



# Fund Finance

# 2018

**Second Edition**

Contributing Editor:  
**Michael C. Mascia**

**glg** global legal group



# CONTENTS

<b>Preface</b>	Michael C. Mascia, <i>Cadwalader, Wickersham &amp; Taft LLP</i>	
<b>Introduction</b>	Jeff Johnston, <i>Fund Finance Association</i>	
<b>General chapters</b>	<i>Hybrid and asset-backed fund finance facilities</i> Leon Stephenson, <i>Reed Smith LLP</i>	1
	<i>Subscription line lending: Due diligence by the numbers</i> Bryan Petkanics, Anthony Pirraglia & John J. Oberdorf III, <i>Loeb &amp; Loeb LLP</i>	11
	<i>Derivatives at fund level</i> Peter Hughes, Danny Peel & Charlie Bischoff, <i>Travers Smith LLP</i>	22
	<i>One size does not fit all: Subscription facilities as a global financing tool for investment funds of various types</i> Jan Sysel, Jons F. Lehmann & Sabreena Khalid, <i>Fried, Frank, Harris, Shriver &amp; Jacobson LLP</i>	33
	<i>Common ground: Achieving a commercial result for borrowers and lenders</i> Mary Touchstone & Julia Kohen, <i>Simpson Thacher &amp; Bartlett LLP</i>	43
	<i>Investor views of fund subscription lines: The ILPA guidelines and the market response</i> – Patricia Lynch & Thomas Draper, <i>Ropes &amp; Gray LLP</i>	53
	<i>Enforcement: Analysis of lender remedies under U.S. law in subscription-secured credit facilities</i> Ellen Gibson McGinnis, Erin England & Richard D. Anigian, <i>Haynes and Boone, LLP</i>	60
	<i>The rise of private equity secondaries financings</i> Samantha Hutchinson & Mathan Navaratnam, <i>Dentons UKMEA LLP</i> Helen Griffiths, <i>Investec Bank plc</i>	81
	<i>1940 Act issues in fund finance transactions</i> Marc Ponchione, <i>Allen &amp; Overy LLP</i>	90
	<i>Recent developments in fund financing: Hybrid facilities, insider leverage and overcall limitations</i> Meyer C. Dworkin & Samantha Hait, <i>Davis Polk &amp; Wardwell LLP</i>	98
	<i>Fund finance: An 'offshore' perspective</i> Alex Last, Danielle Roman & Robert Duggan, <i>Mourant Ozannes</i>	103
	<i>Equity commitment facilities: A primer</i> Michael C. Mascia & Tim Hicks, <i>Cadwalader, Wickersham &amp; Taft LLP</i>	113
	<i>Credit facilities secured by private equity interests and assets held by debt funds</i> Matthew K. Kerfoot, Jay R. Alicandri & Christopher P. Duerden, <i>Dechert LLP</i>	118

## General chapters (continued)

<i>Comparing the European, U.S. and Asian fund finance markets</i> Emma Russell, Zoë Connor & Emily Fuller, <i>Haynes and Boone, LLP</i>	128
<i>Umbrella facilities: Pros and cons for a sponsor</i> Bronwen Jones, Richard Fletcher & Kyrstin Streeter, <i>Macfarlanes LLP</i>	137
<i>Side letters: Pitfalls and perils for a financing</i> Thomas Smith, Margaret O'Neill & John W. Rife III, <i>Debevoise &amp; Plimpton LLP</i>	146
<i>Designing subscription facilities to account for limited partner preferences</i> Manu Gayatrinath, Benjamin Berman & Keely C. O'Malley, <i>Latham &amp; Watkins LLP</i>	156
<i>Overview of the fundraising and fund finance market in Asia</i> Nicholas Davies, <i>Appleby &amp; Maggie Ng, Linklaters</i>	165

## Country chapters

<b>Australia</b>	Tom Highnam, Rita Pang & Victoria Johns, <i>Allens</i>	172
<b>Bermuda</b>	Tonesan Amisshah & Sally Penrose, <i>Appleby</i>	184
<b>Brazil</b>	Fernando J. Prado Ferreira & José Paulo P. Duarte, <i>Pinheiro Neto Advogados</i>	191
<b>Canada</b>	Michael Henriques, Michael Davies & Kenneth D. Kraft, <i>Dentons Canada LLP</i>	199
<b>Cayman Islands</b>	Simon Raftopoulos, Benjamin Woolf & Anna-Lise Wisdom, <i>Appleby</i>	206
<b>England &amp; Wales</b>	Samantha Hutchinson & Adam Pierce, <i>Dentons UKMEA LLP</i>	213
<b>France</b>	Philippe Max, Guillaume Panuel & Meryll Aloro, <i>Dentons Europe, AARPI</i>	223
<b>Germany</b>	Patricia Volhard, Klaudius Heda & Lennart Lorenz, <i>Debevoise &amp; Plimpton LLP</i>	231
<b>Guernsey</b>	Jeremy Berchem, <i>Appleby (Guernsey) LLP</i>	237
<b>Hong Kong</b>	Fiona Cumming, Patrick Wong & Natalie Ashford, <i>Allen &amp; Overy</i>	244
<b>India</b>	Jayesh H & Aditi Bagri, <i>Juris Corp, Advocates &amp; Solicitors</i>	252
<b>Ireland</b>	Kevin Lynch, Kevin Murphy & David O'Shea, <i>Arthur Cox</i>	256
<b>Jersey</b>	James Gaudin & Paul Worsnop, <i>Appleby</i>	264
<b>Luxembourg</b>	Vassiliyan Zanev, Marc Meyers & Antoine Fortier, <i>Loyens &amp; Loeff Luxembourg S.à r.l.</i>	273
<b>Mauritius</b>	Malcolm Moller, <i>Appleby</i>	283
<b>Netherlands</b>	Gianluca Kreuze, Sabine A. Schoute & Michaël Maters, <i>Loyens &amp; Loeff N.V.</i>	289
<b>Scotland</b>	Hamish Patrick, Rod MacLeod & Andrew Kinnes, <i>Shepherd and Wedderburn LLP</i>	296
<b>Singapore</b>	Jean Woo & Lifen Tang, <i>Ashurst ADTLaw</i>	302
<b>Spain</b>	Jabier Badiola Bergara & Luis Máiz López-Teijón, <i>Dentons Europe Abogados, S.L. Unipersonal</i>	310
<b>USA</b>	Jan Sysel, Ariel Zell & Flora Go <i>Fried, Frank, Harris, Shriver &amp; Jacobson LLP</i>	317

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

Patricia Lynch & Thomas Draper  
Ropes & Gray LLP

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

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

## **Recent discussions on the pros and cons of subscription facilities**

### The Marks memo

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

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

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

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

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

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

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

### The ILPA Recommendations

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

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

- *Calculation of IRR*
  - For purposes of determining when the preferred return hurdle has been met for a fund manager's incentive compensation, a fund's IRR should be calculated starting on the date that the subscription facility is drawn, rather than on the date when capital is called from the investors.
- *Disclosure to investors*
  - When a new fund is being formed, the manager should disclose to all potential investors:
    - The IRR of its previous funds, calculated with and without giving effect to the use of any subscription facilities.
    - Its policy on the use of subscription facilities.
  - During the lifetime of the fund, the manager should disclose:
    - Its IRR with and without giving effect to the use of its subscription facility.
    - The cost of the facility (e.g., rates of interest and fees).
    - The purpose of each advance made under the facility and the making of any investment (even if capital has not yet been called).
    - The number of days that each advance is outstanding.
- *Terms of the fund's limited partnership agreement*
  - The fund's limited partner advisory committee should consider discussing the fund's use of credit lines at its meetings, including whether the terms of any subscription facility then in effect are "market".
  - The fund's ability to borrow under its subscription facility should be subject to a cap (e.g., 15–25% of uncalled capital).<sup>1</sup> The ILPA also suggests 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 who don't want to participate in a financing to fund their capital calls in advance of other investors or otherwise contain mechanisms to enable investors to opt out of subscription financing.
- *Terms of subscription facilities*
  - A fund's borrowing base (i.e., the calculation of the amount that the fund is permitted to borrow at any given time) should be based on its uncalled capital, rather than the net asset value of its portfolio assets.
  - The only collateral granted to the lenders should be the fund's right to call capital from its limited partners. The fund should not pledge its portfolio assets or any assets belonging to its limited partners.
  - The loan documents should specify a fixed maturity date for the advances, rather than enabling the lender to call for them to be repaid upon demand.
  - The fund's limited partners should not be required to enter into any agreements relating to the facility other than an acknowledgment of the lender's security interest in their capital commitments, and lender diligence on the limited partners should be limited to publicly available information.

## Market response

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

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

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

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

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

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

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



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

## Outlook

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

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

\* \* \*

## Endnotes

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

**Patricia Lynch, Partner****Tel: +1 617 951 7940 / Email: [patricia.lynch@ropesgray.com](mailto:patricia.lynch@ropesgray.com)**

Patricia represents private investment funds on subscription and credit fund leverage facilities and fund investment managers on acquisition and working capital facilities. She also leads Ropes & Gray's U.S. securitization practice and advises on a wide range of structured finance transactions, including collateralized loan obligations (CLOs), whole-business securitizations, and receivables-backed variable funding note facilities.

**Thomas Draper, Partner****Tel: +1 617 951 7430 / Email: [thomas.draper@ropesgray.com](mailto:thomas.draper@ropesgray.com)**

Tom is one of the leading finance lawyers in New England, with deep experience representing borrowers in a variety of debt transactions, from fund leverage to acquisition finance and public company financings. In the fund borrower area, Tom is a national leader. He has spoken on several panels and has worked on dozens of capital call facilities, portfolio leverage and liquidity financings for private and registered funds. Tom represents a number of private equity sponsors in a range of leveraged buyout debt transactions, including asset-based credits and large syndicated term loans. Tom also negotiates debt financings for life science and public company borrowers. For many years, Tom has chaired the firm's corporate training programs, which have positioned Ropes & Gray as the leading firm for formal training for the past six years according to the *Vault* guide.

## Ropes & Gray LLP

Prudential Tower, 800 Boylston Street, Boston, MA 02199-3600, USA  
Tel: +1 617 951 7000 / Fax: +1 617 951 7050 / URL: [www.ropesgray.com](http://www.ropesgray.com)

[www.globallegalinsights.com](http://www.globallegalinsights.com)

Other titles in the **Global Legal Insights** series include:

- **Banking Regulation**
- **Bribery & Corruption**
- **Cartels**
- **Commercial Real Estate**
- **Corporate Tax**
- **Employment & Labour Law**
- **Energy**
- **Initial Public Offerings**
- **International Arbitration**
- **Litigation & Dispute Resolution**
- **Merger Control**
- **Mergers & Acquisitions**
- **Pricing & Reimbursement**



Strategic partner