.

- *ICAVs*

  The ICAV is an Irish corporate investment fund which was introduced to meet the needs of the global funds industry, pursuant to the Irish Collective Asset Management Act 2015 (the "**ICAV Act**"). Since its creation, the ICAV has replaced the Investment Company as the most commonly used structure for newly established funds in Ireland. The ICAV is a bespoke corporate structure that is specifically designed to give more administrative flexibility than an Investment Company. For example, the ICAV may:

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

  In addition and unlike Investment Companies, the ICAV may also be eligible to elect to be treated as a transparent entity for US federal income tax purposes.

  UCITS and AIFs established in Ireland as Investment Companies may convert into an ICAV subject to compliance with the conversion process specified by the Central Bank. Importantly, this conversion process does not affect the legal existence of the fund or any pre-conversion rights or obligations. The ICAV Act also contains a mechanism for existing corporate collective investment schemes established in the Cayman Islands, the British Virgin Islands, Bermuda, Jersey, Guernsey and the Isle of Man, to migrate or redomicile to Ireland as an ICAV by operation of law. As the ICAV is a separate legal entity, the analysis in relation to who has authority to contract, e.g. borrow, grant security, enter into derivatives, for an ICAV is the same as for an Investment Company.

- *Unit Trusts*

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

- *CCFs*

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

- *Investment Limited Partnership ("**ILP**")*

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

<u>Unregulated structures</u>

- *Limited partnerships*

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

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

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

- *Section 110 companies*

  Section 110 is a reference to Section 110 of the Taxes Consolidation Act 1997 (as amended) which provides for a specific tax regime for certain qualifying companies. They are most commonly used in structured finance deals but we also see them being used as vehicles for loan book transactions and being dropped under regulated fund structures as an investment vehicle. To qualify for the beneficial tax treatment, certain conditions must be satisfied. It would be common to include certain representations and covenants in a loan agreement to give a lender comfort that the relevant conditions are being satisfied. Section 110 is commonly, but not always, established as a "bankruptcy remote" vehicle, and a common ask from borrowers is that recourse is limited to the secured assets, and a "non-petition" clause is included.

Regulation of Irish funds

Broadly speaking, regulated investment funds in Ireland can be established as either UCITS or AIFs.

<u>UCITS</u>

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

<u>AIFs</u>

AIFs are defined under AIFMD as "any collective investment undertaking [...] which raises capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors", and that does not require an authorisation under the UCITS Directive. Therefore, all non-UCITS funds may be considered AIFs. Irish AIFs are established pursuant to the AIFMD Regulations which implement AIFMD in Ireland. AIFMD regulates both EU AIFMs who manage AIFs in the EU and Non-EU AIFMs that manage AIFs in the EU or market AIFs in the EU. The main types of AIFs in Ireland are Qualifying Investor Alternative Investment Funds ("**QIAIFs**") and Retail Investor Alternative Investment Funds ("**RIAIFs**").

QIAIFs can be marketed to professional investors and there is a minimum subscription requirement of €100,000 (which may be disapplied in respect of certain categories of investor). They can avail of the right to market across the EU using the AIFMD passport. A QIAIF can be managed by an EU or non-EU AIFM and can also be internally managed (see below). A QIAIF is not subject to any investment or borrowing limit, but it is obliged to spread risk if established as an Investment Company.

The RIAIF replaces the previous retail non-UCITS regime and has no minimum subscription requirement, but there is a restriction on it borrowing more than 25% of its net assets. As the RIAIF is a retail fund, it cannot use the AIFMD passport which is available to QIAIFs marketing to professional investors. Unlike a QIAIF, RIAIFs cannot be managed by a non-EU AIFM. AIFs are required to appoint an AIFM which can be either an external manager of the AIF or, where the legal form of the AIF permits, such as in the case of an Investment Company or ICAV, and the AIF chooses not to appoint an external AIFM, the AIF itself.

Real Estate Investment Trusts ("REITs")

REITs were first introduced in Ireland in 2013 under the Irish Finance Acts with the purpose of attracting capital and thereby improving the stability of the Irish property market. Irish REITs are established as companies under the Companies Act 2014 and can gain classification as a REIT when notice is given to Irish Revenue and applicable conditions are met. REITs are not collective investment undertakings and so are not subject to regulatory provisions that apply to regulated investment funds in Ireland. However, the Central Bank has indicated that REITs are *prima facie* AIFs for the purpose of AIFMD (requiring the appointment of an AIFM) unless the REIT can demonstrate otherwise.

Regulatory and market update

Brexit

At the time of writing, Brexit remains the most significant market development impacting the financial services sector in Ireland and across the European Union ("**EU**"). Britain triggered the Article 50 mechanism to exit the EU on 29 March 2017 with the initial proposal to leave the EU by 29 March 2019. However, following a series of extensions to this deadline, the current "Brexit" date is set for 31 January 2020.

As such, we are no closer to knowing with certainty what final shape Brexit will take than we were this time last year. However, from a funds perspective, Ireland has already taken a number of measures to help mitigate against the disruption that Brexit would likely cause in the event of a "no-deal" Brexit – for example, permitting UK AIFMs to manage Irish authorised AIFs (subject to certain conditions being met and without the availability of the AIFM marketing passport).

At an EU level, there were also a number of positive initiatives, for example, ESMA agreed a Memorandum of Understanding on behalf of the EU 27 regulators with the Financial Conduct Authority of the United Kingdom (the "**FCA**"), ensuring that the delegation of portfolio management from EU funds to UK-based portfolio managers could continue, even in a hard-Brexit scenario. The UK has also played its part with the implementation of the FCA's temporary permissions regime ("**TPR**") which facilitates the continued marketing of investment funds into the UK in the event of a "hard Brexit".

From a fund financing perspective, it is important for Irish funds that whatever deal (or indeed no deal) scenario plays out, that Brexit does not impact on the ability of UK-based lenders to continue to provide finance to Irish investment funds and, on a broader basis, to investment funds established within the EU post-Brexit.

While the solutions available to lenders post-Brexit will vary depending on their particular circumstances, there is a continuing trend towards lenders exploring the establishment of lending operations in one of the remaining EU countries. Ireland is well placed to benefit from this trend and has seen its share of UK firms seeking to establish operations here over the last number of months.

Investment Limited Partnerships ("ILPs")

The Irish government has recently published the Investment Limited Partnership (Amendment) Bill 2019 (the "**ILP Bill**") which provides welcome reforms to the Irish investment limited partnership ("**ILP**"). The changes are aimed at modernising the ILP to bring the structure in line with other leading jurisdictions. Some of the main changes include:

(i) *The establishment of umbrella ILPs*

The ILP Bill introduces the possibility of establishing "umbrella" ILPs that are divided into sub-funds with segregated liability. The principle of segregated liability means the assets of one sub-fund belong exclusively to that sub-fund and that the liabilities attributable to a sub-fund may only be discharged out of the assets of that sub-fund. The umbrella structure is attractive because it allows separate strategies or investor types to be accommodated in different sub-funds of the same umbrella rather than having to establish stand-alone ILPs for each. This would allow certain economies to be achieved in terms of costs and time to market.

(ii) *Limited Partner Safe Harbours*

As a general rule under Irish partnership law, a limited partner ("**LP**") may lose the benefit of limited liability, thereby becoming liable for the debts of the partnership, if it participates in the management of the ILP. While there are safe harbours under Irish law currently, the ILP Bill clarifies and broadens the safe harbours which allow LPs to undertake certain actions without being deemed to take part in the management of ILPs (e.g., sitting on advisory committees and approving changes to the limited partnership agreement ("**LPA**")).

(iii) *Permitting an LPA to be amended by majority*

The ILP Bill removes the requirement for all LPs to approve an amendment to the LPA. Instead such an amendment would require approval by a majority of the general partners ("**GPs**") and a majority of LPs. The ILP Bill also allows for certain amendments to proceed without LP approval where the depositary certifies that the changes do not prejudice the interests of LPs. This would bring the ILP in line with the flexibility afforded other Irish fund structures. In addition, in line with partnership structures in other jurisdictions, the ILP Bill allows for the LPA itself to make specific provision as to what constitutes a "majority of limited partners" (e.g., a majority by value, by number or by class).

(iv) *Clarifying limited partner obligations*

The ILP Bill includes provisions aimed at removing the risk that, in the event of the insolvency, LPs could be liable to contribute to the partnership. Under the proposals, LPs would not be required to contribute to the capital of the partnership except in the circumstances set out in the LPA.

(v) *Facilitating the replacement of the General Partner*

The ILP Bill streamlines the process for the contribution and withdrawal of capital to and from ILPs and aligns the process with that applicable to other Irish fund vehicles and partnership structures in other jurisdictions.

<u>Unregulated limited partnerships</u>

A public consultation on the 1907 Act took place in early 2019 and legislation is currently being drafted with proposed amendments. The proposed changes are aimed at enhancing and modernising the unregulated limited partnership structure in Ireland. Some of the suggested reforms are, in effect, similar to those contained in the ILP Bill. The proposed reforms of the 1907 Act, which is based on the equivalent English legislation, are also influenced by the recent changes to the English limited partnership regime. The modernisation of the unregulated limited partnership is a welcome development to bring Ireland in line with other leading jurisdictions.

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, although we have found in the past 18 months that very few deals are still structured as a derivative contract. Lending by AIFs is restricted although (as discussed above) it is possible to establish an AIF which is focused on loan origination, including investing in loans. In the last number of years, capital call, subscription and equity bridge facilities have become much more commonplace. Irish fund structures, particularly Investment Companies, ICAVs and ILPs, are also commonly used as property investment vehicles.

The lenders and governing law

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

While many lenders in Irish fund financings hold a bank licence or have "passport" rights to lend into Ireland, it should be assessed on a case-by-case basis whether a bank licence or passporting rights are required on a particular transaction, particularly where the relevant lender(s) do not have either a banking licence or passporting rights and the transaction involves "banking business" as a matter of Irish law. Lenders should also assess with local counsel whether they need to register summary details of the loan with the Irish Central Credit Register maintained by the Central Bank of Ireland.

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 fund's rights, title and interest in and to the securities and/or cash account recorded in the books and records of the Depositary (or Trustee, in the case of a Unit Trust, as such any references hereafter to a Depositary should be read to include Trustee in the context of a Unit Trust) and an assignment of the funds rights in the Depositary Agreement (or Trust Deed, in the case of a Unit Trust). Such a security package is also commonly coupled with a control agreement which will give the lender or its security agent control over relevant rights or assets either on a "day-one" or more commonly "springing lien" basis on the occurrence of a future enforcement event.

A properly drafted and structured Irish law security document should also be able to obtain the benefits of being considered a "financial collateral arrangement" pursuant to the European Communities (Financial Collateral Arrangements) Regulations 2010 (as amended). Relevant bank mandates should be reviewed and where necessary amended to be consistent with the terms of the control agreement. It is very important in this context to also verify where the account is located, and whose name the account is opened in. In many cases, the account holder may be a Depositary or sub-custodian, and the cash account for an Irish fund may not be located in Ireland, particularly where cash is held by a sub-custodian. In this context, and to satisfy the Depositary's obligations to maintain control over the assets, consideration should be given as to whether the Depositary also needs to be party to the control arrangements. 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; coupled with a robust power of attorney either prepared on a stand-alone basis or forming part of the relevant security document.

The fund's constitutional documents, prospectus, as well as the administrative services agreement, other fund service provider appointment documents and the subscription agreement, need to be carefully reviewed to verify who actually makes the subscription call; for example, in the context of a corporate fund such as an Investment Company or ICAV, most commonly it is the directors of the fund that make the call, but sometimes the constitutional documents also give the manager (where the corporate fund is externally managed) the power to make the call.

The Administrator also plays an important role in processing subscriptions, and recording and registering the subscriptions. Depending on the extent of the role performed by the Administrator, consideration could be given to taking specific security over the rights of the fund in and to the administrative services agreement, which would afford the lender "step-in" rights *vis-à-vis* the Administrator in any further enforcement. However, in practice we do not see this, and more usually a side letter addressed to the Lender/Agent is obtained from the Administrator in relation to the performance of their duties under the administrative services agreement. Depending on the extent of the role of other fund service providers, further side letters may be required.

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. It is also possible to apply for an exemption from the Central Bank of Ireland but – even if given – this takes time to obtain. Other structuring solutions do exist, and we would always recommend local advice be sought at term-sheet stage so the solutions can be "baked" into the deal. Guarantees by an Irish regulated fund of the obligations of a 100% owned subsidiary are not captured by the prohibition.

Governing law of security package

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

Security agent

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

Consents and stamp duty

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

Security over the appointment documents of other fund service providers is not common, but should be assessed on a case-by-case basis, depending on the extent of the relevant role of such fund service providers in relation to the secured assets.

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, (i) security created by an Investment Company will be registered on the file of the Investment Company in the Irish Companies Registration Office ("CRO"), and (ii) security created by a trustee or its nominee as part of a Unit Trust structure will be registered on the file of the trustee/its nominee in the CRO.

Importantly, as ICAVs are established under the ICAV Act rather than the Companies Act, registrations for ICAVs are made on the file of the ICAV with the Irish Central Bank rather than the CRO. Particulars of all such security in the form prescribed by the CRO (Form C1) or the Irish Central Bank (Form [CH1]) must be filed within 21 days of the date of creation of the security, and in the absence of such, filing is void against a liquidator and any creditor.

Property fund financing

Irish funds are also popular vehicles for investment in Irish real estate by both Irish and non-Irish investors. In our experience, ICAVs have, since their introduction in 2015, 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, in particular to reflect the role and importance of the relevant service providers in such structures, such as the management company, AIFM and the Depositary, the applicable events of default, regulatory compliance matters, the change-of-control provisions and the security package.

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

As with all fund financing structures, it is crucial at an early stage of any property fund financing deal to ascertain who has title to the assets and who has contracting power. An additional point to note in this regard is that the Depositary of the fund investing in real estate is obliged to maintain “control” over the property and related assets, such as rental income. Previously, this was interpreted by Depositaries to mean that title to the property had to be registered in their name.

However, this potentially exposes the Depositary, as registered owner of the property, to claims, for example, in relation to environmental liability, but also to being named in court proceedings if, for example, there is a rent dispute. The practice which has emerged in this regard is that either the Depositary has title registered in the name of a nominee company it establishes or, more commonly, it registers a caution on the relevant property title which restricts future disposals, including on any enforcement.

It is crucial in this context to obtain a Control Letter/Deed of Control from the relevant Depositary to regulate the rights and duties of the Depositary on any future enforcement by the lenders but also, for example, to regulate how the Depositary operates the fund’s bank accounts to ensure compliance with the account control and waterfall provisions of the facility agreement. Commonly, the rent account in such transactions is opened in the name of the Depositary, and it is Depositary signatories who are named on the bank mandate. Certain Depositaries also interpret their duty of “control” to extend to limited partnership assets where the relevant Irish regulated fund controls the General Partner and is the sole limited partner.

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.

Due diligence

Before deciding on the final lending and security structure, it is of critical importance that the requisite due diligence is undertaken. A good deal of management time, both on the lender and borrower side, can be saved by clearly setting out the proposed structure, the proposed security structure, including what will be required from all stakeholders, including Investors, and what amendments will be required to constitutional documents.

Identifying and seeking to address issues in relation to any of the above in the course of the transaction will lead to additional costs, tension and potentially, in the worst cases, the deal not completing. In this update we focus on some issues which lenders should bear in mind in undertaking their due diligence for subscription facilities.

Power and authority to borrow and give security

Subject to any self-imposed leverage limits, as mentioned below, most AIFs will have broad powers, in their constitutional documents, to borrow and create security. For a subscription call facility, it is preferable that the constitutional documents, when describing the assets over which security can be taken, explicitly refer, for example, to "unfunded capital commitments". But even where they do not, the lender should be satisfied if the constitutional documents refer to the fund's ability to create security over all of its "assets", as the unfunded capital commitments will constitute an asset of the fund.

Borrowing and leverage limits

As referenced above, there are a variety of available fund structures in Ireland, ranging on the regulated side from Investment Companies, ICAVs, Unit Trusts and CCFs to Limited Partnerships, on the unregulated side. The constitutional documents of each type of fund, while bearing similarities to each other in terms of regulatory content, can be quite different structurally and will always need to be carefully reviewed to establish who has the authority to borrow and provide security on behalf of the fund. Such authority should reflect the legal structure of the fund and should be set out in the relevant constitutional document. Typically, the following parties will have authority to borrow and provide security on behalf of a fund:

- **Investment Company**: The directors of the Investment Company.
- **Section 110**: The directors of the section 110 Company.
- **ICAV**: The directors of the ICAV.
- **Unit Trust**: The Manager commonly has the power to borrow, and frequently also has the power to create security, although this varies and sometimes requires execution by the Trustee.
- **CCFs**: As per Unit Trust, above.
- **Limited Partnership**: The General Partner.

Regulated Irish funds may be established as umbrella funds with one or more sub-funds and segregated liability between sub-funds. Importantly, the sub-funds do not have a separate legal personality, so the finance documents are typically entered into by: the corporate entity itself in the case of a corporate fund such as an Investment Fund and ICAV; the Manager, in the case of Unit Trusts and CCFs; and the General Partner, in the case of the Limited Partnership.

In each case, the relevant entity is acting for and on behalf of the relevant sub-fund, and this should be reflected in the finance documents. Segregation of liability means that the assets of one sub-fund cannot be used to satisfy another sub-fund's liabilities or *vice versa*. This is achieved by statute in the case of Investment Companies and ICAVs, and by contract in the case of Unit Trusts, CCFs and Limited Partnerships.

While statute implies the concept of segregated liability in every contract entered into by Investment Companies and ICAVs, it is customary practice to include segregated liability language into any finance document to which the Irish fund is a party, irrespective of its legal form. Segregated liability is not important for a Section 110 company, but as previously mentioned, the concepts of limited recourse and non-petition will be key concerns for borrower counsel.

The constitutional documents – due diligence

Irish funds may be open-ended, open-ended with limited liquidity, or closed-ended. In the context of a capital call facility (in the case of closed-ended funds or limited liquidity funds with a capital commitment structure), it is crucial to understand: (i) the subscription process, including who can make calls on investors; (ii) who determines the price at which units or shares are issued and by what means; (iii) when capital calls can be made on investors; (iv) what an investor can be asked to fund; (v) the implications of an investor not funding a capital call; and (vi) what account subscription proceeds are paid to.

(i) *The subscription process, who can make calls?*

The agreement between the fund and the investor in relation to subscription is typically enshrined in a subscription or capital call agreement. This tends to be a relatively short document, but must be read in conjunction with the constitutional documents and the fund service provider documents. Most commonly it is the fund, through its directors, who will be authorised to make the calls on investors, although this is sometimes a role which is delegated by the directors to either the Investment Manager or the Administrator. For entities such as a Unit Trust or a CCF, which are constituted by deed between the Manager and the Trustee/ Depositary, it is usually the Manager who is authorised to make calls.

(ii) *How and who determines the price at which units or shares are issued?*

For Irish regulated funds, it is not just the fund itself acting through its directors that has a role. Other service providers, such as the Administrator of the fund, also play a crucial role. The Administrator in an Irish regulated fund assumes, for example, the role of calculating the Net Asset Value ("**NAV**") of the fund and its units/shares. This calculation is crucial in determining the number of units/shares that will be issued to the investor in return for their subscription/capital call proceeds.

Once the proceeds are received, the Administrator will then issue all of the relevant shares/ units to each relevant investor. In Irish regulated funds, the constitutional documents commonly provide that physical unit/share certificates are not issued but rather the unit holder/shareholder register is evidence of ownership. Due to the important role played by the Administrator, it is common that an Administrator side/control letter is obtained as part of the security package.

(iii) *When can calls be made on investors?*

Calls are typically made on a Dealing Day, which will be a defined term in the constitutional documents. It is important to check this definition accommodates calls being made by the lender, if they need to, on a future enforcement. The definition of Investment Period is also relevant in this regard. Many constitutional documents only permit calls to be made during the Investment Period, subject to limited exceptions; for example, where the call is made to satisfy sums due for an acquisition which has contracted but did not complete prior to the expiry of the Investment Period.

As noted above, one of the key first steps in making a call is for the Administrator to determine the NAV and how many units/shares will be issued. The constitutional documents must be carefully reviewed to determine what events are specified, the occurrence of which gives the directors the right to suspend calculation of the NAV. The concept of suspension is an important safeguard for the fund to deal with; for example, *force majeure* market events which prevent the fund from valuing a substantial portion of the assets of the fund, or generally where it is deemed in the best interests of the investors in the fund.

However, in practice, while the NAV is suspended, calls may not be able to be made. This risk can be mitigated by having all shares potentially issuable to an investor being issued on a partly paid basis on day one, but the ability to use this mechanism needs to be assessed on a case-by-case basis. A suspension of the NAV where enforcement is necessary is not ideal! A carefully drafted Investor Consent Letter, or drafting included in the Subscription Agreement, can give lenders additional comfort on this issue.

(iv) *What can an investor be asked to fund?*

As you would expect, investor calls are primarily made to fund the acquisition of investments. Preferably, the constitutional documents should also explicitly permit calls to be made to repay sums due to the lenders. Importantly, most Irish funds will operate on the basis that *pro rata* calls are made on investors. This may not be explicit in the constitutional documents, and sometimes may be reflected in an investor side letter.

(v) *What are the implications of an investor not funding a subscription call?*

The constitutional documents and/or the Subscription Agreement will usually provide for a period of time in which the investor must remit the call proceeds. If they are not received in that period, the documents will commonly provide that the fund may then issue a default notice and if the default is not remedied within any applicable remedy period, the fund will have the right to charge default interest and ultimately to realise the defaulting investors shares/units to meet the call. From a lender perspective, the constitutional documents need to be checked to determine if they contain "overcall" provisions. Such provisions permit the fund to call on the other investors to fund another investor's defaulted call, subject of course to the investors' maximum commitment not being exceeded.

As noted above, this needs to be carefully considered in the context of any potential conflict with any "*pro rata*" call provisions in the constitutional documents, any side letter, or the commercial practice of the particular fund. The constitutional documents should also be checked to determine if the investor has any right of set-off, defences, counterclaim (etc.) in respect of unpaid calls against amounts that may be owed by the fund to the investor. If possible, it should be made explicitly clear that the investor must fund even if the fund is insolvent, and that they will meet calls by the lender upon enforcement.

(vi) *What account are subscription proceeds paid to?*

A key part of the security package for this type of facility is security over the Subscription Proceeds Account. There can be some variation between funds as regards how and in whose name their bank accounts are established. For example, it may be in the fund's name, which is the most straightforward position from a lender's perspective, but may also be in the Administrator's or the Depositary's name. The bank account mandates should also be checked to see who has signing rights, and it should be checked with the

Administrator/Depositary whether the proceeds move through any other accounts *en route* to the Subscription Proceeds Account. Appropriate control arrangements should also be considered, to include the above-referenced service providers, where necessary.

The Subscription Agreement, Investor Side Letters and Notice of Security

As mentioned above, the typical Subscription Agreement is quite short, but it is a crucial document. As part of the security package, security is taken over the fund's rights therein by way of security assignment. The Subscription Agreement and any side letters need to be checked to ensure there are no prohibitions or restrictions on such assignment. For subscription into a Section 110 company, commonly investors invest by subscribing for profit-participating notes rather than by subscription for shares, but a security assignment can still be taken over the Section 110's rights therein.

Upon execution of the security, an equitable assignment is created as a matter of Irish law. From a priority perspective, however, it is better to convert this to a legal assignment. There can be some reluctance on the part of the fund to have notices of assignments sent to investors and relevant acknowledgments obtained, particularly where there are a large number of investors. In this regard, some lenders will agree that notices are not served until a future Event of Default. One possible compromise between these two positions is that the relevant notice of creation of security is communicated in the next investor communication.

The year ahead

Brexit, whether a hard-boiled, poached or "sunny side-up" version, and its consequences, will continue to loom large over the financial services sector (and beyond) throughout the EU. From a fund financing perspective, it has been clearly observable that UK-based lenders have been busy planning and implementing appropriate arrangements to ensure that they maintain and can continue to grow their lending to EU-based investment funds post-Brexit.

Ireland has seen a significant amount of UK-based investment banks (as well as other types of UK-based financial and investment firms) relocating some or all of their business here as part of this response to Brexit. These developments and regulatory measures, coupled with the legislative changes being made to our limited partnership law, give us cause for quiet confidence that 2020 will see further significant growth in the Irish market.

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Overview

According to independent analysis published by the '*Associazione Italiana del Private Equity, Venture Capital e Private Debt*' (the Italian private equity and venture capital association – AIFI[1]) and available on its institutional website (www.aifi.it), last year (2018) confirmed the growth of the venture capital and private equity market in Italy.

There have been 359 transactions recorded, distributed over 266 companies, for a counter value of €9,788m, which represents the highest value recorded in the Italian market. Such increase has been influenced by the large number of transactions carried out by international investors. Compared to the previous year (2017), the amount invested in private equity and venture capital transactions doubled (+98%), whilst the number of transactions increased by 15%.

The distribution of investments, selected by turnover of the target companies (considering a turnover less than €50m) or by the size of the deals (considering investments of equity lower than €150m), confirms the strong performance of the middle companies market, which represents the main target for private equity and venture capital investments in Italy. Such result is consistent with the Italian economic landscape, which comprises a large number of small and medium-sized enterprises, mainly undercapitalised, which need new equity to finance their growth and/or generational change.

The distribution of investments by sector shows that during 2018, the ICT (communications, computers and electronics) sector represented the principal investment target in terms of number of transactions (18%), followed by industrial goods and services (15%) and the medical sector (12%). In terms of amounts, the sums invested in such year mainly targeted the transport and logistics sectors (19% of the total), followed by the ICT sector (less than 19%) and industrial goods and services sector (16%).

During 2018, the sales volume (calculated net of the acquisition costs of target companies) went down to €2,788m, a decrease of 26% compared to 2017 (€3,752m). In 2018, 135 divestments were recorded (decreasing by 33% compared to 2017). With regard to the exit procedures, secondary buyouts (37%) represented the preferred disinvestment channel, followed by sale to industrial parties (23%).

From a general standpoint, from 2014 to 2018 Italy experienced a huge growth of private debt operators, which invested almost €2,700m in 278 companies. In particular, the positive trend of previous years continued also during 2018, with over €1,000m invested in 142 transactions, with a 65% growth in terms of amount and 16% in terms of number of investments with respect to the previous year. Such transactions were carried out with bonds in 49% of cases, while direct loans covered 46% of the market, and hybrid instruments 5%. The average duration of the bonds was over five years, with repayment mainly by way of amortisation (71%).

In this frame, fund finance activity confirmed its growth, due to its capacity to leverage the potential of the investment of private equity funds. Furthermore, Italian banks over the last two years have tried to enter this particular market, establishing dedicated desks to support this type of transaction. As for other regions, the rationale for such transactions is mainly to reduce the administration costs involved in issuing multiple capital call notices to investors, to accelerate the process of the execution of investments, and to enhance returns.

Fund formation and finance

The Italian regulatory field

Following the transposition of Directive 2011/61/EU ("**AIFMD**"), the current Italian regulatory framework on collective portfolio management now provides a well-tested system for regulating management companies' organisation and funds' investment activities. In particular, this is the result of integration between clear legislative requirements and the wide freedom of self-regulation (in the drafting of the fund's rules or by-laws).

By way of background, collective portfolio management is ruled by the Italian consolidated law on finance (legislative decree no. 58 of 24 February1998) (the "**Decree 58/98**"), by a specific ministerial decree (no. 30 of 5 March 2015), by the Bank of Italy Regulation on collective portfolio management of 19 January 2015, and by the Joint Regulation of 27 October 2007 made by Bank of Italy and *Commissione Nazionale per le Società e la Borsa* ("**Consob**"), the public authority responsible for regulating the Italian securities market, on the organisation of collective investment management service providers.

Within the above regulatory framework, the life and operations of each fund are governed by the "funds rules" (*i.e.* "*Regolamento del fondo*"), set by the asset management company authorised by the supervising authority (except for the fund reserved to professional investors) and accepted by the participants (*i.e.* the investors who have subscribed to the units of the relevant fund).

With specific regard to the formation of Italian funds, the above-mentioned regulations leave to the management company a wide range of possibilities in choosing the contents of the fund's rules (in accordance with the provision of article 37, Decree 58/98). In other words, the management company can set up the investment policy of the fund with a high level of discretion, as the final step of a self-regulation process that governs the fund's formation (prior to the actual provision of the collective portfolio management).

Therefore, supervision of management companies, the reserved nature of the activity, and self-regulation are the pillars of the current Italian legislative framework. In particular, the recent amendments to the Decree 58/98 have confirmed the basic principles pursuant to which collective portfolio management is reserved to management companies (articles 32 *quater* and 33), and that the obligations assumed on behalf of the fund are satisfied only with the fund's assets (art. 37). Moreover, the Bank of Italy can provide specific limits to the leverage of alternative investment funds, in order to ensure the stability and the integrity of the financial market (art. 6 of Decree 58/98).

With regard to fund financing requirements, it is worth mentioning that in 2017, the last update to the Bank of Italy Regulation on collective portfolio management has confirmed the requirement for asset managers to set forth in the fund's rules the maximum level of leverage used in the management of the fund, and the way to reach such leverage. In this context, the leverage of real estate alternative investment funds ("**AIFs**") must be below 2 (even if real estate AIFs that are not listed may borrow money – within the limit of 10% of the NAV – for early reimbursements in case of issue of new units), while the leverage of AIFs investing in credits must be lower than the limit of 30% of their net asset value. Other closed-end funds must contain their leverage within 10%.

We should also consider that the collective portfolio management may rely on the establishment of companies with fixed or variable equity, namely SICAVs and SICAFs. In terms of regulatory contents, they are defined as open or closed-ended undertakings incorporated as joint stock companies, with variable or fixed equity, and with the exclusive purpose of collective investment in the assets raised by the offering of their own shares (art. 1, lett. i e i-*bis* of Decree 58/98). The funding of this kind of company relies on common rules for commercial companies and those relating to collective portfolio management.

The transposition of AIFMD has confirmed the type of asset manager that had been originally introduced by the Decree 58/98. Nowadays, the "SGR" is the Italian company able to provide all the services related to collective portfolio management, without any specialisation in terms of type of funds which can be managed by it.

From our perspective, nowadays, the industry of collective portfolio management has developed a new way of providing its services, relying on the formation of AIFs investing in credits. Law decree no. 18 of 14 February 2016 has provided specific provisions for supporting lending to Italian firms, confirmed by its conversion into law no. 49 of 8 April 2016. In this respect, EU AIFs aimed at investing into credits of Italian borrowers (other than consumers) must obtain the relevant authorisation in their home country (and adopt a scheme analogous to the one provided for Italian funds, including – among others – the rules on leverage). In such a case, the asset manager of these EU AIFs shall notify to Bank of Italy the intention to invest in Italy (and shall join the Italian Central Credit Register).

In this respect, we have to highlight that this kind of AIF is suitable for supporting non-bank financial intermediation, as they are under public supervision, but out of the scope of capital adequacy requirements. Hence, direct-lending AIFs are in a position to issue the credits and hold or distribute them, depending on the actual set-up of the relevant investment policy. In this scenario, AIFMs may also manage funds aimed at the warehousing of those credits, or their resale on the wholesale market. The last development, in this context, is the management of funds investing in direct lending to other funds. Such investment policy would create a new market whereby investors could rely on activities aimed at investing in the debt (and not in the equity) of other funds.

In this perspective, Undertakings for Collective Investment in Transferable Securities ("UCITS") and AIFs shall be considered as the products of the asset manager, as in the cases of 'ELTIF' (introduced by EU regulation no. 760 of 2015); 'EuVECA' (in relation to a qualifying venture capital fund in the Union, under the EU Regulation no. 345 of 2013); and 'EuSEF' (on European social entrepreneurship funds, under the EU Regulation no. 346 of 2013). The relevant regulations of ELTIF, EuVECA and EuSEF are directly applicable to Member States and uniform, so that asset managers are already able to set up such kind of funds, in order to market and manage them across Europe.

In this context, the transposition of Directive 2014/65/EU has strengthened the transparency of such products in order to allow for safer marketing. However, this Directive did not extend its provision to funds or their management companies, but it limits the duty of cooperation between authorities to the supervision of the latter (articles 11 and 68). Therefore, there is still an open question, regarding the regulatory path to satisfy the collective need for the portfolio management industry to be competitively set up, in the light of the new standards required for complying with MiFID II.

Financing and collateral structure

The common financing structure for fund financing in Italy reflects the structure applied in other regions, where fund financing was introduced a long time ago. Usually, it is built up as a committed revolving credit facility, and provides for an availability period that starts upon the first closing of the fund. The reimbursement usually does not exceed 18 months, which is set out as a target. According to Italian banks' preference, the relevant facility agreements are frequently governed by Italian law.

The typical security package structure provides for: (i) a pledge over the claims (undrawn commitments) (sometimes substituted by a deed of assignment by way of security) of the fund *vis-à-vis* its investors to make future contributions of previously subscribed capital to the investment vehicle (the "**Pledge over the Claims**"); and/or (ii) a pledge over the credit rights arising from the bank account where the capital contributions of the investment vehicle's equity investors have to be made (the "**Pledge over Bank Account**").

In addition to the above and in order to strengthen the lender's security package, banks usually ask (and obtain) from the fund an irrevocable power of attorney (which could be also notarised, in order to strengthen its power) that allows them to directly exercise their rights to call for the undrawn commitments. Such power of attorney shall only be exercisable by the pledgee in case of acceleration event, and to the extent the acceleration event has not been remedied or waived in accordance with the finance documentation.

According to general principles under Italian law and in line with the majority of academics and Italian Supreme Court cases law on this matter, it has to be noted that any power of attorney may be revoked by the relevant principal, despite being expressed to be irrevocable. To mitigate such issue, the power of attorney is frequently incorporated in a specific contractual mandate, given also in the interest of the mandator under article 1723, paragraph two, of the Italian Civil Code (applicable to all contractual mandates), which sets out that the contractual mandate is not extinguishable by revocation by the principal, unless: (i) it is otherwise agreed between the parties; or (ii) there is a specific just case (*giusta causa*, i.e. as a result of: (i) a breach of contractual undertakings; or (ii) non-compliance with the duties of loyalty, diligence or correctness inherent in the fiduciary nature of the contractual relationship) for such revocation.

It is still a controversial matter whether article 1723, paragraph two of the Italian Civil Code, is applicable not only to the contractual mandate but also to a power of attorney linked to this contract: while a minority of academics and a recent Italian Supreme Court case law denied such conclusion, the overwhelming majority of academics, supported also by a dated orientation of the Italian Supreme Court, assert that article 1723, paragraph two of the Italian Civil Code is applicable also to the power of attorney.

Under Italian law, several requirements must be executed in order to perfect the above-mentioned pledges.

With regard to the Pledge over Claims, according to article 2800 of the Italian Civil Code, the pledge over receivables must be granted by a written deed bearing a certain date at law (*data certa*) and may be enforceable with priority against third parties only when, alternatively: (i) a notice of the pledge has been given to the debtor by a court bailiff or by means of another document bearing a certain date at law (*data certa*); or (ii) the debtor has accepted the pledge by means of a document bearing a certain date at law (*data certa*). The same requirements have to be fulfilled in order to perfect the deed of assignment by way of security of the undrawn commitments.

In relation to both such securities, the execution of the relevant deed allows the pledge to be perfected – or the assignment by way of security, as the case may be – between the relevant parties. The notice to the debtor or its acceptance, instead, is required in order to ensure that the relevant security can be considered opposable towards the debtor in respect of undrawn commitments as well as any third party (including any bankruptcy procedure).

In this regard, for investors located in the European Union, pursuant to article 14.2 of the Regulation (EC) n° 593/2008 of the European Parliament and of the Council of 17 June 2008 on the law applicable to contractual obligations (so-called '*Rome I*'), the formalities for the Pledge over the Claims (or the assignment by way of security) to be invoked against the debtors, are governed by the law governing the document under which the credits that are pledged (i.e. the fund documents) were born. Despite the universal nature of such regulation, for investors located outside of the European Union, the formalities to be carried out in order for the Pledge over the Claims (or the assignment by way of security) to be invoked against the debtors and third parties may vary depending upon the law and case law (*jurisprudence*) of the country of residence of said investors.

With regard to the Pledge over Bank Account, according to article 3 of the Italian Legislative Decree No. 170 of 21 May 2004, implementing the Directive 2002/47/EC on financial collateral arrangements, as subsequently amended and supplemented ("**Decree 170**"), such pledge is perfected, valid and opposable towards the debtors of the undrawn commitments and third parties once the Pledge over Bank Account is signed by the Fund and the pledgee. Should the relevant bank account be opened with a bank other than the lenders or the security agent (the "**Depositary Bank**"), according to Italian law it is mandatory that the Depositary Bank also accedes to such pledge agreement in order to make it impossible for the pledgor to dispose of the amounts credited without the consent of the lenders.

While the Pledge over Claims (or the deed of assignment by way of security) allows lenders to be the beneficiaries of payments of any claims *vis-à-vis* the investors, upon the occurrence of an event of default, Decree 170 allows the lenders to perfect several enforcement methods in order to realise the Pledge over Bank Account and, in particular, lenders shall be entitled, beyond any in-court procedure, to the direct appropriation of any amount credited on the pledged bank account for an amount equal to the outstanding sums due to the lenders at the time of the enforcement.

Taking into consideration that fund financing is spreading in Italy but is still not a common practice, and that Italian funds are still not completely familiar in respect of such transactions, during the structuring of the financing, particular attention should be paid to the partnership agreement of the fund, to confirm that it provides for the same provisions as one would expect to see in limited partnership agreements in jurisdictions more familiar with fund financing (i.e. provisions which clearly confirm that the fund can enter into a facilities agreement, as well as provisions which allow the relevant lender to submit, on behalf of the manager of the fund, a drawdown notice to the investors of the fund).

In addition to the above, in the Italian fund financing market it is not customary to have detailed due diligence in respect of the fund's investors, and funds are not comfortable giving evidence of side letters. In this respect, Italian lenders are frequently asked to rely on specific representation that no side letters exist, which could affect the reimbursement of the financing or the enforcement of the relevant securities.

The year ahead

Even though the Italian economy has been recovering modestly from the global financial and Euro area sovereign debt crises and significant challenges remain, in the last two years employment and labour force participation have risen, unemployment has fallen and banks' nonperforming loans have declined. In this scenario, the International Monetary Fund projects growth at 1% in 2018, 0.6% in 2019, and below 1% in 2020 and beyond.

Nevertheless, with respect to the private equity industry, based on the trend in the market of the last two years, we expect to see its growth confirmed, taking into account the unrealised potential of most Italian companies to generate value, and the large amount of capital raised by the funds during 2018 and the first half of 2019. Hence, we expect that the growth of the equity bridge financing market will continue, and this will become a more common financing structure in the Italian market, available to smaller funds.

In this context, the increasing costs of prudential supervision of banks would benefit the business of AIFs investing in credits and, therefore, their need for capital and debt in order to reach an operational size to compete in this market.

Acknowledgment

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Endnote

1. Source: www.aifi.it.

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Jersey

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Overview

As an international financial centre (**IFC**) of choice for global investments primarily into the UK and Europe, Jersey is currently home to regulated funds with aggregate net assets under management of approximately £350 billion. In comparison, figures as at Q2 2018 (30 June) showed an aggregate of £296 billion net assets under management.

This stark rise reflects Jersey's increasing popularity as a funds jurisdiction and, in particular, as a home for funds investing in alternative asset classes, including hedge, real estate and private equity funds, which make up approximately 81% of funds business in Jersey. In addition, the lightly regulated Jersey Private Fund introduced in 2017 also continues to increase in popularity, with over 250 JPFs launched to date.

There are many reasons for the continuing confidence in Jersey: as an IFC. With an increasing global need to demonstrate local economic substance, Jersey, with its 13,000-strong financial sector workforce and well-developed local infrastructure, have the edge over competitor jurisdictions who cannot comply with global substance requirements as readily as Jersey. With the introduction of the Taxation (Companies – Economic Substance) (Jersey) Law on 1 January 2019, Jersey was removed from the EU Code Group Grey List in March 2019.

Notwithstanding Brexit's continued suppressing influence on activity generally, the weak pound is still attracting market participants using Jersey as a base for rest-of-the-world transactions and as a launch point to access investors in the UK and EU member states. As Jersey is not part of the EU and its access to these markets is based on strong existing bilateral relationships entirely independent from the Brexit process, Jersey can offer greater certainty of access to investors in both the EU and the UK post-Brexit – whatever the outcome.

Fund formation and finance

Save for the follow-on from the reform of the private fund regime introduced in 2017 (and the recent developments in substance requirements, see below), there have been no substantial changes to the regulatory regime impacting fund formation, lending or security. The most commonly used fund structures in Jersey follow well-established patterns and remain as companies, limited partnerships or unit trusts. The regulatory oversight ranges from unregulated eligible investor funds, moving through lightly regulated private funds, to fully regulated retail collective investment funds.

Security is taken under and governed by the Security Interests (Jersey) Law 2012 (the **2012 Law**). In force since January 2014, the 2012 Law is a stable and well-trodden security regime specifically designed for the needs of financial services. Perfection requirements for a Jersey law-governed security depend on the collateral and range from possession of the certificates representing certificated investment securities, control of deposit or portfolio accounts by way of notices and acknowledgments with the relevant account bank or custodian, to registration on the public Security Interests Register (**SIR**), which will perfect security over any collateral and is the most common, and highly recommended, means of perfection.

A registration fee of currently £150 is payable for each security document registered on SIR. No other stamp duties, taxes or registration fees are due in Jersey for the taking and registration of security.

In a fund finance context, lenders commonly take as transaction security:

Collateral	Market practice comment	Usual perfection method(*)
Call rights	These rights will usually be under the relevant fund documents (e.g. partnership agreement, subscription agreement or articles of association). Investors are usually notified of the security interest and asked to sign an acknowledgment of the notice. The notice and acknowledgment provide an "estoppel" argument, but neither is required to perfect the security interest.	SIR registration
Bank accounts	Notice and acknowledgment from the account bank are obtained. In this context a "bank account" could be a deposit account or a portfolio/securities account. Bank account security, combined with call rights security, is still the most common security package sought.	Control over bank account via notices and acknowledgments and/or SIR registration
Contract rights regarding a custodian agreement	Notice is served on the custodian and acknowledgment obtained. This is generally combined with a security over any relevant portfolio/securities account - but not often seen in a fund finance context.	SIR registration
Shares or units	Notices and acknowledgments are generally obtained but not required for perfection. Share certificates and blank share transfer forms are delivered at completion. Share or unit security (as opposed to rights to call unpaid capital on those shares or units) isn't often relevant in a fund finance context.	Possession of share or unit certificates (for certificated securities) and/or SIR registration

In general, there is no legal or regulatory impediment to lending to funds in Jersey. The fund manager and directors/controllers of the fund can agree limits and restrictions in the constitutional documents of the fund and the investment manager agreement, if they so choose. In particular, the ability of the fund manager to borrow additional sums or grant security over the fund's assets is an important commercial point to consider.

There are no regulatory restrictions on borrowing for Very Private Funds, funds under the Private Placement Funds Regime, Unregulated Funds or Jersey Private Funds.

For slightly more regulated Expert Funds, Listed Funds and Eligible Investor Funds, no legal restrictions are set in stone but the JFSC reserves the right to additional scrutiny if the fund is permitted to borrow money in excess of 200% of its net asset value.

For open-ended certified collective investment funds offered to the general public, which are more heavily regulated, the JFSC provides guidance on borrowing restrictions of the following fund type:

Guidance on borrowing restrictions	
Fund type	**Limits on borrowing**
General Securities Fund	Not more than 25% of the fund's total net asset value.
Fund of Funds	May borrow up to 10% of its total net asset value, but only on a temporary basis for the purpose of meeting redemption requests or defraying operating expenses.
Feeder Fund	May borrow up to 10% of its total net asset value, but only on a temporary basis for the purpose of meeting redemption requests or defraying operating expenses.
Money Market Fund	May borrow up to 10% of its total net asset value, but only on a temporary basis for the purpose of meeting redemption requests or defraying operating expenses.
Warrant Fund	May borrow up to 10% of its total net asset value, but only on a temporary basis for the purpose of meeting redemption requests or defraying operating expenses.
Real Property Fund	May borrow for the purpose of purchasing real property and for short-term purposes like defraying expenses or to facilitate redemption. The maximum aggregate amount which may be borrowed is 35% of the total net asset value. Borrowing for the purpose of purchasing real property must not exceed 50% of the purchase price of the real property. For real property funds with a net asset value of less than £5 million, and especially during the early life of the fund, some relaxation of the above limits may be granted by the JFSC.
Futures and Options Fund	Must be discussed with the JFSC.
Guaranteed Fund	Must be discussed with the JFSC.
Leveraged Fund	Must be discussed with the JFSC.

Developments in the Jersey fund landscape

In light of base erosion and profit-shifting (**BEPS**), the changes in AIFMD reporting and the findings published by the EU's Code of Conduct Group for Business Taxation, the funds world (not only in IFCs) sees a continued focus on substance. In order to take advantage of appropriate tax benefits, regulatory exemptions and reduced compliance burdens, it is more and more important that funds and fund managers can demonstrate substance in their jurisdiction of tax domicile. This means that there is also more importance placed on what the economic reality of a corporate structure looks like, where fund managers, administrators and key decision-makers are based, where economic value is being created, and to whom relevant staff report.

This has been addressed in Jersey most recently by the introduction of the Taxation (Companies – Economic Substance) (Jersey) Law 2019, which led to the Island's removal from the EU Code Group Grey List in March 2019. Under the law, those who carry on certain specified activities (including fund management) will need to demonstrate greater local resources, and that they carry out core income-generating activities in Jersey. The requirements imposed by the legislation are in line with those which have been imposed globally in all major competing IFCs, and service providers and professional advisors on the Island are well positioned to ensure compliance is as painless as possible for those who may previously have lacked economic substance.

As a "substance" jurisdiction, Jersey has the necessary manpower, expertise and regulatory flexibility to move ahead of other offshore IFCs and benefit from the greater difficulty other IFCs may have in complying with their obligations.

The year ahead: A glimpse into the future of Jersey funds for 2020/21

Moving into 2020 and beyond, funds in Jersey will increasingly have to be mindful of where their key decision-makers are located, risk-management takes place, assets are held and employees and management reside. It is also thought that Jersey, as a reputable "substance jurisdiction", will become increasingly attractive to investors who wish to access EU markets using the benefits of tax-neutral vehicles and expertise without needing to worry about regulatory or reputational concerns.

At the time of writing, the final outcome of the Brexit referendum is no clearer than it was back in 2016. While Jersey is neither part of the United Kingdom nor the EU, it enjoys close links with both and, whatever the outcome, will be recognised as a stable route for investors across both regions. Jersey is becoming an ever-more attractive platform for European-focused funds.

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His extensive experience covers banking and asset finance, real estate investment structures, public and private debt and equity issues, securitisations, repackagings and initial public offerings, as well as structures involving Jersey limited partnerships and unit trusts. More recently, James has advised on some of the largest corporate restructurings to have occurred in the Jersey market. He also advises banks and other global financial institutions in relation to the Jersey elements of complex cross-border insolvencies. The majority of his time is spent on real estate finance and funds.

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Paul Worsnop is an Associate in the Corporate department in Jersey and works closely with James Gaudin, servicing both fund managers and lenders in connection with high-value, secured and unsecured, capital call and NAV facilities. In his time at Appleby he has advised on the provision of well in excess of €5 billion of finance to funds established in Jersey.
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Luxembourg

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Overview

Luxembourg continues to strengthen its ranking as the world's second-largest fund domicile after the United States: in 2017, the assets under management of Luxembourg-domiciled funds crossed the bar of €4 trillion for the first time, and stand at €4.5 trillion as at 31 August 2019.[1] This increase is not only based on the growth of traditional Luxembourg-domiciled undertakings for collective investment in transferable securities (**UCITS**) funds, but also due to the continued strong growth in respect of alternative investment funds, including private equity, real estate, infrastructure and debt.

Concurrently with the surge in the alternative investment funds market, Luxembourg has seen a significant development in fund finance activity, supported by the possibility of implementing efficient security packages in the context of credit facilities for funds. Recent years have been particularly active as regards fund finance transactions in Luxembourg, with positive growth, strong credit performance and absence of credit defaults. While capital call subscription credit facilities and bridge facilities are still used and continue their steady growth, permanent leverage facilities have become increasingly popular.

Fund formation and finance

Legal overview – fund formation

When selecting Luxembourg as their hub for setting up their investment fund, initiators generally opt for either a non-regulated ordinary commercial company (**SOPARFI**) or one of the following (regulated and non-regulated) alternative investment fund (**AIF**) regimes:

- an investment company in risk capital (**SICAR**), based on the law of 15 June 2004, as amended, on the risk capital investment company (**SICAR Law**) (the SICAR is a vehicle specifically dedicated to private equity and venture capital investments, whether diversified or not);
- a specialised investment fund (**SIF**), based on the law of 13 February 2007, as amended, on specialised investment funds (**SIF Law**);
- a reserved alternative investment fund (**RAIF**), based on the law of 23 July 2016, as amended, on reserved alternative investment funds (**RAIF Law**); or
- an undertaking for collective investment (**UCI**), based on Part II of the law of 17 December 2010, as amended, on undertakings for collective investment (**Part II UCI**) – given the declining popularity of Part II UCIs with fund initiators (in light of the flexibility of the other available alternative investment fund regimes), this article will not cover any particular aspects related to funds formed as Part II UCIs.

On the basis of Directive 2011/61/EU of the European Parliament and the European Council of 8 June 2011 on alternative investment fund managers (**AIFMD**), implemented in Luxembourg by the law of 12 July 2013 on alternative investment fund managers (**AIFM Law**), whose impact on financing transactions taking place within the framework of investment funds will be discussed below, an AIF is defined as a collective investment undertaking, or the compartments of which: (i) raise(s) capital from a number of investors; (ii) with a view to investing such capital in accordance with a defined investment policy for the benefit of those investors; and (iii) which is not covered by EU Directive 2009/65/EC on UCITS.

While the RAIF is an AIF within the meaning of the AIFM Law by virtue of the RAIF Law (and must accordingly appoint an authorised alternative investment fund manager (**AIFM**) as well as a depositary), the SICAR and the SIF are deemed to be AIFs (and required to appoint an AIFM), unless they qualify for one of the exemptions under the AIFM Law.

It is important to note that any unregulated SOPARFI will be considered an AIF if it fulfils all the above criteria, thereby triggering the application of the AIFM Law, including the obligation to appoint an AIFM and a depository in respect of the assets held by the SOPARFI (except if such SOPARFI is managed by an Exempted AIFM (as defined below)). This is even more relevant, as Luxembourg has taken advantage of the AIFM Law to modernise the existing Luxembourg corporate and limited partnership forms and introduce a new special limited partnership without separate legal personality, thereby setting the stage for the use of Luxembourg unregulated limited partnerships as fund vehicles.

Insofar as the AIFM Law applies, an AIFM may freely market the AIFs it manages to professional investors (within the meaning of EU Directive 2004/39/EC, as amended (**MiFID**)) in the European Union.

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

While non-regulated SOPARFIs, SICARs, SIFs and RAIFs are not subject to any legally imposed limits with regard to leverage, insofar as those vehicles qualify as AIFs and are considered as leveraged, the AIFM Law may nevertheless need to be taken into consideration.

- *Meaning of leverage*

The AIFM Law defines leverage as any method by which the AIFM increases the exposure of an AIF it manages, whether through borrowing of cash or securities, leverage embedded in derivative positions, or by any other means.

The AIFMD gives the European Commission the power to adopt delegated acts to specify the methods of leverage as defined in the AIFMD, including any financial and/or legal structures involving third parties controlled by the relevant AIF when those structures are specifically set up to directly or indirectly create leverage at the level of the AIF. It is important to note, in particular for private equity and venture capital funds, that leverage existing at the level of a portfolio company is not intended to be included when referring to those financial or legal structures.[2]

The Commission has also used its powers under the AIFMD to clarify that borrowing arrangements entered into by an AIF are excluded from the leverage calculations if they are: (i) temporary in nature; and (ii) fully covered by capital commitments by investors (i.e. a contractual commitment by an investor to provide the AIF with an agreed amount of investment on demand by the AIFM).[3] The Commission's Level 2 Regulations give details of the method to be used by AIFMs to calculate leverage in respect of the AIFs they manage.

- *Impact of leverage under the AIFMD and the AIFM Law*

Any leverage at the AIF level may affect whether or not the AIF must appoint an authorised AIFM and a depositary.[4] Under the AIFM Law, any vehicle qualifying as an AIF must appoint an AIFM, but a lighter regime applies to AIFMs managing: (i) AIFs whose total assets under management (**AuM**), including any assets acquired through use of leverage, do not exceed a threshold of €100m; or (ii) AIFs whose total AuM do not exceed a threshold of €500m which are unleveraged and have no redemption rights exercisable during five years following the date of the initial investment in each AIF (each a *de minimis* exemption).

AIFMs qualifying for a *de minimis* exemption (the **Exempted AIFMs**) must nonetheless register with the relevant supervisory authority of their home Member State (the **Regulator**). When registering, Exempted AIFMs must identify the AIFs they manage and provide the Regulator with information on their investment strategies. Once registered, Exempted AIFMs must regularly (at least annually) provide the Regulator with information on the main instruments in which they are trading, the principal exposures and the most important concentrations of the AIFs they manage, in order to enable the Regulator to monitor systemic risks effectively. If Exempted AIFMs cease to qualify for the *de minimis* exemption, they must notify the Regulator accordingly and apply for a full authorisation.

The AIFM Law also requires AIFMs to set a maximum level of leverage which they may employ on behalf of each AIF they manage, as well as the extent of the right to re-use collateral, or guarantees which could be granted under the leverage arrangement.

For each AIF they manage which is not an unleveraged closed-ended AIF, AIFMs must employ an appropriate liquidity management system and adopt procedures which enable them to monitor the AIF's liquidity risk, and ensure that the liquidity profile of the investments of the AIF complies with its underlying obligations. They must regularly conduct stress tests, under normal and exceptional liquidity conditions, which enable them to assess the AIF's liquidity risk, and monitor that risk accordingly.

The AIFM concerned must provide investors with disclosures in respect of the AIF in which they intend to invest, including, but not limited to: a description of the circumstances in which the AIF may use leverage; the types and sources of leverage permitted and the associated risks; any restrictions on the use of leverage and any collateral and asset re-use arrangements; and the maximum level of leverage which the AIFM is entitled to employ on behalf of the AIF. In addition, AIFMs managing EU AIFs employing leverage or marketing AIFs employing leverage in the EU must disclose, on a regular basis for each such AIF: (i) any changes to the maximum level of leverage which the AIFM may employ on behalf of the AIF, plus any right to the re-use of collateral or any guarantee granted under the leveraging arrangement; and (ii) the total amount of leverage employed by that AIF.

In addition to the disclosures to be made, AIFMs must also provide the competent authorities of their home Member State with information in respect of the AIFs they manage. In this context, AIFs employing leverage on a substantial basis must make available information on: the overall level of leverage employed by each AIF they manage; the breakdown between leverage arising from borrowing of cash or securities and leverage embedded in financial derivatives; and the extent to which the AIFs' assets have been re-used under leveraging arrangements. This information includes the identity of the five largest sources of borrowed cash or securities for each of the AIFs managed by the AIFM, and the amounts of leverage received from each of those sources for each AIF. For non-EU AIFMs, the reporting obligations referred to in this paragraph are limited to EU AIFs which they manage and non-EU AIFs which they market in the EU.

Structuring the security package

Credit facilities relating to funds are typically secured by the unfunded capital commitments of the funds' investors. These facilities are subject to a borrowing base determined by the value of the pledged/assigned investors' commitments satisfying certain eligibility criteria. Investors' commitments relating to Luxembourg funds may be structured in different ways and they may take the form of equity capital commitments (i.e. to make equity contributions to the fund) and/or debt capital commitments (i.e. to provide debt financing to, or to subscribe for, debt instruments issued by the fund).

The security package typically comprises: (i) a pledge by the fund of the rights in and to the unfunded capital commitments of the investors and the claims against the investors in relation to those commitments; and (ii) a pledge over the bank account into which investors are required to pay their contributions. However, other forms of security interests may be envisaged (notably pledges over shares in intermediary vehicles). The fund's underlying investments are not usually part of the security package, although in some facilities, certain investments may be added to the borrowing base.

Luxembourg law typically governs the security interests granted by the borrowing fund over the rights in and to the investors' unfunded capital commitments, and any claims against the investors in relation to such commitments. The relevant security interest is in the form of a financial collateral arrangement governed by the Luxembourg law of 5 August 2005 on financial collateral arrangements, as amended (the **Collateral Law**). According to the Collateral Law, security over claims against the investors may be created by way of a pledge or an assignment for security purposes. Pledges are the most common security interests over investors' commitments in relation to Luxembourg funds. The pledge/assignment agreement must be evidenced in writing, and the relevant security interest agreement must be executed by the fund (as pledgor or assignor), the fund's general partner and the security taker. If the AIFM is empowered to make capital calls and/or enter into borrowing and security interest arrangements on behalf of the fund, it must be added as party to the security interest agreement.

According to Luxembourg conflict-of-law rules, the courts in Luxembourg will generally apply the *lex loci rei sitae* or *lex situs* (the law of the place where the asset subject to the security interest is situated) in the case of creation, perfection and enforcement of security interest over the asset. Thus, Luxembourg law will apply in relation to the creation, perfection and enforcement of security interests over assets which are located or deemed to be located in Luxembourg or governed by Luxembourg law. Claims (*créances*) governed by Luxembourg law or owed by a debtor located in Luxembourg, or accounts opened with banks located in Luxembourg, will be considered as located in Luxembourg and fall within the scope of the Collateral Law. In addition, the provisions of the Regulation (EU) of the European Parliament and the Council No. 2015/848 of 20 May 2015 on insolvency proceedings (recast), as amended, have to be considered. According to that regulation, claims against a third party (other than claims in relation to cash held in bank accounts) will be considered as situated in the EU Member State within the territory of which the third party required to meet the claims (i.e. the debtor) has its centre of main interests (**COMI**).

Concerning claims against investors which are subject to security interests, certain conflict-of-laws rules must be taken into consideration when structuring the security package. According to article 14 of Regulation (EC) N° 593/2008 of the European Parliament and of the Council of 17 June 2008 on the law applicable to contractual obligations (**Rome I Regulation**): (i) the relationship between the security provider and the security taker is governed by the law applicable to the contract between the security provider and the security taker under the Rome I Regulation; and (ii) the law governing the pledged/assigned claim will determine its assignability, the relationship between the security taker and the debtor, the conditions under which the pledge or assignment may be invoked against the debtor, and whether the debtor's obligations have been discharged. Because the fund documentation and subscription agreements are typically governed by Luxembourg law, that law will apply to such matters. Since the Rome I Regulation does not provide explicitly for any conflict-of-law rules concerning the enforceability of and possibility to invoke a pledge/assignment over claims against third parties, some Luxembourg legal practitioners consider that a pledge over, or assignment of, claims would become invocable *vis-à-vis* third parties other than the debtor if the legal formalities applicable in the debtor's jurisdiction are duly complied with.

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

On 12 March 2018, the EU Commission published a proposal for a regulation on the law applicable to the third-party effects of assignments of claims (the **EU Commission Proposal**). This proposal will have an impact on the current conflict-of-laws rules and will reduce the uncertainties that surround the enforceability of security interests over claims against debtors (including investors) located in different jurisdictions. The new rules clarify which law applies to the third-party effects of assignments of claims in cross-border transactions. The EU Commission Proposal defines the term "*assignment*" as 'a voluntary transfer of a right to claim a debt against a debtor'. The term includes outright transfers of claims, pledges, transfers by way of security or other security rights over claims. As a general rule, the law that governs the third-party effects of assignments of claims is the law of the country where the assignor has its habitual residence. If adopted, the new regulation will provide increased certainty with respect to the perfection and enforceability of security interests over claims against investors (located inside or outside of the European Union) in relation to their commitments, and it will significantly reduce the discussions around the applicable creation, perfection and enforceability formalities.

The Collateral Law allows a security interest to be created over present and future claims, provided that they are identified or identifiable at the time of entry into the security interest agreement. It is common practice for the security provider to provide the security taker periodically with an updated list of the investors' commitments.

Under Luxembourg law, pledges/assignments for security purposes which are not notified to or accepted by the investors are fully recognised and enforceable. However, the debtor of a pledged/assigned claim may be validly discharged from its obligation *vis-à-vis* the security provider if it had no knowledge of the pledge/assignment in favour of the security taker. It is therefore usual for lenders to require security interests granted by the fund to be notified to and accepted by the investors, in order to ensure that the investors act in accordance with the security taker's instructions and pay the unfunded commitments to the pledged accounts if the security interest is enforced. Notices may be served to the investors by different means (registered letters, emails, electronic communications, etc.). Alternatively, notices may be included in the financial reports (distributed to the investors) or published on an investor portal.

It is usually required by the lenders that the investors waive any defences, right of retention or set-off and counterclaim the investors may have with regard to the pledged/assigned claims and any transferability restrictions which may be applicable. According to the Collateral Law: (i) a debtor of a claim provided as financial collateral may waive its rights of set-off in writing or a legally equivalent manner, as well as any other exceptions *vis-à-vis* the creditor of the claim provided as collateral and *vis-à-vis* persons to whom the creditor assigned or pledged such claim as collateral; and (ii) the waiver is valid between the parties and enforceable against third parties. A proper waiver will give comfort to the lenders that the investors will pay their capital commitments upon the enforcement of the security interest without challenging their obligations.

Given the above, and to pre-empt any difficulties with the investors, it becomes usual to include "bankable" financing provisions in advance in the fund documentation (notably the partnership agreements and the subscription arrangements), such as: investors' acceptance of the possibility for the fund and its general partner to borrow and pledge the unfunded capital commitments; the security taker's right to initiate and enforce capital calls; waivers of defences to funding; provisions allowing the security taker to give instructions to the investors upon the occurrence of an event of default; subordination of the investors' claims, etc. In addition, it is important to ensure that the investors' commitments are structured as obligations to pay rather than obligations to subscribe for interests/shares.

Concerning the right of the fund to make capital calls and enforce the obligations of the investors to contribute capital, it should be considered that such right is an ancillary right to the pledged/assigned claim (*droit lié à la créance gagée/transférée*), and as a result the security taker may be entitled to exercise that right in accordance with the provisions of the security interest agreement. This view is supported by the Collateral Law, which provides that the pledge/assignment of a claim implies the right for the security taker to exercise the rights of the security provider linked to the pledged/assigned claim. Without prejudice to and independently of the above, Luxembourg security interest agreements provide for a power of attorney granted by the borrowing fund and its general partner in favour of the security taker to make the capital calls, send funding notices and require the investors to make payments into the pledged accounts, it being understood that this power of attorney may be subject to certain limitations arising under Luxembourg law.

The Collateral Law allows the enforcement of a security interest over claims upon the occurrence of an event of default (freely determined by the parties) without prior notice (*mise en demeure*). Subject to the terms of the fund documents and certain Luxembourg regulatory requirements, in respect of pledges, the security taker (as pledgee) may, *inter alia*: (i) serve a funding notice on the investors, requesting payment into the pledged accounts; (ii) request direct payment from the investors; (iii) appropriate the pledged claims (at a value determined using the valuation method agreed upon by the parties); (iv) sell the pledged claims by way of a private sale (at arm's length conditions) or a public sale; or (v) request a court to attribute the pledged claims. Concerning assignments for security purposes, in the event of the security provider's failure to perform the relevant financial obligations, the security taker (as assignee) is discharged from its obligations to re-transfer the assigned claims up to the amount of the secured obligations.

The security interest over bank accounts (held in Luxembourg) into which investors are required to fund their contributions may be created by way of a pledge in accordance with the Collateral Law. The pledge agreement must be evidenced in writing and perfected in accordance with Luxembourg law. In practice, as a result of their general terms and conditions, Luxembourg account banks have a first-ranking pledge over such accounts. Provided the terms and conditions do not prohibit pledges, the pledge will become valid and enforceable against the account bank and third parties, once the existence of the pledge has been notified to and accepted by that bank.

Involvement of depositaries in fund finance transactions

The implementation of the AIFMD in Luxembourg through the AIFM Law has broadened the involvement of the depositaries in Luxembourg fund structures. Before the AIFMD, the appointment of a depositary was only mandatory in respect of Luxembourg regulated funds, including SICARs and SIFs. The AIFM Law and the RAIF Law have extended the requirement for appointing a depositary to: (i) non-regulated SOPARFIs qualifying as AIFs (except if they are managed by an Exempted AIFM); and (ii) RAIFs.

The increased use of Luxembourg as the jurisdiction of choice within the EU for the setting-up of AIFs means that in the context of fund finance transactions, it is essential to have a clear understanding of the duties of the depositaries, and of the interactions between their duties and the rights of the lenders. The duties of a depositary of a Luxembourg fund may generally be described as covering: (i) safekeeping and supervision of the assets; (ii) day-to-day administration of the assets; and (iii) control over the transactions of the fund (including compliance with investment policies and monitoring of the cash flows). With the ultimate goal being increased investor protection, the exact scope of a depositary's duties depends on whether the AIF concerned is subject to the SICAR Law, the SIF Law, the RAIF Law and/or the AIFM Law.

- *Depositary's duties in respect of SICARs and SIFs*

The depositary of a fund organised as a SICAR or a SIF is entrusted with the supervision of the fund's assets. This implies that the depositary must always know how the fund's assets of the fund have been invested, and where and how they are available. However, this does not prevent the physical safekeeping of the fund's assets by third parties designated by the fund, with the approval of the depositary. When carrying out its duties, the depositary must act independently and solely in the interest of the fund's investors. Entrusting some or all the assets in its custody to a third party does not affect the depositary's liability.

- *Depositary's duties in respect of AIFs*

With the implementation of AIFMD, the initial role of depositaries was supplemented by additional overview obligations relating to: (i) the valuation of assets; (ii) the subscription and redemption of shares or units; (iii) the execution of the AIFM's instructions; (iv) the timely settlement of transactions; and (v) distribution of the AIF's income. Depositaries are now also required, in addition to the custody/safekeeping of assets of the relevant AIF, to monitor and reconcile the AIF's cash flows by obtaining a full overview of its cash positions and cash movements. These duties apply to any depositary appointed in respect of an AIF, whether it is organised as a SICAR, a SIF, a RAIF or any non-regulated SOPARFI qualifying as an AIF (except for a SOPARFI managed by an Exempted AIFM).

The depositary must in general ensure that the AIF's cash flows are properly monitored, and ensure in particular that all payments made by or on behalf of investors upon the subscription of units or shares in the AIF have been received, and that all the AIF's cash has been booked in cash accounts opened in its name, the name of the AIFM acting on behalf of the AIF, or the name of the depositary acting on behalf of the AIF.

- *Interactions between the duties of the depositary and the rights of the lenders and the security takers*

Owing to the responsibilities imposed on depositaries of Luxembourg-based funds, their potential exposure to liability has increased, meaning that they will seek to limit their risks and secure additional protection in depositary agreements. It is important for the borrowing fund, the lenders and the security takers to verify whether the provisions of the depositary agreements and the duties of the depositary might have an impact on the financing transaction and the effectiveness of the security package. The exact scope of such contractual protection should be analysed on a case-by-case basis, as each depositary may have its own requirements. It may cover both assets and accounts held in custody by the depositary and any other assets owned by the borrowing fund. In practice, the depositary agreements usually provide for: (i) a right of information; (ii) a right of prior consent; and/or (iii) a right of pledge over the assets of the fund.

The right of information usually provides that the depositary must be informed in advance of any transaction in respect of the fund or its assets (in particular, borrowings and any transaction involving a transfer of rights/ownership of the fund's assets, such as the granting or enforcement of security interests). The right of prior consent obliges the fund to obtain the depositary's consent before entering into borrowing arrangements and granting security interests over the fund's assets. Both these rights aim to ensure that the depositary obtains sufficient information on transactions affecting the fund's assets which it has to monitor and supervise, and is able to block transactions which may violate the fund documentation or the applicable laws and regulations. Any fund which enters into a financing transaction that breaches the depositary agreement would expose itself to contractual liability. From a lender's perspective, the depositary may also challenge the financing arrangements and the security interests, and bring claims against lenders who have acted despite being aware of the breach of contract. It is therefore usual for lenders to require an acceptance letter from the depositary in relation to the financing transaction and the security package.

The depositary arrangements often provide for a pledge over all or part of the fund's assets of the fund in favour of the depositary. As long as that pledge remains in place, the fund will not be able to grant a first-ranking pledge over the same assets for the purpose of a financing transaction. A waiver of the pledge granted in favour of the depositary will be required in order to conclude the new security interest agreement validly and perfect the pledge it creates. Without such a waiver, the pledge granted by the fund in favour of the lenders may either rank as junior to the pledge granted in favour of the depositary, or even be considered as not validly created.

When the lenders and/or security takers exercise their rights under the security interests, they must take the duties of the depositaries into consideration. The security interest agreements would typically allow them to make capital calls on the investors upon the occurrence of an event of default. Special attention must be paid to situations where lenders and/or security takers require the investors' contributions to be paid into an account, which is not opened in the name of the fund, the AIFM acting on behalf of the fund or the depositary acting on behalf of the AIF. In such situations, the exercise of the lenders' and/or the security takers' rights may potentially conflict with the duty of the depositary to monitor the fund's cash flows and supervise its assets for the purpose of the AIFM Law.

GDPR impact on fund finance transactions

The EU Regulation No. 2016/679 on the protection of natural persons with regard to the processing of personal data (the **GDPR**) regulates how personal data (relating to natural persons) is processed and transferred. In the context of fund finance transactions, a point of attention is how personal information regarding investors and their commitments may be transferred to the lenders in order to determine the borrowing basis and take the security interests over the unfunded capital commitments. As a result, GDPR provisions and consents are included in the fund documentation in order to authorise the fund and its general partner to share such information with the lenders and transfer such information outside of Europe.

Securitisation Regulation

The Regulation (EU) 2017/2042 of the European Parliament and of the Council of 12 December 2017, laying down a general framework for securitisation and creating a specific framework for simple, transparent and standardised securitisation (the **EU Securitisation Regulation**), came into force on 1 January 2019. Certain fund finance transactions (notably leveraged transactions) and borrowing entities may potentially fall within the scope of the EU Securitisation Regulation, which would trigger a broad array of obligations for the borrowing entity, but also for originators, sponsors and certain investors (among others, requirements with regard to risk retention, due diligence, transparency and disclosure, restrictions on sale to retail investors, etc). In order to determine whether such obligations would be applicable, one needs to assess whether the transaction meets the definition of "securitisation" as set out in the EU Securitisation Regulation and whether any of the involved entities may be considered as a securitisation special purpose entity (**SSPE**) for the purpose of the EU Securitisation Regulation.

Article 2(1) of the EU Securitisation Regulation defines "securitisation" as a transaction or scheme, whereby the **credit risk associated with an exposure or pool of exposures is tranched**, having all of the following characteristics:

- payments in the transaction or scheme are dependent upon the performance of the exposure or the pool of exposures; and
- the subordination of tranches determines the distribution of losses during the ongoing life of the transaction or scheme.

It follows from the above definition that a transaction would only fall within the scope of the EU Securitisation Regulation if the securitised credit risk is tranched. The EU Securitisation Regulation defines "tranche" as:

- a contractually established segment of the credit risk associated with an exposure or a pool of exposures;
- where a position in the segment entails a risk of credit loss greater than or less than a position of the same amount in another segment; and
- without taking account of credit protection provided by third parties directly to the holders of positions in the segment or in other segments.

Furthermore, the transactions falling within the "specialised lending" exception (as described in article 147(8) of the Regulation (EU) 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms (CRR)) are not subject to the EU Securitisation Regulation, even if the above conditions are satisfied.

In addition, it has to be assessed whether any of the involved entities may be considered as an SSPE for the purpose of the EU Securitisation Regulation. According to article 2 of the EU Securitisation Regulation, an SSPE is defined as "a corporation, trust or other entity, other than an originator or sponsor, established for the purpose of carrying out one or more securitisations, the activities of which are limited to those appropriate to accomplish that objective, the structure of which is intended to isolated the obligations of the SSPE from those of the originator".

The definition of securitisation under the EU Securitisation Regulation is thus quite large and it is therefore advisable to assess each transaction (notably any transaction involving entities investing in credit assets and receiving financing with different payment priorities and seniorities) and the involved entities on a case-by-case basis to determine whether the above conditions are met.

Outlook

Significant drivers for the success of Luxembourg as a European hub for the structuring of AIFs, in particular over the past few years, have been:

- the success of the modernisation of the Luxembourg partnership regime, which has been able to offer fund initiators accustomed to Anglo-Saxon partnerships a new onshore alternative for fund structuring; and
- the addition of the RAIF to the Luxembourg fund structuring toolbox, replicating, without any regulatory supervision at product level, the flexibility of regulated AIF regimes.

There is no reason to doubt that this trend will continue and sustain a growing demand from fund managers for financing solutions.

* * *

Endnotes

1. As at August 2019.
2. According to Recital 78 of the AIFMD.
3. Commission Delegated Regulation (EU) No 231/2013 of 19 December 2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (the Level 2 Regulations).
4. SIFs, SICARs and RAIFs are obliged to appoint depositaries in any event on the basis of the SIF, SICAR and RAIF Laws, respectively.

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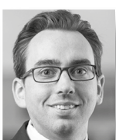

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Mauritius

Malcolm Moller
Appleby

Overview

With its diversified economy, politically stable and business-friendly environment, coupled with an impressive "speed to market" in implementing legislative changes, Mauritius has bolstered its position as a jurisdiction for financial services and is poised to be the preferred investment hub in Africa. In fact, during the past few years, Mauritius has projected itself as an investment and trading bridge between Africa and Asia, particularly with the conclusion of the double taxation treaty between Mauritius and India (Treaty) and other African member states of the African Union, and the recent amendments made to the Treaty. The economy has since experienced a positive trend in its global business market.

Broadly, global funds (that is, investment funds and their intermediaries) (Global Funds) in Mauritius are regulated by the Financial Services Commission (Commission). The Commission has, since 2001, developed a very flexible set of guidelines as well as a consolidated regulatory and supervisory framework for the regulation of such global funds, namely the Securities Act 2005 (Securities Act), the Securities (Licensing) Rules 2007 (Securities Licensing Rules), Securities (Preferential Offer) Rules 2017, the Financial Services Act 2007 (FSA 2007) and the Securities (Collective Investment Schemes and Closed-end Funds) Regulations 2008 (Securities Regulations 2008). As a result, the number of authorised funds being regulated by the Commission stood at 1,024 as at 30 June 2018. The number of fund intermediaries increased by 3% to reach 445 entities as at 30 June 2018.[1]

Further growth is expected to be seen following the recent amendments to the legislations in Mauritius, including the global business regime (discussed below) affecting the global funds market. These changes correspond with the approachability of the regulators in Mauritius, and their willingness to listen and accordingly respond to industry needs and demands in a commercial manner, while at the same time protecting the Mauritius 'brand'. These changes also seek to address the uncertainties investors may be having, to realign the present regulatory framework with the Organisation for Economic Cooperation and Development (OECD)/Base Erosion and Profit Sharing (BEPS) requirements, and to see Mauritius as a one-stop shop for financial products and services.

Fund formation and finance

<u>Global funds – Overview</u>

The present regulatory framework contemplates two main categories of Global Funds, namely: an open-ended fund, also known as a collective investment scheme (CIS); and a close-ended fund, commonly known as a private equity fund (Private Equity Fund). Global funds can be structured as companies incorporated under the Companies Act, 2001

(Companies Act), as limited partnerships which came into force pursuant to the Limited Partnership Act 2011 or licensed as companies or partnerships holding a Global Business Licences (GBL) under the FSA 2007.

Any CIS or closed-end fund (individually a scheme or collectively schemes) wishing to be approved, registered with, recognised and/or licensed by the Commission under the Securities Act must first apply to the Commission for authorisation as a CIS or closed-end fund in the manner set out in the Securities Regulations 2008, and obtain a GBL under the FSA. Funds usually take the form of companies, limited partnerships, protected cell companies (PCC) or trusts. The typical vehicle used to structure a closed-end fund is a private company limited by shares or a limited partnership, while a collective investment scheme is commonly structured as a public or private company, unit trust or PCC.

The Mauritian Limited Partnership (LP) combines features of both a company and a partnership, and acts as another preferred vehicle for foreign investors that may provide flexibility in structuring a CIS. It can have separate legal personality just like a company, while at the same time enabling some partners, known as limited partners, to contribute and participate in the returns of the LP without being engaged in its day-to-day management. The general partner is responsible for managing the business and affairs of the limited partnership, and is personally liable for the debts of the partnership.

The Limited Liability Partnerships Act, 2016 was recently introduced to further equip the economy's financial sector with innovative tools, as well as alternative and attractive vehicles to investors – the Limited Liability Partnership (LLP). Similar to the LP, the LLP combines features of both a company (holder of a GBL) and a partnership, where the LLP is incorporated as a body corporate having separate legal personality from its partners, thus providing the flexibility of a partnership. Under an LLP, the partner is accountable and liable to the LLP only to the extent of its contributions (except in the event of insolvency). The LLP is required to have at least two partners and one manager. The relationship between the partners and the LLP is governed under a partnership agreement.

On 1 January 2000, the Protected Cell Companies Act 1999 (the PCC Act) came into force, which created an incorporation and registration regime whereby a Mauritian company carrying out global business would be able to register as a protected cell company. A protected cell (in some jurisdictions known as a 'segregated account' or 'segregated portfolio') is an account containing assets and liabilities (known as 'cellular assets') that are legally separated from the assets of the company's ordinary account, called its 'non-cellular assets', and also separate from assets and liabilities allocated to the company's other protected cells (if any).

A trust, established under the Trusts Act 2001, is a legal relationship created by the beneficial owner creating the trust (the settlor) and the persons willing to undertake the office of trustee (the trustees). As part of this relationship, property (the trust fund) is declared to be held by the trustees for the benefit of certain parties (the beneficiaries) or for certain purposes, creating a binding obligation on the part of the trustees to act in accordance with the terms of the trust. Trusts are normally liable to income tax on its chargeable income. Chargeable income is calculated as the difference between the net income derived by the trust and the aggregate income distributed to the beneficiaries under the terms of the trust.

The regulatory and supervisory framework for global funds is in line with international principles and practices as laid down by the International Organisation of Securities Commissions (IOSCO). Intermediaries ensure the proper functioning of investment funds and hence protect the best interests of investors. All global funds are therefore subject to ongoing reporting obligations, as imposed by the Commission under the Securities Act and the FSA 2007. Reporting obligations include submission of Audited Financial Statements and Quarterly Statutory Returns (Interim Financial Statements), in accordance with the FSA 2007. A fund is required to be managed by an investment manager licensed in Mauritius. A foreign regulated investment manager may alternatively be appointed, subject to the prior approval of the Commission.

As in recent years, despite numerous headwinds, fund finance markets have continued their outpaced growth in the first half of 2019, building upon and continuing a market trend in place since at least 2010. Similarly, fund finance performance remained pristine, and no loan losses or write-downs from last year have become public. Other than the infrequent dust-up that has occurred between an investor and a general partner/investment manager, we are still not aware of any substantial case law relevant to fund finance in 2019. Also, as indicated above, we expect further positive growth in 2020.

Fund financing

As the private funds sector grows and matures in Mauritius, financing solutions are increasingly required by funds and fund managers. The need for finance can vary, from equity bridge or capital call facilities used to assist liquidity and speed of execution for private equity funds, to more esoteric products used by hedge funds in addition to their prime brokerage agreements, such as NAV-based margin loans to provide liquidity or leverage, and equity or fund-linked derivative solutions. Consistent with prior quarters, capital call subscription credit facilities continued their positive momentum in 2019 and had an outstanding year as an asset class.

In fact, we still have not been consulted on a single facility payment event of default in the first half of 2019. Also, as more investors look to limit their investments to a smaller group of preferred sponsors, sponsors are also diversifying their product offerings. We have, for instance, noticed a trend involving a number of sponsors leveraginging their existing investor relationships by creating funds focused on sectors in which they have not traditionally participated (i.e., buyout shops creating direct-lending funds). In addition to the very positive credit performance, the asset class seemed to enjoy significant year-over-year growth in the Mauritius fund industry. Below we set forth our views on the state of the fund finance facility market and the current trends likely to be relevant in 2019. We remain confident based on our experiences, as well as anecdotal reports from multiple facility lenders, that the fund facility market expanded materially from 2010 to 2019. The positive growth for private funds was driven by a confluence of factors, the more so as investors have become increasingly comfortable with global funds structures.

We consider that the following four key trends continue to dominate the market, even in the first half of 2019: (i) the general maturation of the fund financing product and market; (ii) the continuing expansion of fund financing into various fund asset classes, and particularly, private equity; (iii) fund structural evolution, largely responsive to the challenging fundraising environment and investor demands; and (iv) an entrepreneurial approach among funds to identify new investor bases and new sources of capital commitments. In our view, these trends will continue to have a material impact on the fund financing market in 2019 and beyond.

General security structure for Mauritius transactions

Historically, funds have predominantly been incorporated as corporate structures. Some companies may have more than one class of shares, which denote various fee structures and/or limitations on the types of investments some shareholders can make. There may also exist multiple series within each class of shares. To widen its array of financial products, Mauritius introduced its Limited Partnership Act 2011, adding a new dimension to the international investment community. This investment vehicle enables Global Funds to be structured as partnerships in Mauritius, reducing the need for complex master-feeder structures and ensuring tax-efficient structures.

Mauritius has become a central hub for foreign direct investment into India and Africa due to its network of double taxation avoidance agreements and investment protection and promotion agreements with various African countries. However, while investors have been able to form global business companies for foreign direct investment, the more rigid structure of companies means they are not always perfectly suited for these investment projects. For example, for funds structured as a Mauritius corporation, a shareholders' agreement governs the relationship with the shareholders rather than a partnership agreement. Shareholders' obligation to pay in capital contributions is contingent upon the issuance of further shares, and a corporation's ability to issue shares is generally not delegable under Mauritius Law, thus limiting the ability to make capital calls on investors in an event of default under the fund financing facility.

Security for the fund finance consists of: (a) a security assignment by the fund of the capital commitments, right to make capital calls, right to receive and enforce the foregoing and the account into which the capital commitments are to be funded; and (b) a charge on the bulk of its other assets including its accounts, investments compensation from various of its assets including bonds, guarantees, negotiable instruments and the like. The security package relating to the capital calls is tailored in order to account for specifics of Mauritius law and the structure of the fund as a corporation (rather than a limited partnership, as most funds in Mauritius are structured as corporations). In particular, various rights in respect of the fund are vested in the board of directors and cannot be easily delegated. Mauritius law requires that shares be issued in exchange for capital calls.

One would expect security to be taken over bank accounts of the fund and assignment of rights to make capital calls, accompanied by a power of attorney in favour of the lender to exercise such rights on behalf of the fund/general partner and/or manager (as the case may be) in a typical fund financing security transaction.

So while one would have a pledge over the security provided above, the ability for a lender to make a capital call on its own would be complicated by the foregoing. In a worst-case scenario, the preferred enforcement mechanism would have the lender appoint a receiver (and if necessary, a liquidator), as each have statutory authority to make capital calls and issue shares in order to satisfy creditors to whom such security is pledged. Indeed, after an event of default, a lender is entitled to appoint a receiver under the Insolvency Act of 2009. Security documents, such as fixed and floating charge documents, would need to provide that if a receiver were appointed, it would have full management powers to the exclusion of the board of directors. Under the Insolvency Act of 2009, the receiver would have the power to make calls of unfunded capital to the extent such assets are included in the charge granted to a lender and issue shares.

It is also recommended that a liquidator be appointed in order to avoid certain issues relating to set-off of claims by shareholders against the called capital (described further below). The liquidator would also be permitted to call capital. For example, various contract law defences may be waived in Mauritius by contract in the situation where the fund is not in insolvency (including non-performance by the fund). In the US, such language was cited in the Iridium line of cases. Generally, such language is sought for three reasons: (a) to waive contract law defences such as lack of consideration, mutual mistake, impracticability, etc.; (b) to prevent the LPs from claiming that they may set off amounts owed to them by the fund against what is due to the lender; and (c) claims that an issuance of shares or some other action by the fund is required as a condition for payment of capital contributions.

We recommend that such language be included in this transaction, since in the event of insolvency of the fund, the language may prove helpful and could avoid other defences raised by shareholders that their commitment to contribute capital is a "financial accommodation" or otherwise avoidable under insolvency laws. Such ability to waive in advance the right to raise the defence above and other defences by contract could be inserted in the contract (presumably by amendment to the shareholders' agreement or by an investor letter); however, general waivers are not effective, so specific waivers would be required as to each of the possible defences.

Moreover, such contractual waivers would not be effective in a number of circumstances, including rights to set-off pursuant to Insolvency Act of 2009. By statute, under the Insolvency Act of 2009, while a receiver is in place, principles of contractual, legal and equitable set-off apply which would permit set-off by shareholders, and such set-off is available to the extent that claims have been incurred prior to the commencement of the liquidation (subject to other limitations). To avoid such risk, we normally recommend the initiation of winding-up by a lender by appointment of a liquidator, as such appointment would crystallise the liability of shareholders as a statutory liability which cannot be set off against amounts owing to the shareholder.

Key developments

Some of the key amendments made to the present regulatory framework are as follows:

<u>Amendments to the Companies Act</u>

The definitions of 'GBL 1' and 'GBL 2' have been removed from the Companies Act and new definitions of 'GBL', and 'Authorised Companies' have been introduced.

Companies are also required to keep their share registers for a period of at least seven years as from the date of the completion of the transaction, act or operation to which it relates, failing which, the companies may be liable to a fine.

Companies are equally required to keep an updated record of the names of any nominees in alphabetical order, and the last known addresses of the beneficial owners or the ultimate beneficial owners, giving instructions to the shareholder to exercise a right in relation to a share either directly or through the agency of one or more persons. Any failure to comply with this requirement would constitute an offence and the company (other than a small private company) shall, on conviction, be liable to a fine not exceeding Rs 300,000.

<u>Amendments to the FSA 2007</u>

The FSA 2007 has been amended to introduce new definitions of 'GBL', 'Global Business Corporations' and 'Authorised Companies'.

The GBL will be required: (a) where the majority of shares or voting rights or the legal or beneficial interest in a resident corporation, other than a bank licensed by the Bank of Mauritius and such other corporation as may be specified in the rules issued by the Commission, are held or controlled, as the case may be, by a person who is not a citizen of Mauritius; and (b) such corporation proposes to conduct or conducts business principally outside Mauritius or with such category of persons as may be specified in rules issued by the Commission. The holder of the GBL is subject to strict, enhanced, substance requirements which are as follows:

- has to be managed and controlled from Mauritius;
- has to be administered by a management company;
- has to at all times carry out its core income-generating activities in, or from Mauritius by:
  - employing, either directly or indirectly, a reasonable number of suitably qualified persons to carry out the core activities; and
  - having a minimum level of expenditure, which is proportionate to its level of activities.

When assessing the core income-generating activities of its licensees, per type of licence, the Commission will rely on indicative definitions, some of which are listed below:

Collective investment scheme: Investment of funds in portfolios of securities, or other financial assets, real property or non-financial assets; diversification of risks; and/or redemption on the request of the holder.

Closed fund: Investment of funds collected from sophisticated investors, in portfolios of securities, or in other financial or non-financial assets, or real property.

In determining whether the holder of a GBL is managed and controlled from Mauritius, the Commission shall have regard to such matters as it deems necessary in the circumstances, in particular, that the company: (a) has at least two directors, resident in Mauritius, of sufficient calibre to exercise independence of mind and judgment; (b) maintains at all times, its principal bank account in Mauritius; (c) keeps and maintains, at all times, its accounting records at its registered office in Mauritius; (d) prepares its statutory financial statements and causes such financial statements to be audited in Mauritius; and (e) provides for meetings of directors to include at least two directors from Mauritius.

Another amendment brought to the FSA 2007 is that every licensee is required to keep and maintain, at all times, a register of beneficial owners of each of its clients and record such information as the Commission may determine. The Commission may now request for any information on the licensees relating to the due diligence procedures on the beneficial owners of any person acting on behalf of the clients of the licensees.

Also, in its quest to position Mauritius as a fintech hub for Africa, the Government has introduced two new licensable activities under the list of financial business activities under the FSA 2007, namely: the 'Digital asset marketplace'; and 'Custodian services (digital asset)'. These new licences aim to provide a regulated environment for the safe custody of digital assets by investors and further enable the exchange of digital assets.

Amendments to the Income Tax Act

The reform to the tax regime seeks to have a harmonised tax system between the holder of a GBL and a domestic company. The Deemed Foreign Tax Credit regime available to a holder of a GBL 1 has been abolished and a partial exemption regime has been introduced, applied subject to the companies satisfying a predefined substantial activities requirement by the Commission. Under the partial exemption regime, 80% of specified income will be exempted from income tax, except for banks. The below provides for some of the circumstances where the exemption would apply:

- foreign source dividends derived by a company and profits attributable to a foreign permanent establishment;
- interest and royalties; and
- foreign source income derived by a CIS, closed end fund, CIS manager, CIS administrator licensed or approved by the Commission.

The existing credit system for relief of double taxation will continue to apply where partial exemption is not available. The GBL will be required to comply with pre-defined substantial activities so that its specified income is exempt from tax.

<u>Amendments to the Limited Partnership Act</u>

The amendments to the present regulatory framework seek to introduce new obligations to certain structuring vehicles. Thus, LPs are required to main a register of partners, disclosing the name of the beneficial owner or ultimate beneficial owners where the partner is a nominee. A beneficial owner or ultimate beneficial owner means a natural person who holds, himself or by his nominee, not less than 25% of the aggregate voting power exercisable at a meeting of the partners. Where an update or entry is made to the register of partners, the updated register of partners will need to be filed with the Registrar of Limited Partnership (Registrar) within 14 days of such change. The Registrar shall not disclose the details on the register of partners to any person unless it is required by the beneficial owner or ultimate beneficial owner, or ordered by the Court of a Judge in Chambers to do so, or unless it is required for the purpose of an investigation enquiry, to do so.

<u>Amendments to the Limited Liability Partnership Act</u>

All references to 'GBL 1' have been amended to references to 'GBL'. LLPs are required to main a register of partners, disclosing the name of the beneficial owner or ultimate beneficial owners where the partner is a nominee. A beneficial owner or ultimate beneficial owner means a natural person who holds, himself or by his nominee, not less than 25% of the aggregate voting power exercisable at a meeting of the partners. Where an update or entry is made to the register of partners, the updated register of partners will need to be filed with the Registrar within 14 days of such change. The Registrar shall not disclose the details on the register of partners to any person unless it is required by the beneficial owner or ultimate beneficial owner, or ordered by the Court of a Judge in Chambers to do so, or unless it is required for the purpose of an investigation enquiry, to do so.

Other related developments

Anti-money laundering: The Financial Intelligence and Anti-Money Laundering (FIAMLA) Regulations 2003 have been replaced with the FIAMLA Regulations 2018 which came into force on 1 October 2018. The FIAMA Regulations 2018 have redefined or introduced certain key definitions which include that of a 'customer', 'competent authorities' and 'reporting person'.

The existing provisions on the question of undertaking verifications on the identity of customers and beneficial owners have now been repealed. Accordingly, under the new regime, the relevant supervisory authority or regulatory body has discretion to allow a reporting person to complete the verification of the identity of a customer and beneficial owner once the business relationship has been established. However, this is subject to the following conditions:

- the verification of identity is essential not to interrupt the normal conduct of business;
- the verification of identity occurs as soon as reasonably practicable; and
- the money laundering and terrorism financing risks are effectively managed by the reporting person.

An important caveat to this new regime is that once a reporting person has been allowed to establish the business relationship before the completion of the verification exercise/s, he has an obligation to adopt and implement risk-management procedures concerning the conditions under which a customer may use the business relationship prior to verification.

Fintech: The surge of financial technology (Fintech) activities has already started to redefine the financial sector on a global scale, and this movement is also gaining ground in Mauritius. Two new licensable activities, 'Custodian of Digital Assets', and 'Digital Asset Marketplace', have been introduced (as mentioned above) to establish a regulated environment for the safe custody of digital assets by investors. Also, to keep abreast of latest technological advances, the Commission previously introduced the Online Data Capture System, as well as the Online Licensing Submissions Platform. The introduction of the abovementioned licensable activities is intended to reduce the uncertainty of investors, and will help reflect Mauritius as a robust jurisdiction from which the international blockchain companies may operate.

Establishment of sovereign fund: Mauritius plans to establish a sovereign fund to provide seed capital for the development of Fintech activities, and which is intended to be used as a means to attract companies to Mauritius and promote the economy as a robust and transparent regulatory regime for Fintech.

The year ahead

As 2019 is coming to a close, it continues the generally steady growth in the global funds finance market, with investors continuing to reap the benefit of hefty distributions at record rates, and Mauritius further enhancing itself as a fund domicile as well as a preferred jurisdiction for setting up global funds targeting investment opportunities in India and Africa.

Mauritius has indeed proved itself to be a highly responsive jurisdiction to evolving market demands, and the results are a more efficient and user-friendly company product which offers flexibility in structuring, and certainty when engaging in transactions requiring securing company assets in the global funds market.

The effectiveness of Mauritius' anti-money laundering defences has been endorsed by the country's Financial Services Commission, while International Monetary Fund and Financial Action Task Force (FATF) assessments point to clear evidence of action, such as enforcement.

Its quick implementation of a series of innovative changes to the existing legislations has ensured that Mauritius will remain one of the premier locations in which to do business. The changes to the legislation encourage the highest standards of conduct without stifling the innovation of investors, and further enable them to compete on a global platform. We remain cautiously optimistic for a robust fund finance market in 2020 – and we further expect the number of facilities consummated to continue to grow at a solid clip as fundraising improves and the product further penetrates the private equity market, and a greater number of existing facilities get refinanced.

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Endnote

1. Page 43 of the Annual Report 2017/18 of the Commission: https://www.fscmauritius.org/media/77956/fsc-ar-2017-2018-for-web.pdf.

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Overview

Historically speaking, the Netherlands has been a gateway (both literally and figuratively speaking) to the financial and investment world; not only spearheading the establishment of the first company in worldwide history to issue securities to the public, but also making major contributions to the way the world does modern (transnational) banking and finance. The Netherlands has remained a major location in both fields. The Netherlands is widely recognised as a leading international financial centre and has a mature investment funds industry with an attractive investment environment due to, amongst others, flexible corporate legislation, various tax structuring options, and an extensive network of bilateral investment treaties and tax treaties.

In terms of both fundraising and invested capital, 2018 has been an extremely successful year for the Netherlands. Based on annual research conducted by the *Nederlandse Vereniging van Participatiemaatschappijen* (the Dutch Association of Private Equity Firms) and PWC,[1] in 2018 alone Dutch private equity firms have raised around €2.1 billion in new funds, of which approximately €1.3 billion in new funds have been raised by Dutch venture capitalists, the highest number ever recorded for venture capitalists. In 2018, 183 Dutch private equity or venture capital firms managed approximately €25.4 billion (committed capital) in 369 funds, and over €6 billion has been invested by national and international private equity and venture capital firms in approximately 466 Dutch companies. As a consequence of growing numbers for fundraising and private equity and venture capital investments in the Netherlands, the Dutch fund finance practice also enjoys increased attention, which we do not expect to decline in 2020.

Another development adding to the increased importance of the Netherlands as an international financial centre is the potential migration of several financial institutions as a result of Brexit. Several firms are currently shifting their focus away from London towards mainland Europe, and in particular, the Netherlands as an often-mentioned candidate amongst others due to its excellent legal, tax and financial infrastructure and living environment. A shift towards the Netherlands would likely increase the amount of funds established in, and amount of financing structured through, the Netherlands.

In view of the aforementioned increasing relevance of the Dutch fund formation and fund financing market, this chapter seeks to provide further background on the following relevant aspects: (a) fund formation and the most commonly used Dutch fund vehicles; (b) certain regulatory aspects of fund formation and fund financing; and (c) the structuring of the security package.

Fund formation

Dutch alternative investment funds (**AIF**)[2] may be structured in various ways, both as corporate and contractual entities. Corporate entities have legal personality, enabling them to hold legal title to assets, and which are governed by mandatory corporate law, whereas contractual entities lack such legal personality (*rechtspersoonlijkheid*) and are unable to hold legal title, but enjoy the benefit of more contractual freedom. The most frequently used corporate investment vehicles are the private limited liability company (*besloten vennootschap met beperkte aansprakelijkheid*) and the cooperative (*coöperatie*). Contractual investment vehicles are most commonly established in the form of a limited partnership (*commanditaire vennootschap*) or a mutual fund (*fonds voor gemene rekening*). The ultimate selection strongly depends on the outcome of relevant tax and legal structuring analyses.

Regardless of whether a contractual or legal entity is selected, an AIF established in the Netherlands should take into account that the European Alternative Investment Fund Managers Directive 2011/61/EU (the **AIFMD**) is applicable and has been implemented in the Dutch Act on Financial Supervision (*Wet op het financieel toezicht*, the **AFS**). Consequently, the AIFMD and all rules and regulations promulgated thereunder (including Delegated Regulation (EU) 231/2013, the **Delegated Regulation**) have to be complied with in the Netherlands by any alternative fund manager (an **AIFM**), unless an AIFM can benefit from exemptions (such as, *inter alia*, AIFMs managing AIFs below the Threshold (as defined below)).

In the event that a Dutch authorised AIFM establishes a contractual investment vehicle as AIF (lacking legal personality), under the AFS it is required to also establish a single-purpose corporate entity to hold the assets of one or more of such AIFs set up by the licensed AIFM (as is further set out below).

<u>Asset owning SPV holding the assets of contractual AIFs managed by a Dutch AIFM</u>

In the event that an authorised Dutch AIFM contemplates using a contractual investment vehicle as an AIF, the legal title (*juridische eigendom*) to the assets of such AIF should be held by an entity whose single purpose is to hold the assets of one or more AIFs. In practice, Dutch AIFMs use a Dutch foundation (*stichting*) for this purpose. A Dutch foundation does qualify as a legal entity, but is not limited by shares and hence can operate as a bankruptcy-remote vehicle.

In addition, Dutch law provides that the assets of a certain AIF (or a sub-fund structured within an AIF) form a separate estate (*afgescheiden vermogen*) serving solely to satisfy claims arising from: (a) liabilities related to the management, custody and ownership of the legal title of the assets of such AIF and which, pursuant to the information as referred to in article 4:37m sub 1 AFS, may be charged to the estate of such AIF (i.e. the information set forth in article 23 AIFMD); and (b) the investors of such AIF.

In practice, this arrangement is implemented into the governing documents of the respective AIF (for instance, the limited partnership agreement), which provides that the foundation shall hold the legal title of the assets of an AIF for the risk and account of such AIF. In order to enable the AIFM to deal with the assets of an AIF, the governing documents shall likely also include an unconditional and irrevocable power of attorney to the AIFM to enter into any and all acts on behalf of such foundation acting as asset-owning special purpose vehicles (**SPV**).

The above requirement also applies if a Dutch authorised AIFM manages a non-Dutch AIF that qualifies as a contractual investment vehicle. Consequently, a Dutch foundation may also hold legal title of the assets of an AIF where the AIF itself is, for instance, a Scottish limited partnership. The Dutch Financial Markets Authority (*Autoriteit financiële markten* or **AFM**) may grant exemption from the requirement to incorporate an asset-owning SPV entity upon request. In our experience, the AFM does not easily grant such exemption (especially where it considers new AIFs).

Regulation of fund raising and fund managers

Authorisation

Following the implementation of the AIFMD in the Netherlands, the management or marketing of AIFs in the Netherlands by 'large' AIFMs, i.e., managers which, directly or indirectly, manage portfolios of AIFs whose assets under management amount to €500 million or more, or – when open-ended or leveraged – €100 million or more (together, the **Threshold**), triggers an authorisation requirement in the Netherlands, subject to certain exemptions and grandfathering rules. An AIFM is deemed to manage an AIF in the Netherlands if it is itself established in the Netherlands, or if the AIF managed by it is established in the Netherlands.

Dutch AIFMs that fall below the Threshold may manage and market their AIFs without Dutch authorisation in the Netherlands, provided that:

(a) the AIF's units or shares (e.g. LP interests) are exclusively offered to professional investors within the meaning of the AFS (e.g. banks, insurers, pension funds, brokers, AIFMs, AIFs or qualifying large corporates); or

(b) the AIF's units or shares are offered to fewer than 150 persons; or have a nominal value of, or are offered for a consideration payable per investor of, at least €100,000, provided that a banner or selling legend as to the AIFM's unregulated status (in a recently updated predefined size and layout) is printed on the AIF's offering documents; and

(c) in each case, the relevant AIFM is registered with the Dutch competent authority, the AFMAFM. The aim of said registration is (amongst others) to ensure that the AFM can assess whether or not the sub-Threshold regime is legitimately relied upon, and to effectively monitor any build-up of systemic risks. Such Dutch AIFMs are required to disclose to the Dutch Central Bank (*De Nederlandsche Bank*), amongst others, information on the main instruments in which the AIFs are trading, the principal exposures and the most important concentration of the AIFs managed.

Dutch AIFMs that do not require authorisation for managing and marketing their AIFs in the Netherlands may voluntarily apply for authorisation, provided such AIFM complies with all applicable AIFMD requirements (as implemented into Dutch law). Not many Dutch AIFMs have chosen to apply for authorisation voluntarily.

Finally, considering that AIFs making private equity investments are not excluded from the scope of the venture capital regulation (Regulation 345/2013/EC or **EuVECA**), EU-based managers of (EU) AIFs that comply with the conditions of EuVECA, may benefit from an EU marketing passport as introduced therein for the marketing of units or shares to potential investors that are or may, on request, be treated as professional clients (within the meaning of Directive 2014/65/EU (**MiFID II**)), or to investors investing at least €100,000, provided that they have confirmed their awareness of the risks associated with their investment.

Both authorised AIFMs and sub-Threshold AIFMs can benefit from EuVECA: enabling authorised AIFMs to use the EuVECA marketing passport to also market interests to investors who commit to invest at least €100,000 (and not only to professional clients within the meaning of MiFID II as is allowed under article 32 of the AIFMD). We are seeing an increasing number of (sub-Threshold) Dutch AIFMs obtain EuVECA-labels to benefit from the marketing passport (providing market access in a transparent manner).

Fund financing

With increasing availability of capital for investments and demand for high returns by investors, the need for financing solutions by Dutch AIFMs and Dutch AIFs is expected to continue its upturn. Depending on the type of AIF and type of investor, the need for financing can vary, from the more traditional capital call facilities to assist in providing liquidity and expediting the making of investments, to credit facilities based on, e.g. net asset value of investments to provide leverage or liquidity for the AIF.

There is very limited data publicly available on the use of the various types of fund financing in the market, which makes it difficult to assess the size of the fund financing market in the Netherlands. In our experience, traditional capital call facilities continue to be the main type of financing selected by AIFMs and increasingly, AIFMs require the possibility to take out this type of financing and the creation of security by the fund on its assets and receivables (as discussed below) to be explicitly included in the relevant fund documentation.

An important consequence of incurring leverage at the level of a Dutch AIF is that, depending on the details of the financing, the relevant AIFM managing such AIF may be required to obtain authorisation in the Netherlands, as further discussed below.

Leverage calculation at the level of the AIF

Whether or not an AIF incurs leverage may affect the relevant AIFM's regulatory status (i.e. it may lead to a lower Threshold to be applied for purposes of determining whether authorisation is required in the Netherlands). Additionally, if AIFMs deploy leverage, the AIFMD (and rules and regulations promulgated thereunder) impose additional obligations on an AIFM. Consequently, incurring leverage may affect an AIFM.

The term 'leverage' is defined by the AIFMD as any method by which an AIFM increases the exposure of an AIF it manages, whether through borrowing of cash or securities, or leverage embedded in derivative positions, or by any other means.

The Delegated Regulation sets out two mandatory methods for calculating and reporting leverage, referred to as the "Gross Method" and the "Commitment Method".[3] The Gross Method requires the absolute value of all positions to be calculated, converting derivatives into positions in the underlying assets without taking account of netting and hedging arrangements. The Commitment Method allows a few types of derivatives not to be converted into underlying asset positions and taking into account a limited range of netting and hedging arrangements.

In addition, the Delegated Regulation provides that AIFMs, when calculating exposure, should 'look through' corporate structures. Therefore, exposure which is included in any financial and/or legal structures involving third parties controlled by the relevant AIF, where those structures are specifically set up to increase, directly or indirectly, the exposure at the level of the AIF, should be included. However, for AIFs whose core investment policy is to acquire control of non-listed companies or issuers, AIFMs should not include in the calculation any leverage that exists at the level of those non-listed companies and issuers, provided that the relevant AIF does not have to bear potential losses beyond its capital share in the respective company or issuer.

On the other hand, borrowing arrangements entered into by the AIF are excluded under any of the abovementioned methods if these:

(a) are temporary in nature; and
(b) are fully covered by 'capital commitments' from investors (i.e. the contractual commitment of an investor to provide the AIF with an agreed amount of investment on demand by the AIFM).

Revolving credit facilities should not be considered as being temporary in nature.

Structuring the security package

Credit facilities to be granted to AIFs can be secured in a variety of ways. For example, security may be granted over the assets in which an AIF would (indirectly) invest, depending on the type of assets and the way the AIF is structured. Typically, credit facilities granted to AIFs would be secured by providing security in the form of a right of pledge over the receivables or contractual rights that the investors owe to the AIF arising out of the members' agreement, limited partnership agreement or otherwise relating to the AIF, such as the right to make drawdowns from the capital commitments. Pursuant to Dutch law, security over receivables can be established by way of a disclosed right of pledge, or by way of an undisclosed right of pledge.

A disclosed right of pledge is created by way of a security agreement and notification of the right of pledge to the relevant debtors of the secured receivables. An undisclosed right of pledge is created either by way of a notarial deed or by way of a security agreement that is registered with the Dutch tax authorities for date-stamping purposes. As an undisclosed right of pledge can only be created over present receivables and future receivables arising from legal relationships existing at the time of creation of such undisclosed right of pledge, it is required to periodically file with the Dutch tax authorities supplemental security agreements to also secure present and future receivables resulting from legal relationships that have been entered into in the interim.

Choosing one form of pledge over the other strongly depends on whether it is commercially desirable to disclose the right of pledge to the relevant investors, and whether an undisclosed right of pledge is acceptable to the beneficiary of the right of pledge.

With respect to creating an undisclosed right of pledge over capital commitments in particular, the question is whether the receivable owed by the investor to the AIF with respect to payment of the capital commitments qualifies as a current receivable, a future receivable arising from an existing legal relationship, or as an absolute future receivable.

If it must be held that the legal relationship, and thus the receivable arising out of that legal relationship, only comes into existence once the AIFM sends the capital call notice to the relevant investor, then the receivable is an absolute future receivable. This means that prior to the moment that the AIFM has sent the capital call notice, only a disclosed right of pledge can be created over this receivable. In Dutch literature and case law, the prevailing view is that the receivable owed by the investor to the AIF qualifies as a future receivable arising from an existing legal relationship, which receivable comes into existence once the AIFM sends the relevant capital call notice to the relevant investor, and can also be made subject to a undisclosed right of pledge.

However, if the AIFM sends the capital call notice after the pledgor's (the AIF's) bankruptcy, then the receivable comes into existence after such pledgor's bankruptcy and therefore forms part of the pledgor's bankruptcy estate unencumbered by the right of pledge. To overcome this potential problem, a provision could be included in the fund documentation, stating that the parties acknowledge and agree that the receivable arising out of the right to make drawdowns from the capital commitments comes into existence once the fund documentation is entered into, and thus constitutes an existing but conditional claim; conditional upon the capital call being made. A right of pledge created over an existing but conditional receivable is valid, also if the condition (the capital call) is met after the pledgor's bankruptcy.

However, there is no statutory law and limited case law confirming that such a provision would work to avoid any of the aforementioned issues. Therefore, in practice, the investors are requested to grant to the pledgee a direct, independent right to issue capital call notices in default situations. If such direct agreement is not (commercially) feasible, the AIFM may grant a power of attorney to the pledgee to issue, in certain default situations, a capital call notice in the AIFM's name to the investors, who are requested to acknowledge this right of the pledgee. However, as a power of attorney is cancelled in the event of bankruptcy of the entity that has granted the power of attorney, the latter option is less favourable to the pledgee.

An important note to make in respect of an undisclosed right of pledge is that the pledgee may only collect a receivable after the debtor has been notified of such right of pledge. Until a notification has been made, the pledgor remains authorised to collect payments and the debtor of the relevant receivable remains authorised to pay to the pledgor. Following bankruptcy:

(a) payments made by debtors to the pledgor prior to notification will form a part of the bankruptcy estate of the pledgor, it being understood that the pledgee will have a preferred claim (*preferente vordering*), maintaining its priority in respect of such paid proceeds, but will have to share in bankruptcy costs (which may be significant); and

(b) in respect of payments actively collected by the bankruptcy trustee from debtors prior to notification (the bankruptcy trustee must grant the pledgee a reasonable period of time to notify the debtors, must provide the required administration to the pledgee and, if the bankruptcy trustee actively collects within such period, this will constitute a wrongful act), the pledgee will have a preferred claim on the bankruptcy estate (*preferente boedelvordering*) for the amount of such collected proceeds, and an unsecured claim on the estate (*concurrente boedelvordering*) for any damages resulting from the bankruptcy trustee's wrongful act to actively collect such payments.

Both the pledgor and pledgee may notify the debtors. However, unless the pledgee and the pledgor have otherwise agreed, the pledgee may only notify the debtors if the pledgor or debtor of the secured claim has failed to, or the pledgee has good reason to believe, that the pledgor or debtor of the secured claim will fail to (properly) perform its obligations owed towards the pledgee.

Another element to take into consideration when structuring the security over the AIF's assets is that receivables and contractual rights may, through a clause in (the general conditions to) the contract from which such receivables or contractual rights arise, be made non-assignable/transferable or "non-pledgeable". Depending on the wording of the relevant provision of the contract, such non-assignability clause could have an effect *in rem*, in which case creating a right of pledge over such receivable or right will simply not be possible. Especially for small to mid-sized companies, in sectors where these restrictions are very common, this leads to lower access to financing.

This, and other objections, to the effect of these restrictions, led to the submission in July 2018 by the Dutch Ministry of Justice of a preliminary legislative proposal for consultation to amend the Dutch Civil Code in order to abolish provisions that prohibit assigning or pledging monetary claims for financing purposes (*Wet opheffing verpandingsverboden*), also with the aim of following the example of other European countries who have done the same with a view to restoring an international level playing field.

In the consultation phase of the legislative proposal, critics have claimed that although the initiative is welcome to increase the access to financing generally, the current proposal results in too many uncertainties to have practical value. We are waiting on the Dutch Minister to either submit a new draft for consultation, or to submit the current draft as a legislative proposal to the Dutch Parliament. Current practice for fund financing, however, is that fund documentation generally caters for the possibility to assign, transfer or encumber any right to make drawdowns from the capital commitments or other receivables of the AIF, making this less of an issue.

The year ahead

As emphasised, 2018 and 2019 have been interesting and important years for the Dutch fund-formation and fund-financing markets. With current national and international political developments confirming and strengthening the Netherlands' position as a mature and well-equipped jurisdiction for funds and investments, we expect that 2020 will be another important year for the Dutch private equity and venture capital markets.

Acknowledgment

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* * *

Endnotes

1. A summarised report of their findings can be found on the website of the NVP, http://www.nvp.nl/pagina/ondernemend%20vermogen/ (this information was accurate on the date of this publication).
2. We note that this chapter does not focus on collective investment undertakings that require authorisation pursuant to Article 5 of Directive 2009/65/EC (UCITS).
3. Annexes to the Delegated Regulation set out methods of increasing the exposure of the AIF, conversion methodologies for some standard types of derivatives; and duration netting rules.

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Scotland

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Overview

Scotland has a long history of innovation in the financial sector, from the 17th and 18th century banks that are still with us, the insurers and the fund managers, to cutting-edge fintech. The funds sector remains very strong and is closely integrated with the rest of the UK market and worldwide, and has shared fully in the recent opportunities and challenges in those markets.

Scotland has played a strong role in investment innovation over this long history in, for example, development of the investment trust and other corporate investment vehicles and in the use of partnerships as investment vehicles. In particular, Scottish limited partnerships have become a significant element in investment structures in the UK and worldwide, and the reasons for this are outlined below, along with some recent and prospective developments.

Fund formation and finance

Scottish limited partnerships are useful to the funds market for a number of reasons. These are, principally, their stability as longstanding mainstream business entities from a G8 state, their flexible and non-bureaucratic nature, their tax transparency in various jurisdictions, and their separate legal personality from their partners.

Save for the separate legal personality of Scottish partnerships, Scottish and English partnerships are much the same and are very common business entities widely used in all sectors and established under a relatively simple and stable code set out in the UK Partnership Act 1890. A partnership can be formed as a limited partnership by filing details of its general and limited partners, their capital commitments, the nature of the partnership business and a few further details with the UK Companies Registrar, who then issues a certificate of registration. On registration, the UK Limited Partnerships Act 1907 then overlays limitation of limited partners' liability on the 1890 Act code, linking limited liability to limits on limited partners' active participation in a partnership's business, and limiting liability to capital commitments. Ongoing filings then relate largely to changes to details originally filed.

Partnership agreements are not filed and there are relatively few restrictions as to their form and content, though applying Scots law and court jurisdiction are important elements in establishing that a partnership is Scottish – as is ensuring that as many further connections as practicable exist with Scotland, particularly at the outset.

Flexibility in partnership agreements means that limited partners can provide most of their contributions by way of debt rather than capital if they wish and that complex structures for contribution, investment and distribution can be set up and changed much as partners wish. Management by general partners is similarly flexible, provided limited partners do not participate actively in management, and a general partner can readily delegate most operational functions to external managers.

Separate personality of a Scottish limited partnership means that it can hold investments directly in its own name (including land), borrow directly or issue guarantees in its own name, or be a general or limited partner in another partnership. Scottish limited partnerships are accordingly popular feeder fund vehicles into other funds, or play other roles in complex fund structures.

Consequently, when a fund wishes to borrow, a Scottish limited partnership can participate in an active and flexible manner in that borrowing by virtue of its separate personality. For term borrowing to leverage investment, a Scottish limited partnership can accordingly act as borrower or guarantor in its own name and grant security over its assets for such borrowing or guarantees, or as third party security. Limited and general partners can also grant security over their interests in the Scottish limited partnership. Similarly, when bridge lending is provided to a fund pending drawdown of investor commitments, a Scottish limited partnership can itself grant security over those commitments as part of that lending structure, whether those commitments are capital commitments or debt commitments embedded in its partnership agreement.

There are two basic types of security interest in Scots law – fixed securities and floating charges. Floating charges create security over all or a category of assets owned from time to time by a chargor, and provide a slightly lower level of protection to a secured creditor than fixed securities. Floating charges are flexible and easy to constitute but unfortunately can only be granted by incorporated companies and not by conventional partnerships. Scottish limited partnerships cannot, therefore, grant floating charges over investments or other assets held by them and must, therefore, use fixed securities relevant to the asset in question.

When granting fixed security over commitments to it from limited partners under its partnership agreement, a Scottish limited partnership is required to assign its rights to those commitments in security to the lender or a security trustee, and give notice of that assignment (the Scottish term being *assignation*) to the limited partners. A degree of control over the rights assigned and/or their proceeds must also be provided to the assignee. The flexibility inherent in a Scottish partnership agreement can facilitate this process by clarifying and separating payment, drawdown and other supporting rights to be assigned, confirming their assignability and severability, eliminating internal set-off rights and easing notice procedures by authorising general partners to receive notice for multiple limited partners. Various methods are used to establish assignee control of rights assigned, ranging from fully blocked proceeds accounts to countersigned drawdown notices and a series of variants to suit the administrative requirements of the various parties involved.

Security granted by partners over interests in Scottish limited partnerships is also effected by assignment in security of rights under the relevant partnership agreement. Notice is then given to the partnership itself and (depending on the rights assigned) other relevant partners, and control over rights assigned taken by the assignee. If all of a partner's rights under a partnership agreement are assigned, the assignee will, however, become a partner in place of the assigning partner. While this may not be too problematic when assigning the interests of a limited partner, this change is normally required to be publicised in the Edinburgh Gazette and by advising the Companies Registrar. While it is less common to do so, when assigning the rights of a general partner under a partnership agreement, the liability of a general partner for all partnership debts, and its management responsibilities as a general partner, need to be borne in mind.

Again, the flexibility of a Scottish partnership agreement can facilitate security assignments of rights by partners so that only certain separated defined rights (for example, rights to receive distributions) are assigned, cleanly and conveniently and without the assignee becoming a partner.

Partners that are incorporated companies can also grant floating charges over the whole or parts of their interests in Scottish limited partnerships in a relatively straightforward manner, and without risking the security holder becoming a partner prior to enforcement of the charge.

In situations in which parties wish to have more complex matching of funding to tranches or other categories of commitment, investment or distribution by and to partners and partnerships, this can also be facilitated in Scottish partnership agreements. Relevant classifications can be embedded in the partnership agreement and the relevant rights tracked through in a severable manner. Such severable rights can then be assigned in security or (as applicable) charged separately to fit in with funding, security and operating requirements. Additionally, it is possible to set up "cascading" security structures, under which commitments to a feeder fund or other rights may be assigned down to a main fund and then on to a lender rather than being assigned direct.

Developments

Brexit & Scottish independence

At the time of writing, the manner in which the UK will leave the European Union, following the "leave" vote in the June 2016 referendum, was still not clear and it was still thought possible by some that the UK may reverse its decision to leave and remain in the EU. The funds industry has, however, sought since 2016 to address many of the practical issues that may arise out of the various Brexit options, few of which issues are distinctively Scottish.

Following the majority "remain" vote in Scotland in the 2016 EU referendum compared to the majority "leave" vote across the UK as a whole, there was an increase in support for Scottish independence in opinion polls and the Scottish National Party, in power in the devolved Scottish government, has since been planning for a second referendum on Scottish independence from the UK, on the basis that the changing relationship with the EU, and the differing vote in Scotland from the UK as a whole, justifies a further independence referendum.

The Scottish government has stated that it wishes such a second referendum to take place during 2020. It remains to be seen whether or not this will happen and, if a second independence referendum were to take place, whether or not it is likely to lead to a vote in favour of Scottish independence. Over the last few years, polling support for Scottish independence has remained broadly similar to that in the referendum in 2014 in which independence was rejected, although if the UK were to leave the EU without a trade agreement with the EU, it is thought likely that support for Scottish independence may increase.

Private fund limited partnerships

As indicated above, limited partners in a limited partnership lose their limited liability when they participate in managing the partnership. There have been concerns for some time about the extent to which limited partners may become involved in the management processes of funds partnerships without running this risk. In 2017, a "white list" of activities in which limited partners in Scottish and English limited partnerships may become involved without risking their limited liability was introduced by the Legislative Reform (Private Fund Limited Partnerships) Order 2017, including taking part in decisions approving managers' actions in acquiring or disposing of investments. To benefit from this more specific protection, a limited partnership is required to be a collective investment scheme under the UK Financial Services and Markets Act 2000 and elect to register as a "private fund limited partnership" with the Companies Registrar. An existing or new limited partnership may so register. Many private fund limited partnerships have been formed or designated since the 2017 reforms, which appear to have operated reasonably well in practice.

In addition, partners in private fund limited partnerships are not obliged to make capital contributions and capital may be withdrawn (in both cases, not previously possible due to statutory restrictions), and capital information does not require to be filed with the Companies Registrar. This increases funding flexibility for funds, and limited partner funding through capital rather than debt may become more common for UK limited partnerships over time, as is the case with investment vehicles in many other jurisdictions.

Trading and securing full limited partnership interests in private fund limited partnerships is now also more straightforward than for corresponding interests in other limited partnerships, as assignments of such interests in private fund limited partnerships do not require to be advertised in the official London or Edinburgh Gazette as they do for other partnerships.

People with significant control regime

In parallel with the relaxation of some administrative requirements for private fund limited partnerships, the regime for registering "people with significant control" of UK companies was extended to apply to Scottish limited partnerships (including private fund limited partnerships) and certain other Scottish partnerships. The regime has not yet been extended to English partnerships, as they do not have separate legal personality – the criterion of the EU 4th Money Laundering Directive under which this extension of the "PSC" regime took place.

Under the PSC regime, the details of those having direct or indirect control of a Scottish limited partnership require to be registered with the Companies Registrar and, if a partner or other relevant entity does not comply with notices from the partnership to provide relevant information, the partnership can issue a "restrictions notice" to that party, restricting dealings with its partnership interests. While the details of the PSC regime are complex, as they are designed to address avoidance of its application, in most circumstances general partners and managers of a Scottish limited partnership (or, possibly, holding entities) will require to go on its PSC register, but limited partners holding less than 25% of the partnership will not normally require to go on the register, while holders of security over commitments will not require to be registered. The previous general requirements for registering details of all partners with the Companies Registrar continue to apply for Scottish as for English limited partnerships.

Following its introduction, the expanded PSC regime has led to some relatively minor extra administration for Scottish limited partnerships, but is not considered to have increased risks to lenders or security taken on subscription facilities significantly where Scottish limited partnerships are involved. In addition, the application of the PSC regime has arguably increased the prudential standing of Scottish limited partnerships.

Further partnership reforms

While the extension of the PSC regime to Scottish limited partnerships has gone some way towards addressing some use in recent years of Scottish limited partnerships as vehicles for international fraud, pressure has continued to make further changes to partnership law to deter further fraudulent use of partnerships. Following consultation on possible further changes to the law applicable to both Scottish and English limited partnerships, the UK Government proposes, when legislative time becomes available, to require both Scottish and English limited partnerships: (a) to be formed through regulated agents; (b) to maintain a UK place of business or a UK service address with a regulated agent; (c) to provide some additional information to the Registrar of Companies regarding partners; and (d) to be capable of being struck off by the Registrar of Companies from the register of limited partnerships (subject to protective provisions).

Security interest reform

The Scottish Law Commission's report on moveable transactions was published in December 2017. This project arose from practical problems in transferring and constituting fixed security under Scots law over moveable property, such as claims and financial instruments. The reform proposals have been well received by business and, at the time of writing, the Scottish government has started focused consultation on specific elements of the proposed reforms with a view to taking them forward when its legislative programme permits.

There is therefore a reasonable prospect that some of the slightly restrictive rules around giving notice of assignments, and assignee control of assigned rights mentioned above, may be relaxed to some extent within the next few years. While the Scottish Law Commission did not look at the restrictions mentioned above on partnerships granting floating charges, it is possible that the Scottish government will be open to relaxing this restriction, for limited partnerships at least, when considering implementation of the Scottish Law Commission's proposals in the related field of fixed security.

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Singapore

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General economic outlook

At the time of writing this article, Hong Kong was entering its fifth month of protests. The socio-political landscape in Asia remains challenging. Change seems inevitable. The impact of the US-China trade war is also being felt in 2019.

In September 2019, private sector economists and analysts slashed their forecast for Singapore's economic growth for 2019 from an earlier estimate of 2.1% to 0.6%.

Comparatively, and in the same period, Hong Kong announced that it has entered into its first recession for a decade – its economy shrank 3.2% in the July-to-September 2019 period. Hong Kong now expects its economy to shrink 1.3% for the full year.

Asia Pacific Fund Finance Symposium – 2019

The 3rd annual Fund Finance Association Asia-Pacific Fund Finance Symposium was held on 25th September 2019 in Asia. Ashurst wrote a key takeaways article on that seminal event.[1] One of the key highlights of that event was Preqin's opening presentation on "Attractiveness of Private Capital in Asia & China".

Below are some of the key takeaways of that presentation.

- The figures for Asia Pacific (APAC) focused private capital assets under management (AUM) in 2018 continue to accelerate. Hillhouse Capital Group raised US$10.6 billion for its Fund IV, while Carlyle Group raised US$6.55 billion for its Asia Partners V fund.
- AUM for APAC in 2018 hit US$1,200 billion compared to just above US$1,000 billion for the year in 2017. China's share of the AUM leapt and is greater than the rest of APAC aggregated as a whole. However, despite China's dominance in APAC, its figures pale in comparison with the US, which still remains very dominant – the total AUM in US is more than thrice that of APAC's AUM as a whole.
- Socio-political factors have disrupted the pace of APAC's fundraising momentum – which has slowed considerably since 2018. In 2018, only US$105 billion of capital was raised compared to double that in 2017 of US$209 billion. Figures remain tepid in 2019. Year-to-date (September 2019) data only recorded US$101 billion of funds raised.
- China has been and remains the dominant leader in the region for venture capital deals, where the number of deals closed in China outstripped that of the rest of APAC by more than twice. In ASEAN,[2] Singapore and Indonesia remain as the leading venture capital powerhouses.

Key themes in Singapore

Singapore is an island country and will be affected by the macro-economic issues sweeping through the region. One silver lining is that the Singapore Government is continuing to innovate and execute various strategies to become the main asset management and venture capital hub in Asia.

On 11 October 2019, ING Bank announced that it had introduced the world's first "sustainability improvement fund financing" for a Singapore-based private equity fund, Quadria Capital. This ground-breaking deal reflects the rising interest from the financing sector in factoring in environmental, social and governance (ESG) in capital-raising activities.

A month later, Singapore's Education Minister, Mr Ong Ye Kung, unveiled a new US$2 billion green investment fund (GIF) programme whilst speaking at the 2019 Singapore Fintech Festival x Singapore Week of Innovation and Technology.

For this programme, the Monetary Authority of Singapore (MAS) will place funds with asset managers in "public market investment strategies" that have a strong green focus. These are managers who have demonstrated "a firm commitment to deepening their green investment capabilities" across various functions such as research, stewardship and policy.

We set out below two main themes that have dominated the investment funds space in Singapore in 2019, and are likely to continue to do so.

1. **ESG considerations** have become more of a priority to investment fund managers in recent years.
    - Preqin's *Future of Alternatives 2018* report shows that the majority of fund managers and investors across sectors believe that ESG will grow in importance over the next five years.
    - However, this differs depending on geography and industry type. ESG appears more highly valued amongst investors in Europe than those in the US.[3] According to a recent survey conducted by Preqin, real assets fund managers lead the way of ESG.
    - More than three-quarters of infrastructure and natural resources fund managers that Preqin surveyed have an active ESG investment policy. At the other end of the ESG spectrum, two-thirds of hedge fund managers do not have a policy in place and have no plans to implement one in the near future.[4]

2. **Singapore VACC**: It is difficult to discuss the outlook for Singapore investment funds industry without mentioning the impending introduction of the variable capital company (Singapore VACC).
    - The Singapore VACC is a new corporate fund vehicle which is more suited for investment funds than the currently available unit trusts, limited partnerships and companies.
    - It is expected to bring the Singapore asset management offering at par with similar structures available in other global investment hubs; for example, the UK open-ended investment company, Irish collective asset management vehicle and Luxembourg variable capital company.

Why are ESG issues important?

Mark Twain once famously said: "*Plan for the future because that's where you are going to spend the rest of your life*".

The famous American writer was born shortly after an appearance of Halley's Comet (which passes Earth once every 75 years), and predicted that he would "go out with it" as well. Twain died of a heart attack the day after the comet returned.

From increasing temperatures to rising global sea levels, it is difficult to ignore the hazardous impact of climate change. The quote from Twain above is often used for this topic to inspire public interest in a subject which will affect all of us in the future.

Rather significantly, the Prime Minister of Singapore said that issues relating to climate change were matters of life and death for Singapore. In his 2019 National Day Rally speech, Prime Minister Lee Hsien Loong highlighted that Singapore, as a low-lying island, is under threat from global warming and rising sea levels.

It was estimated that the cost of protecting Singapore against rising sea levels is probably $100 billion or more.

Singapore as a centre for excellence for green and sustainable financing

Finance plays an important part in driving investment decisions and behaviour, and it cannot be discounted as a way to drive climate action.

Fortunately in this context, green finance is starting to take off in Asia. Singapore, in particular, is aiming to be a green financing hub in the region. There is great potential for growth as the current global market is estimated at some US$80 billion (S$112 billion).[5]

As early as 2015, the Association of Banks in Singapore (ABS) published Guidelines on Responsible Financing to promote and support ESG disclosures.[6]

More recently at the beginning of 2019, a think tank known as the Asia Sustainable Finance Initiative (ASFI) was launched in Singapore to help shift Asia's financial flows towards sustainable economic, social, and environmental outcomes.

The ASFI brings together the finance industry, academia and science-based organisations to help Singapore-based financial institutions operating in the region to deepen their expertise in sustainable finance.

Green funds

The investment funds industry is one of the focal points for the Singapore green finance initiatives. The Singapore Government has supercharged efforts in the investment fund space with the recent announcement of the US$2 billion green investment fund (GIF).

Under the programme, MAS will place funds in public market investment strategies which have a strong green focus, with asset managers who are committed to deepening green finance activities and capabilities in Singapore.

It is helpful to note that the principles and standards for green fund finance are no different from mainstream green financing considerations. A few key pointers follow:

(*See box on the next page*)

Establishment of standards

There is presently no global standard for what is defined as a green financing instrument. However, there are a number of worldwide efforts at defining "green" and "sustainability". The establishment of standards and benchmarks is important as it mitigates the risks of "greenwashing", which is a term used to describe the misleading practice of overstating the environmental benefits of a product, service or activity.

Setting clear standards is important as it boosts investor confidence and enables the market to develop.

Minimum standards

The Loan Market Association ("LMA"), Asia Pacific Loan Market Association ("APLMA") and the Loan Syndications and Trading Association ("LSTA") launched their Green Loan Principles with the support of the International Capital Market Association ("ICMA") in March 2018. The Green Loan Principles are similar in scope to ICMA's own Green Bond Principles.

A year later, in March 2019, the Sustainability Linked Loan Principles were published by the LMA, APLMA and the LSTA.

Both the Green Loan Principles and the Sustainability-Linked Loan Principles are voluntary frameworks, widespread adoption of which would mitigate the risks of greenwashing in the loan markets.

High watermark

Some stakeholders feel that the high watermark for green financing may take the form of the EU taxonomy on sustainable finance – a classification tool to help investors and companies analyse the sustainability of potential investments.[7]

By developing a taxonomy, the European Commission aims to develop a "universal understanding" of what is environmentally sustainable shared by scientists, governments, industrialists and individuals. It will, like the metric system did in its time, foster science, innovation and industrial growth.[8]

Lower bank capital requirements?

In its July 2017 interim report, the High Level Expert Group on Sustainable Finance (HLEG), which reports to the European Commission on the opportunities and challenges of sustainable finance, raised the possibility of a "green supporting factor" regulation to boost green investment, while also noting multiple drawbacks.

Financial regulators require banks to insulate themselves against potential losses by maintaining a certain level of capital, which can be adjusted depending on the riskiness of their investments. These regulations are designed to make banks more resilient, with the aim of avoiding another financial crisis where governments have to bail out banks to keep them from failing.

A "green supporting factor" would lower capital requirements for green investments.

The European Commission hopes that this would encourage sustainable investment, because some European banks have responded to higher capital requirements by reducing lending.

New Singapore corporate structure for investment funds (Singapore VACC)

On 10 September 2018, the Singapore Variable Capital Companies Bill was tabled for first reading in the Singapore Parliament. The Bill establishes the regime for the incorporation and regulation of the Singapore VACC – a new corporate structure for investment funds.

The new legislation is regarded by some as a game-changer for Singapore's fast-growing fund management industry, as it is a separate and bespoke legal regime developed specifically for a funds vehicle. The Singapore VACC has features which make it more attractive to fund managers to operate it as a funds vehicle on an ongoing basis.

On 3 September 2019, a further Variable Capital Companies (Miscellaneous) Amendment Bill ("Amendment Bill") was passed which introduces a tax framework for the Singapore VACC. In the parliamentary speech delivered at the Second Reading of the Amendment Bill, it was stated that the Singapore VACC framework will become operational at the end of 2019.

At present, a substantial proportion of funds managed and operated by fund managers in Singapore are domiciled in more established offshore jurisdictions like the Cayman Islands, Dublin and Luxembourg. Repetition breeds familiarity and familiarity breeds investor confidence.

Investors choose these jurisdictions to incorporate their funds due largely to the familiarity which investors have with regards to the legal and regulatory regime in these jurisdictions. As a result, most of the economic benefits generated by service providers to these investment funds accrue outside of Singapore.

The Singapore Government's strategy is simple. By attracting funds to be domiciled and managed from Singapore, supporting professional service providers – for example, lawyers, bankers, accountants – will also benefit from the activity generated by a vibrant funds industry.

To encourage the existing pool of funds to switch to Singapore, the Bill provides for a re-domiciliation mechanism for existing overseas investment funds constituted as corporate structures, similar to Singapore VACCs.

In addition, to facilitate existing funds to switch to a Singapore VACC structure, those funds using corporate structures like private limited companies, trusts and limited partnerships can take advantage of the new Singapore VACC regime to restructure and become a Singapore VACC.

Key features of Singapore VACC – and its benefits as a funds vehicle

- The Singapore VACC is incorporated under the Singapore VACC Act instead of the Companies Act (CA). This enables the Singapore VACC to function as a corporate structure tailored specifically for investment funds.
- A Singapore VACC will have the flexibility to issue and redeem shares without having to seek shareholders' approval.
  - This allows investors to exit their investments in the investment fund when they wish to, and pay dividends using its capital.
  - This is in contrast to the company structure that has restrictions on capital reduction and can only pay dividends out of profits.
- The Singapore VACC may be established as a standalone fund or as an umbrella fund with multiple sub-funds.
  - The umbrella with a sub-funds structure creates economies of scale.
  - Each sub-fund can share a common board of directors and use the same service providers, including the same fund manager, custodian, auditor and administrative agent.
- As a safeguard for Singapore VACC shareholders and to enhance creditor protection, the assets and liabilities of each sub-fund will be ring-fenced from other sub-funds.
- The Singapore VACC will allow for a wider scope of accounting standards to be used in preparing financial statements, which helps to serve the needs of global investors. Apart from Singapore accounting standards and recommended accounting principles, International Financial Reporting Standards (IFRS) and US Generally Accepted Accounting Principles (US GAAP) can be used by Singapore VACCs.

Final summary

The key messages in this article:

- Political issues have affected economic growth in Asia. Singapore has an open economy that is dependent on trade. It cannot expect to be insulated from this challenging global environment. This is reflected in the less than stellar economic growth in 2019.
- Thomas Edison once said that the value of an idea lies in the using of it. ESG considerations and investment fund-specific vehicles like the Singapore VACC are not new ideas.
- However, in view of the challenging socio-economic landscape in Singapore, there is hope that such innovation will drive productivity – which hopefully will in turn drive better economic growth within the investment fund industry space.

* * *

Endnotes

1. https://www.ashurst.com/en/news-and-insights/insights/asia-pacific-fund-finance-symposium----key-takeaways/.
2. Association of Southeast Asian Nations (ASEAN) consisting of Brunei Darussalam, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Vietnam.
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5. Article on "Can Singapore be an Asian Hub for Green Finance", Lawrence Loh for the *Straits Times*, Published April 25, 2017, 5:00 am SGT Time – https://www.straitstimes.com/opinion/can-singapore-be-an-asian-hub-for-green-finance.
6. To read further - https://www.abs.org.sg/docs/library/responsible-finance-guidelines-version-1-1.pdf.
7. On 18 June 2019, the European Commission Technical Expert Group (TEG) on sustainable finance published its Technical report on EU taxonomy. The report sets out the basis for a future EU taxonomy in legislation. The report contains technical screening criteria for 67 activities across eight sectors that can make a substantial contribution to climate change mitigation; a methodology and worked examples for evaluating substantial contribution to climate change adaptation; and guidance and case studies for investors preparing to use the taxonomy.
8. The taxonomy has six environmental goals: climate change mitigation; climate change adaptation; sustainable use and protection of water; transition to a circular economy and waste prevention and recycling; pollution reduction; and biodiversity. The taxonomy consists of economic activities that contribute substantially to one of these six environmental goals, do no significant harm to the other five, and meet minimum social safeguards.

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Spain

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Overview

During recent years, the venture capital and private equity industry in Spain has suffered an exponential increase in total investment volume. Indeed, according to *Asociación Española de Capital, Crecimiento e Inversión* (the Spanish private equity and venture capital association) (**ASCRI**), the first nine months of 2019 show that total investment reached a record volume of €5,890m across 549 investments.

Highlights of the venture capital and private equity industry in Spain in 2019 are:

(a) a significant number of deals with investments higher than €100m in equity (16 transactions until October 2019), representing 70% of total investment volume, mainly performed by international funds which have been very active in the Spanish market;

(b) a strong performance of the middle market (deals with investments in equity from €10m to €100m), mainly performed by national funds which have also been remarkably active (46 transactions amounting to €1,185.8m);

(c) domestic private equity firms raised €1,049m in new funds; and

(d) divestment volume remained very high; €1,918.6m (at price cost) in 188 transactions.

By development stage, buyouts stood out, with an investment volume of €4,660.2m in 48 transactions. Growth capital received 61 investments, totalling €530.3m. Venture capital received €543.8m, which is a 42% increase with respect to the same period in 2019.

From a legal standpoint, there have not been significant updates since the enactment of Act 22/2014, dated 12 November 2014, regulating venture capital entities, other closed-ended investment entities and closed-ended investment entities' management companies (**Private Equity Act**), which implemented the Alternative Investment Fund Managers Directive (**AIFM Directive**) in Spain Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010. The Private Equity Act has played, and still plays, an important role in enhancing the access financing in Spain of venture capital and closed-ended investment entities, as explained in more detail below.

Fund finance framework in Spain

The Private Equity Act indirectly created the necessary legal framework to allow funds to accede to fund financing by allowing the assets of a private equity entity to be charged. In this sense, section 93.d) of the Private Equity Act contemplates that funds can pledge their assets provided that this does not result in a breach of their bylaws or limited partnership agreements. Article 15.4 of the AIFM Directive (which is implemented by section 62.4 of the Private Equity Act) also sets forth the possibility of charging the assets of private equity entities. The Private Equity Act addresses a point that the previous legislation did not tackle: it formally recognises the possibility of charging the assets not only for private equity companies or *sociedades de capital-riesgo*, but also for private equity funds – *fondos de capital-riesgo*.

During the last few years, as fund financing has emerged in Spain, an increasing number of Spanish private equity houses have expressly included in their bylaws (*estatutos sociales*) or limited partnership agreements (*reglamentos de gestión*) the ability to enter into third-party financings, and charge the assets of their investment vehicles or the undrawn commitments of their investors. This trend could not have arisen without the change to the Private Equity Act, but it probably owes as much to influences from the United States and the United Kingdom, as well as the favourable curve of interest rates. In any case, it is a type of financing that better fits the current needs of managers of private equity funds.

It lowers the cost of capital, enhancing the fund manager's returns and giving the fund manager fast and reliable access to liquidity – typically within a couple of business days. Not having to issue multiple capital call notices to investors facilitates the speed and certainty of deal execution. Indeed, fund financing provides short-term revolving credit to funds, which bridges the gap between making an investment and receiving capital contributions from investors.

The possibility of charging fund assets or the undrawn commitments of investors extends to all investment vehicles promoted by Spanish fund managers, irrespective of the domicile of the investment vehicle.

The largest Spanish financial institutions have already become active players in fund finance transactions, mainly subscription (capital call), and arranged several transactions for Spanish and international funds during the last year.

Financing and collateral structure

As regards the financing structure for fund financing transactions, most of the transactions closed in the Spanish market and by Spanish players have been subscription line (capital call) facilities. Nevertheless as Spanish lenders have continued analysing NAV facilities and, even in a few cases, hybrid facilities, it is reasonable to anticipate that they will be entering into NAV and hybrid facilities transactions in the near future.

<u>Subscription (capital call) facility transactions</u>

A standard subscription (capital call) facility transaction typically consists of a committed revolving credit facility – *subscription facility* – granted by a foreign fund or credit institution to an investment vehicle, directly put in place at fund level. It may involve some form of recourse to the fund.

Subscription (capital call) facility transactions contemplate that repayment will be made from the prospective capital commitments of the investors. Lenders carefully analyse the creditworthiness of the investors and decide whether to include their prospective contributions when calculating the size of the facility.

The security instruments that Spanish investment funds put in place for this kind of transaction consist of: (i) Spanish law pledges over the credit rights of the fund against investors who have committed to make future contributions – *unfunded capital commitments* – (**UCC Pledge**); and (ii) Spanish law pledges over the bank accounts in which capital contributions are deposited – *deposit account* (**Bank Account Pledge**).

In addition to this collateral, it is essential for the lenders to obtain from the fund an irrevocable power of attorney that allows them to call and receive the undrawn investors' commitments in the event of a default under the subscription facility (the **Power of Attorney**). The Power of Attorney has to comply with the requirements of Spanish law, such as the requirement that a duly empowered representative of the fund must grant them in a public deed (*escritura pública*) before a Spanish notary public.

<u>NAV and secondary fund facility transactions</u>

Even if most of the transactions closed in the Spanish market or by Spanish lenders have been subscription line (capital call) facilities, large Spanish banks are showing interest in NAV and secondary fund facility transactions. These type of transactions provide either for financing of the acquisition of assets on the secondary market, or financing of the investment vehicles' current portfolios.

The borrowing base for NAV and secondary fund facilities comprises the reported NAV of the investment vehicle's portfolio, and requires significant due diligence by the lenders on the assets to be financed and the permitted indebtedness of the investment vehicles, considering the structural subordination that may be put in place for the NAV facilities.

Collateral for NAV and secondary fund facilities is based on: (i) Spanish law pledges over share or quotas held by the investment vehicle in the leveraged vehicle or asset; and (ii) Spanish law pledges over proceeds attributable to leverage excess and the credit rights from the bank account to which proceeds will be paid.

<u>Practical issues affecting the collateral – Notifying the investors under the UCC Pledge</u>

The investor's notification of the UCC Pledge is one of the hot topics in subscription financing transactions, due not only to perfection requirements of the pledge over capital call, but also to reputational risk resulting from this notification.

In addition, as further developed below, due to a recent case involving the Abraaj group, giving notice of the security to investors is regarded by lenders as a particularly relevant topic, which is being discussed in most fund finance seminars at the moment.

(a) *The necessity to notify*: Spanish law does not expressly regulate pledges over credit rights (such as the UCC Pledge). This lack of clear legal regulation has led to debate among legal scholars. Some scholars follow a conservative approach that, in order to create a valid pledge over credit rights, it is necessary to notify the debtor (in the case of the UCC Pledge, the investor who has committed to invest in the fund). For most scholars, serving notice of the creation of the pledge constitutes delivery of possession of the pledged credit rights, which perfects the creation of the pledge. Other scholars[1] do not consider it necessary to notify the debtor, and follow the more commercial approach that notification serves only to enable the investor to discharge the pledge by paying his subscription.

    Funds have argued that serving notices of the UCC Pledge on debtors is burdensome and uncommercial, triggering a significant reputation risk for the fund manager.

    In practice, lenders are reluctant to dispense with notices. Traditionally, notices were sent through the Spanish Notary before whom the UCC Pledge was granted. However, lately the system of serving notices is becoming more creative and in some deals, other options are being explored. The most aggressive position would probably be serving notices by mailing systems or web-based notices. Another option would be to include notices in the relevant investor report but, in our view, there is a risk that investors may claim that they were not properly made aware of the creation of the UCC Pledge.

An intermediate position would be to ask the pledgor to sign the relevant notices when granting the pledge, depositing the signed notices with the Spanish Notary and agreeing that notices could be sent by the pledgee (using an irrevocable power of attorney) only when an event of default occurs under the facility. Nevertheless, we still share the opinion that the notarial notification procedure makes lenders more comfortable. Indeed, this procedure minimises the risk of an investor arguing that the notification has not been delivered and they were not aware of the existence of the UCC Pledge, and consequently, it reduces the probability of the fund and the investors releasing, amending or terminating the investors' commitment related to uncalled committed capital calls.

(b) *Sensitivity of the notice*: Notices to all the investors of a private equity fund need to be drafted so as not to jeopardise the commercial relationship between the investors and the fund, while meeting the requirements for perfection under the conservative approach. Hence, the sensitivity of fund managers to the requirement for notices. A standard notice would ideally inform the investor clearly: (i) that on a relevant date the fund had entered into a facility agreement with the lender and that, to secure the obligations of the fund under such financing, a pledge over the commitments of the investor had been granted in favour of the lender; and (ii) that, as of the date on which the lender (or security agent, if applicable) informs the investor of the occurrence of an event of default according to the pledge, the investor must deposit its commitment in the bank account indicated by the lender (or security agent, if applicable). Language of this notice should be carefully chosen so that the commercial relationship with the investor is not damaged but, at the same time, drafted in such a way as to limit the risk of the investor claiming that it was not made aware of the existence of the financing and the pledge over its commitments.

(c) *Transfer of interests*: Investment vehicles often permit the transfer of units or the shares, as the case may be, by their investors, in certain circumstances and subject to certain conditions. Fund financing should not limit this right to transfer. But the collateral must be drafted in such a way that any future acquirer is notified of the pledge. Otherwise, a good faith payment to an account of the fund that is not pledged would defeat the UCC Pledge. In order to facilitate this: (i) the notification should contain a statement that the existing investor must notify any transferee investor of the existence of the pledge; and (ii) the pledge should allow the lender to update the list of investors and to carry out the steps necessary in order to maintain the pledge (including serving notice on investors acquiring shares or units from existing investors).

(d) *New closings*: Investment vehicles in Spain, as elsewhere in the global private markets, are characterised by sequential closings, such that new investors acquire shares or units at different stages. The security package in a fund financing must include an obligation on the fund manager to update the pledge in order to capture all prospective commitments. This will entail new notices to incoming investors.

Specific documentation issues

<u>Defaulting investor</u>

By and large, limited partnership agreements for Spanish funds contain the same provisions as one would expect to see in limited partnership agreements in more familiar jurisdictions and, in particular, shortfall provisions and remedies in the event of a default by an investor in funding its commitment. Usually, limited partnership agreements first impose a penalty on a defaulting investor, to be paid with its commitment within a period of time (15 days to a month). Then, if the defaulting investor does not pay the penalty and its commitment within that period, the fund manager may: (i) sell the units or the shares of the defaulting investor to a third party; or (ii) the investment vehicle may acquire the units or shares of the defaulting investor and then redeem them.

Defaulting investors do have an impact on the UCC Pledge. Although the investment vehicle still holds the pledged credit right, in practice, if an investor defaults, the UCC Pledge is weakened because the credit right is unlikely to be paid. In addition, the lender does not have a direct action against the defaulting investor, only the investment vehicle has an action. Given that the fund usually sells or redeems the units or shares, the credit right against the defaulting investor ceases to exist.

If the fund sells the units to a third party (incoming investor), the fund acquires credit rights against the incoming investor over its unfunded capital commitments. Hence, if the incoming investor is creditworthy, the lenders should not be affected from a legal point of view by the sale of the units or shares of the defaulting investor to the incoming investor, as these credit rights are already pledged by the UCC Pledge.

If the fund redeems the units or shares of the defaulting investor, the pledged credit rights diminish. Even though the fund still holds credit rights against the defaulting investor for the non-payment penalty, and even though the UCC Pledge subsists over these credit rights, the amount of the penalty is lower than the amount of the promised investment (and may be difficult to recover).

<u>Side agreements and non-disclosure agreements</u>

In most jurisdictions, investors may enter into separate agreements with the fund which alter the terms of their subscription agreements to provide, among other things, that they retain sovereign immunity, waive violations of investment policies, or alter their rights to transfer. These side agreements may operate to reduce facility limits.

Side agreements or letters are also common in the Spanish market. Among the different side agreements, particular attention has to be paid to non-disclosure agreements entered into by the fund and certain investors (the **Anonymous Investors**). These non-disclosure agreements typically restrain the fund from disclosing certain information related to the subscription agreements of the Anonymous Investors to any third party (other than employees of the fund), which may even extend to disclosing the identity of the Anonymous Investors. Consequently, these non-disclosure agreements may impact on: (i) charging the commitments of the Anonymous Investors under the UCC Pledge; and (ii) calling and receiving the undrawn Anonymous Investors' commitments by using the Power of Attorney.

Opposed to other jurisdictions, under Spanish law there is no floating charge or "catch all" security documents. Therefore, in order to pledge the commitments of the investors by virtue of a UCC Pledge, as a matter of Spanish law it is necessary to identify clearly the credit rights charged under the pledge. If the fund (as pledgor under the UCC Pledge) is not in a position of disclosing the identity of the Anonymous Investors pursuant to the terms of a relevant non-disclosure agreement, then the UCC Pledge will not be validly constituted and the commitments of the Anonymous Investors will not be pledged under the UCC Pledge. Nevertheless, the amounts to be contributed by the Anonymous Investors will be deposited in a bank account pledged in favour of the lenders by virtue of the Bank Account Pledge.

According to the above, lenders should consider carefully the existence of non-disclosure agreements and Anonymous Investors when structuring a fund finance transaction.

Key developments

As previously mentioned, it is possible for a private equity fund manager to charge its assets in accordance with section 93.d) of the Private Equity Act. These entities do not have legal personality according to Spanish law and therefore could not charge their assets before the enactment of the Private Equity Act. This has been essential in the emergence and development of fund finance.

It is also worth noting in regard to private equity funds (but not private equity companies), that the possibility of these funds being declared bankrupt according to Spanish law is questionable, due to the fact that they lack legal personality. Section 1 of Act 22/2003, dated July 9 and as amended (**Spanish Bankruptcy Act**), sets forth that the declaration of bankruptcy can be ruled only in respect of persons or legal entities with legal personality.

<u>The Abraaj case – what would happen in Spain in a similar set of facts?</u>

As advanced above, hot topics of discussion in the Spanish market are now finding more sophisticated and less burdensome ways to send notices to the pledged debtors, bearing in mind lessons learnt in the Abraaj case, mainly: (i) notifying investors as soon as possible of the creation of the pledge of uncalled capital commitments; (ii) providing relevant regulation in the facility agreements preventing the fund from amending or releasing investors from their obligations without the prior consent of the lenders; and (iii) including events of default related to litigation between the fund and its investors.

Would an investor in a Spanish fund who has already been notified of the existence of a UCC Pledge be released from its commitment once the relevant release notice is received from the fund?

In our opinion, the obligation of the investor to attend capital calls arising from the subscription agreement is an obligation of the investor *vis-à-vis* the fund (and not *vis-à-vis* the lender). Once the investor is informed and has acknowledged the existence of the fund financing and the UCC Pledge, it would be very difficult for an investor to pretend not to attend to instructions from the lender or damaging the lender's interest. This position is maintained by some legal scholars,[2] who consider that once a notice is served to the debtor, the lender benefits from the pledgor not being able to enter into agreements with the debtor for the purposes of releasing the pledged debt, as the investor is already aware of the lender's interest.

Second, according to article 1527 of the Spanish civil code, a debtor who pays the assignor before being aware of a debt assignment is released from any responsibility. In our view, the rationale behind 1527 is to protect debtors who have paid in good faith (*buena fe*). In the case at hand, the debtor (i.e. the investor) would indeed be aware of the assignment (i.e. the UCC Pledge); it could not pretend to be a good faith debtor if it claimed to be released from its responsibilities *vis-à-vis* the lender. Lastly, even if ruled for different sets of fact, certain Spanish case law[3] maintains payments from the debtor after being notified of a debt assignment should be considered as done at the debtor's own risk (even if it acts in good faith).

On the basis of the above, it is highly recommended: (i) that notice of the creation of the UCC Pledge is promptly sent to the investor (in order to mitigate the risk of the fund releasing the investor of its commitments before it is aware of the existence of the pledge) in a proper manner (ideally through a Spanish Notary) in order to avoid the investor claiming lack of receipt of the relevant notice; and (ii) including a provision in the facility agreements preventing the fund from releasing investors from their obligations without the prior consent of the lender.

This fund finance analysis is: (i) applicable to both private equity companies (*sociedades de capital-riesgo*) and private equity funds (*fondos de capital-riesgo*), even when we use the expression "fund finance" informally; and (ii) also applicable, with respect to most of its contents, to closed-ended entities (*entidades de inversión colectiva de tipo cerrado*).

The year ahead

The consensus in the private equity industry in Spain is that the 2019 growth trend will continue through 2020, given the large amount of capital raised last year. In addition, as the major Spanish players have been showing increasing interest in fund financing and have actively participated in some transactions, it seems that fund financing will become a reality in the Spanish market.

In addition, it will be interesting to see the consequences in the fund finance market of the lessons learnt from the Abraaj case. Presumably lenders will be very concerned about timing and procedures to be followed regarding notices to investors of pledge creation, while facility agreements will provide more detailed covenants/events of default related to commitments release. Time will tell.

* * *

Endnotes

1. Angel Carrasco Perera: *Tratado de los derechos de garantía*, page 252. Fernando Pantaleón Prieto: Anuario De Derecho Civil (1988) Cesión de créditos, page 1044.
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2019 in review

After navigating some choppy waters in 2018, US markets appear to be on an extended bull run, with relatively robust economic growth for much of 2019. Unlike the wild swings in public market indicators which marked 2018, the S&P 500 index and the Dow Jones Industrial index have been much less volatile and rallied overall in 2019; they are up by double-digits for the year, with almost all other asset classes out of the red as well.

Numerous economic policy developments, however, including Federal Reserve interest rate adjustments and further changes in trade tariffs, have significantly impacted not just the US, but global markets as well. Significant geopolitical events (including Brexit, US presidential impeachment proceedings and the upcoming presidential election in the US) and their outcome are likely to further influence the international economy. After a record-setting pace of growth in the previous years, private capital fundraising remains strong as investors continue to pursue yields and trophy assets in an environment of high valuations and rising borrowing costs.

While private fund formation reached its peak levels in 2017, fund finance has enjoyed continued growth since then, potentially as a result of record amounts of yet un-invested dry powder available in the market, with some market participants believing that certain indicators have again reached record activity for 2019.

This article explores some of these recent trends in the private capital markets, including the fund finance industry, and also examines renewed public discourse surrounding subscription facilities, specifically in light of the Institutional Limited Partners Association (ILPA) publishing its "Principles 3.0" and "Model Limited Partnership Agreement". It further address notable legal developments for fund financings and concludes with a brief outlook for the year ahead.

State of the market

Private capital fundraising had arguably the most successful fundraising period worldwide in the years recently past.[1] Between 2013 and 2016, aggregate fundraising increased by more than $50 billion each year, and in 2017, fundraising for the private capital markets totaled $925 billion. In 2018, that amount reached $757 billion, and the first three quarters of 2019 were generally on par with 2018.

Appetite for private equity remained strong, with a trend of concentrating capital among a smaller number of larger funds. By June 2019, the reported amount of commitments and cash available for investments held by alternative asset managers soared to a record high of $2.44 trillion, over half of which was held by private equity funds. Further, U.S. private equity firms raised $191 billion in the first nine months of 2019 according to reports,[2] nearly as much as in all of 2018, demonstrating the popularity of this asset class whose returns in the US have, since 2000, outperformed various public equity benchmarks. These investment vehicles benefited from a significant year-on-year increase, despite the overall reduction in the number of funds raised. This may be a sign of investors' belief that well-known money managers will be able to create value and achieve attractive returns despite the uncertainty surrounding the global markets.

Fund finance

The market for subscription line facilities and other financing products that leverage private capital funds is closely linked to the fundraising success of those funds and, as such, has generally benefited from the growth trend thereof. Separately, the proportion of private capital funds utilising subscription line facilities as part of their capital structure has also been steadily increasing. Although there are no published reports on the aggregate amount of lender commitments under subscription line facilities, anecdotal evidence from market participants indicates that 2019 is shaping to be another successful year for the fund finance space, with some estimating several hundred billion dollars of committed facilities.

Consistent with previous years, no significant defaults under subscription line facilities have been reported by lenders or their counsel in the US (while we are aware of one foreign fund experiencing a default in 2018, that has been an exceptional event, which hasn't to our knowledge repeated itself in 2019). These factors further support the proposition that in the US, subscription line facilities and other fund-level financing products play a key function in the capital structure for private capital funds, and sponsors now regularly draft limited partnership agreement terms to account for use of fund leverage.

Market developments: Increasing complexity and variety

The US subscription facility market continues diversifying: complexity of investment fund structures evolves, new entrants (both on the borrower and lender side) establish their presence and historical participants expand operations. The combination of the variety of investor demands, fund structures increasingly tailored for different investors and asset classes, and an evolving regulatory environment results in a customisation of subscription line facilities in virtually every case. Indeed, the notion of a "cookie-cutter" subscription line facility is a myth, perhaps even more so than it has ever been. While not exhaustive, we discuss below certain trends observed in the market.

In our experience, the number and size of uncommitted facilities continues to grow. While an uncommitted "accordion" (which allows a borrower to increase the size of an initial facility, subject to lender consent and credit approval) has historically been a frequent component of subscription facilities, we now see a rising number of facilities that are not legally committed at all (or that contain committed and uncommitted "tranches", both of which are available from the outset). Even though these facilities lack the legal certainty of funding, we are not aware of an experience where a lender refused to provide a requested advance. This product appears to be popular with both borrowers (as it may provide less expensive alternatives, in particular for those who use it sparingly) and lenders (as it may provide relief in connection with capital reserve requirements and thus positively impact pricing).

We have also seen alternative approaches to borrowing base construction. Often, individual investors are designated as either "included" investors (i.e., typically institutional investors with certain rating and/or sufficient financial strength), or "designated" investors (i.e., typically other investors meeting specific criteria on a case-by-case basis), which in turn determines the applicable market-standard range of advance rates and concentration limits that contribute to the aggregate borrowing base. However, there are other potential approaches – a segment of the US market functions on the basis of a "simplified" borrowing base with a "flat" advance rate against an aggregate investor pool, which generally encompasses all of a fund's investors.

We also increasingly see further specification of borrowing base components, either for certain categories of investors or for specific investors, depending on additional supporting criteria. For example, there may be a higher advance rate and/or concentration limit afforded after certain percentages of aggregate capital commitments have been funded. For sponsor borrowers, this feature is desirable because a higher advance rate or concentration limit counteracts the decreasing uncalled commitments as capital is drawn by the fund. And from a lender's perspective, the risk assessment of higher advance rates and/or concentration limits is counterbalanced by an increase in the invested assets of the fund, and by the investors having more "skin in the game" and thus, greater incentive to fund future capital calls.

To provide suitable investment platforms for their investor base and satisfy demand for varying risk profiles, investment funds increasingly utilise levered and unlevered sleeves within one fund family that invests in the same assets (such that the levered sleeve's economic results may be amplified, both positively and negatively, and result in different returns when compared to those of the unlevered sleeve). Additionally, in response to the many tax and regulatory developments worldwide, which affect US and non-US investors alike, it has become more common to utilise multiple jurisdictions and legal entity forms as both entry points for investors to come into the fund, as well as vehicles through which investments are made. In particular, we have seen US sponsors increasingly incorporate various European (Luxembourg, Ireland and other) structures within their funds, seeking to attract investors from the "old continent".

We have also seen a rise in the number and frequency of so-called "umbrella" financings, which are products that combine multiple facilities (typically for distinct funds managed by the same sponsor) under one credit agreement and one set of security documentation. This strategy can be efficiently used in a number of circumstances to reduce legal cost. The obligations of individual borrowers are typically separate, such that each is only responsible for its own borrowings (and not of the other borrowers).

However, some market participants also view facilities provided to complex structured fund families with multiple entities as falling under the umbrella rubric. These have become increasingly popular in the context of funds organised as separate "series" of one legal entity, which is usually a Delaware limited liability company or limited partnership, the financing of which has been recently facilitated by amendments to the underlying statutes, which we discuss later in this chapter.

Market developments: The public discussion of subscription line facilities

There has been a robust conversation concerning the role of subscription line facilities and investors' experience with levered closed-end funds as compared to unlevered funds over the past few years. Most notably, in June 2017, the Institutional Limited Partners Association ("ILPA"), a trade organisation representing the interests of institutional investors in private equity funds, released "*Subscription Lines of Credit and Alignment of Interests: Consideration and Best Practices for Limited and General Partners*" (the "ILPA Guidelines").

The ILPA Guidelines discussed the potential lack of alignment of interests between a fund and its investors with respect to subscription line credit facilities and where, in ILPA's view, the differing interests may be detrimental to investors. They sparked substantial public discussion, including responses from numerous industry participants, including the Fund Finance Association ("FFA"), law firms, fund managers, fund advisory firms, accounting firms, international newspapers and media companies and trade publications.

In 2018-19, there was continued conversation about subscription line facilities. In June 2019, the ILPA published "*ILPA Principles 3.0: Fostering Transparency, Governance and Alignment of Interests for General and Limited Partners*" ("ILPA Principles") which reiterated some of the disclosure recommendations previously made, including: (i) subscription facilities should be employed mainly for administrative ease purposes or to serve as bridge financing, rather than chiefly to enhance reported internal rate of return ("IRR"), which could accelerate the accrual of carried interest; (ii) facilities should be of short duration (no more than 180 days), and limited to a maximum percentage of fund commitments; and (iii) facilities should not be used to fund early distributions. In addition, it recommended that LPs should be offered the option to pull out of a facility at the onset of the fund, and that LPs should have at least 10 business days' notice of a capital call.

These standards have also formed the basis of the model limited partnership agreement published by ILPA in October 2019, with a stated mission of providing a starting point for an investor-friendly fundraise. As far as we are aware, there has been no renewed response from the FFA addressing these latest publications or any significant discussion from market participants. However, the CFA Institute released the latest iteration of its principles for representing investment performance known as the Global Investment Performance Standards (GIPS), which go into effect on January 1, 2020 and require firms to report returns with and without a subscription line, subject to certain exceptions.

It should also be noted that ILPA representatives continue to discuss these issues with industry participants and appear on panels at industry events, including the FFA Global Fund Finance Symposium, together with representatives from lenders, investors and law firms. ILPA representatives have noted that the ILPA Guidelines are not universally applicable to all subscription line facilities, and that the recommendations in the ILPA Guidelines (and thus likely also the ILPA Principles) are most relevant for facilities that are intended to manage cash flows and avoid multiple investor capital calls.

In our experience, consistent with previous years, fund sponsors continue to communicate and negotiate with their LPs concerning leverage limitations and usage for funds and related investor reporting. Given the continued popularity of subscription facilities, we expect the conversation about these facilities to continue into 2020, as industry participants further customise them on a case-by-case basis.

Market developments: Alternatives to LIBOR

On July 27, 2017, Andrew Bailey, the chief executive of the United Kingdom's Financial Conduct Authority (the "FCA"), delivered a speech at Bloomberg London on the future of the London Interbank Offered Rate ("LIBOR"). As a response to the LIBOR manipulation scandals, the FCA has been regulating the administration of LIBOR since 2013. Bailey noted that the FCA has discussed with the banks which submit contributions to LIBOR (the "Panel Banks") a plan to sustain LIBOR quotations until the end of 2021, but that it does not intend to maintain LIBOR through its influence or legal powers thereafter. The FCA called for the planning, and the transition to alternative reference rates (collectively, the "Successor Rate"), to begin now.

Search for the Successor Rate

LIBOR represents the cost of unsecured funding in a specified currency and specified term in the London interbank market. Specifically, the Panel Banks submit to the ICE Benchmark Administration Limited (the "IBA"), the current administrator of LIBOR, the rate at which they could borrow funds by asking for, and then accepting, interbank offers in a reasonable market size. However, because such unsecured interbank lending is no longer sufficiently active, the determination of LIBOR often involves the Panel Banks' judgment.

As early as 2014, the Federal Reserve of the US convened an Alternative Reference Rates Committee (the "ARRC") with the express mandate of identifying a Successor Rate that is more firmly based on transactions. Currently, the ARRC has more than 30 global and national financial institutions as members, and the relevant government bodies including the Federal Reserve, the US Securities and Exchange Commission and the US Treasury Department as *ex officio* members.

SOFR as the Successor Rate

On June 22, 2017, the ARRC recommended the Secured Overnight Financing Rate ("SOFR") as an alternative to LIBOR in the US. SOFR is a rate that is derived from the repurchase agreement ("repo") market for Treasury securities. A repo agreement is an agreement for one party (the "seller") to sell an asset (e.g., securities) to another party (the "buyer") and to repurchase the same at a higher price. Effectively, the seller is borrowing funds from the buyer, and the difference between the sale price received by the seller and the repurchase price paid by the seller acts as interest paid to the buyer. The repo market for Treasury securities is widely utilised by financial institutions for short-term investing or borrowing for short-term needs.

The ARRC has recommended the SOFR as the alternative to LIBOR because, among other reasons, the SOFR is: (i) fully transaction-based; and (ii) based on a deep market (i.e., the repo market for Treasury securities) underpinned by nearly $800 billion of daily transactions. These factors make the SOFR difficult to manipulate and unlikely to become obsolete – addressing some of the key problems of LIBOR.

Recent volatility

On the week of September 16, 2019, SOFR jumped from 2.43% to 5.25% and then came back down to 2.55%, over the course of two days. This volatility has highlighted some of the key differences between LIBOR and SOFR, and potential challenges ahead.

- *Overnight v. term*

  LIBOR has relatively long, forward-looking terms, including one-month, three-month, six-month and 12-month terms (while overnight LIBOR is available, it is rarely used in loan facilities). SOFR is currently published as an overnight rate (and the Federal Reserve Bank of New York (the "Fed") has sought public comments on its planned methodology to publish three compound averages of SOFR with one-month, three-month and six-month terms). However, the financial contracts that reference SOFR use a type of averages of SOFR.[3] This averaging has the effect of "smoothing out" the daily volatility that may exist in SOFR. However, it should be noted that the spike in September still translates to an increase of 13 basis points for a one-month average of SOFR, and of three basis points for a three-month average of SOFR.[4]

- *Different market*

  The change in SOFR was a reflection in the conditions of the repo market for Treasury securities. That SOFR is a backwards-looking rate based on actual market transactions is, as discussed above, a difference that is seen as a key improvement over LIBOR. Also, the repo market for Treasury securities is a broad, easily-accessible market that is already used by a wide range of financial institutions as a key source of liquidity (i.e., it reflects an economic cost of lending and borrowing that is relevant to such financial institutions). However, it seems clear (and inevitable in hindsight) that the conditions that impacted the repo market (at least this time) are not identical to those that are considered in the determination of LIBOR. LIBOR increased by only three basis points over the same time period.[5]

- *Market stability*

  The volatility in September was believed to be due to a number of causes which were temporary and technical in nature. Chief among those cited was the fact that corporate tax payments were due at the same time large Treasury auctions settled. Immediately after the SOFR spike in September, the Fed infused $53 billion through a "repo operation", which promptly brought SOFR down to normal levels. This was the Fed's first intervention to the repo market since the 2008 financial crisis.

  However, since then, the Fed has injected additional hundreds of billions of dollars into the repo market, and announced plans to continue doing so. This has sparked discussion about the long-term stability of the repo market in recent press. In addition, certain market participants have raised the question as to whether a rate that is actively managed by the Fed can truly be considered a "market" rate.

<u>Transitioning to the Successor Rate</u>

In the legal space, the transition away from LIBOR will require the creation and acceptance of market contractual terms. In October 2018, the ARRC held a public comment process (the "<u>Consultation</u>") for interest rate replacement provisions in syndicated loan contracts that could be adopted on a voluntary basis going forward. In April 2019 and June 2019, ARRC recommended contractual fallback language for U.S. dollar-denominated LIBOR syndicated loans and bilateral business loans, respectively.

The proposed language for the syndicated loans and business bilateral loans is similar and offers two approaches: an "amendment approach" and a "hardwired approach". On or after any "trigger event", the amendment approach provides for an amendment process for the parties to select the Successor Rate, while the hardwired approach provides for a "waterfall" of alternative benchmark rates that should be selected as the Successor Rate (after which the amendment process must be used). Under both approaches, if no Successor Rate is selected, then the loans accrue interest at base rate.

We have seen lenders and borrowers in the fund finance space take an approach similar to the "amendment approach". Usually, any replacement interest rate requires the approval of both the administrative agent and the borrower (often subject to a negative consent majority of lenders) and, at times, includes a provision that the rate cannot be materially worse for the borrower than LIBOR.

However, while this wait-and-see approach may give comfort to the parties for the time being, the actual implementation of an interest rate amendment may prove to be challenging if, as the Consultation notes, LIBOR becomes unexpectedly unavailable and a myriad of credit facilities need to be amended in a short period of time. We expect the fallback provisions used in syndicated loan agreements to continue to evolve in 2020.

Legal developments: Delaware law updates

Effective August 1, 2019, Section 17-220 was introduced to the Delaware Revised Uniform Limited Partnership Act (the "DRULPA") to provide for a "division" of a limited partnership, in much the same way and with the same effect, as Section 18-217 of Delaware Limited Liability Company Act (the "DLLCA"), which became effective a year earlier. These provisions allow for division of Delaware entities, with the resulting and surviving entities being distinct and independent entities such that their debts, liabilities and duties are separately held by each of them as specified in the plan of division. These amendments are expected to facilitate spinoffs and are consistent with flexibilities already provided for under the laws of certain other state jurisdictions.

Most loan agreements restrict borrowers and guarantors from effectuating mergers or consolidations with or into another party or transfers of substantially all of their assets to another party unless the surviving party continues to be bound by the various terms and conditions of the agreement. While a division would have an equal effect and would be treated as such under Delaware law, given that most loan agreements in the US market (including the fund finance market) are governed by New York law, we now frequently see lenders request the inclusion of language specifically addressing divisions in the same manner as a merger or consolidation.

Also effective August 1, 2019, Delaware enacted legislation to provide for a concept of a "registered series" under DLLCA Section 18-218 and DRULPA Section 17-221. Previously, these Delaware entities were able to form multiple "series" with segregated assets and liabilities, which could be owned by different members or limited partners, but still respected as separate units within one legal entity. These series, however, did not meet the definition of "registered organization" under the Uniform Commercial Code ("UCC"). Therefore, there was some ambiguity surrounding the perfection of security interest in the assets of such entities.

These historical series have now been renamed as "protected series", and can be converted into "registered series" (and *vice versa*). A registered series is a registered entity under Delaware law, which qualifies as a "registered organization" for UCC purposes (and can have its own certificate of good standing issued by the Delaware Secretary of State); thereby allowing lenders to take security interest over assets of a registered series by simply filing a UCC-1 financing statement in the name of such registered series (as opposed to filing against the entire fund). Each of the types of series can enter into its own credit facility with separate creditors, and each of the types of series can also be a borrower under one combined ("umbrella") facility, either individually or on a joint and several basis.

Legal development: Tax reform

The loan market's expected transition from LIBOR to one or more alternative reference rates may result in alterations to the terms of existing credit facilities (e.g., a change in an existing facility's reference rate from LIBOR to SOFR), which could result in the realisation of income, deduction, gain, or loss for U.S. federal income tax purposes or other tax consequences. However, on October 9, 2019, the U.S. Treasury Department released proposed regulations that provide the alteration of the terms of a debt instrument to replace LIBOR with a "qualified rate" (e.g., SOFR) and any associated alterations are not treated as realisation events for U.S. federal income tax purposes. Although the proposed regulations are subject to change, taxpayers are entitled to rely on them under certain circumstances.

Another noteworthy development occurred on June 14, 2019, when the U.S. Treasury Department released regulations that change the treatment of domestic partnerships that own controlled foreign corporations ("CFCs"). Under the prior treasury regulations, a domestic partnership that owned 10% or more of the stock (by vote or value) of a CFC would be considered a "United States Shareholder" of such CFC and, accordingly, would be required to include its *pro rata* share of certain income of the CFC in its partnership income currently. The income generally consists of certain types of passive income and so-called "global intangible low-taxed income" (GILTI), which is generally most of the CFC's remaining income above a certain rate of return on depreciable assets. This income inclusion would flow-through such partnership to its U.S. partners, even if a partner owned less than 10% of the CFC.

Under the new regulations, a domestic partnership is allowed to look-through to its partners in determining whether such partners own 10% or more of the CFC and are required to take into account certain income of the CFC currently, which aligns the treatment of domestic partnerships with what has historically been the rule for foreign partnerships. This change may make domestic partnerships more desirable as fund vehicles by eliminating a detrimental tax comparison to Cayman partnerships, especially those that own stock of CFCs that have passive income and GILTI. The regulations are finalised for GILTI and are proposed for passive income, entitling taxpayers to rely on them under certain circumstances.

Legal development: CFIUS

In 2018, the Foreign Investment Risk Review Modernization Act (FIRRMA) was signed into law and expanded the jurisdiction of the Committee on Foreign Investment in the United States (CFIUS). In 2019, proposed regulations were issued to implement FIRRMA, which also clarifies CFIUS's jurisdictional with regard to U.S.-managed funds with foreign limited partners.

In addition to reviewing foreign control transactions, CFIUS now also has the ability to review certain non-control investments in U.S. businesses that deal in or maintain critical technology, critical infrastructure, or sensitive personal data. Additionally, certain foreign government-controlled investments will require a CFIUS filing. However, FIRRMA includes a narrow jurisdictional carve-out for U.S.-managed investment funds with foreign limited partners. To avoid CFIUS jurisdiction derived from the foreign limited partners' indirect investment in a U.S. business through the fund, all of the following must be true:

- the fund must be managed exclusively by a U.S. general partner or managing member;
- any advisory board or committee containing the foreign limited partners does not have approval rights or control over investment decisions of the fund or decisions made by the general partner or managing member;
- the foreign limited partners do not otherwise have the ability to control the fund (including approval rights or control over investment decisions of the fund or general partner and the right to select the compensation of or dismiss the general partner); and
- the foreign limited partners do not have access to material nonpublic technical information in the possession of the U.S. business.

These developments mean that CFIUS is more relevant than ever for private equity funds, and that funds and fund managers should understand CFIUS's expanded jurisdiction under FIRRMA and the potential consequences for their investments.

Legal development: The Volcker Rule

The Volcker Rule, in effect since 2015, has, among other things, placed considerable burdens on the abilities of banks to invest in, sponsor, or enter into certain lending and transactions with so-called "covered funds", a term that includes, among other things, private funds exempt from registration under the Investment Company Act of 1940 in reliance on Sections

3(c)(1) or 3(c)(7) thereof, as well as many non-US equivalents of such funds.

On August 20, 2019, the Federal Reserve Board, Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency announced that they, and the other federal financial services agencies ("Agencies"), were issuing a final rule amending the Volcker Rule ("Final Rule"). More than a year ago, the Agencies issued a proposed rule to amend the Volcker Rule ("Proposal"), which would, among other things:

(i) adopt proposed changes to the covered funds provisions of the rule as provided, including codifying prior interpretive guidance regarding the so-called SOTUS exemption, providing additional flexibility for U.S. financing for ownership or sponsorship under the exemption;

(ii) make substantial changes to the proprietary trading restrictions designed to limit their scope; and

(iii) create a three-tiered approach to tailoring Volcker compliance program requirements based on the size of their trading assets and liabilities ("TALs").

In many respects, the Final Rule closely tracks the Proposal, with a few notable exceptions in the Volcker Rule's proprietary trading and compliance provisions. With respect to the Volcker Rule's covered fund provisions, the amendments as finalised track the Proposal, but the Agencies expect to issue a notice of proposed rulemaking in the future that will propose new – and potentially significant – changes to the covered fund provisions that may impact financing in these transactions.

Among other things, the Final Rule loosens the Volcker Rule's exemption for covered fund investment and sponsorship conducted "solely outside of the United States" such that a non-U.S. banking entity may rely on the SOTUS exemption even if financing for the ownership or sponsorship is provided by a U.S. branch or affiliate of the banking entity, which was previously sufficient to render the SOTUS exemption unavailable. The Final Rule also codifies guidance regarding the SOTUS exemption's marketing restriction such that non-U.S. banking entities may invest in third-party covered funds that are offered and/or sold to U.S. residents, so long as the non-U.S. banking entity does not participate in such offers or sales.

A banking entity need not count toward its aggregate fund limit (3% of its total Tier 1 capital), or the required deduction from capital for covered fund interests, any interest held in a third-party fund under the underwriting or market-making exemptions to the Volcker Rule's covered fund prohibition.

Legal development: Bank Holding Company Act (BHCA)

On April 23, 2019, the Board of Governors of the Federal Reserve System ("Board" or "Federal Reserve") issued a notice of proposed rulemaking regarding control of – and by – a banking organisation (the "Control NPR"). The Control NPR would make changes to the Board's Regulation Y and Regulation LL that would constitute a comprehensive overhaul of its control rules, designed to provide greater transparency and more clear and concrete standards to banking organisations with respect to their own investments, as well as to equity fund investors in banking organisations, to determine when control exists.

Among other things, the proposal establishes a number of new standards, including new presumptions of control and "non-control"; a new tiered structure for establishing presumptions of control; and standards for "decontrol" through stock divestiture; notably the Fed is proposing to double the permissible passive investment threshold from 5% to up to 9.9%.

The Control NPR also proposes a number of revisions to currently existing criteria for control, and poses 56 wide-ranging questions for public comment on all aspects of the proposal. Once adopted, these changes will have broad implications for both banking organisations in structuring their investments in funds, and for funds, both in terms of structuring investments in banking organisations, and structuring fund investment terms to take into account control limits on banking organisation investors, and for lenders in these transactions.

Conclusion

This year brought many notable developments and, overall, was a successful year for private fundraising and fund financing. We expect that 2020 should continue on a positive note, although the markets will need to absorb the effects of various economic policies and geopolitical events that are expected to take place.

However, 2019 has shown that investors continue to participate in funds employing leverage and we believe that trend will continue, in particular if interest rates remain low. Keeping open lines of communication among lenders, fund sponsors and investors, including with respect to subscription line facilities and other forms of leverage, can and has contributed positively to the development of fund financing in the mutual best interest of all constituencies. We imagine robust communication and sustained market interest will remain key to continued success of the industry.

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Endnotes

1. The various data points cited herein are sourced from Preqin publications, reports and updates.
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