GLI GLOBAL LEGAL INSIGHTS

Fund Finance

2021

Fifth Edition

Contributing Editor: **Michael C. Mascia**

glg global legal group

FUND FINANCE association

CONTENTS

Investor views of fund subscription lines

Patricia Lynch & Patricia Teixeira
Ropes & Gray LLP

In recent years, the use by private investment funds of capital call subscription facilities has increased dramatically. Fund managers that previously did not use subscription facilities have begun setting them up for their newer funds, and managers that 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. We initially wrote on investor views of fund subscription lines a few years back when a number of articles 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.

At that time, the Institutional Limited Partners Association (**ILPA**) published a set of guidelines on fund subscription facilities that expressed concerns as to their widespread use and recommended that investors negotiate limitations on their use where possible. Since then, the fund finance market has continued to grow, as both sponsors and investors have become more comfortable with the use of subscription lines, and discussions between investors and fund managers on the use of subscription facilities have focused on a handful of key points, mainly around disclosure.

Against this backdrop of increased disclosure and the growing use of subscription facilities, this past June, the ILPA released follow-on guidance (**2020 Guidance**) on the use of subscription facilities. This chapter explores how the market has responded to both sets of ILPA 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.

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 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 concerns for investors have periodically been raised by investors and other market observers. These potential concerns fell into four general categories:

1. *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.
2. *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 may 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 its 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 otherwise have.
3. *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.
4. *Systemic risks*: 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

The ILPA's 2017 guidelines (**2017 Guidance**) for the use of subscription facilities, titled "Subscription Lines of Credit and Alignment of Interests: Considerations and Best Practices for Limited and General Partners",[1] were released largely in response to the four categories of investors' concerns listed above and included the following recommendations for funds that use subscription facilities:

<u>Calculation of IRR</u>

- 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.

<u>Disclosure to investors</u>

- 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.

<u>Terms of the fund's limited partnership agreement</u>

- 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% to 25% of uncalled capital).[2] 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 do not 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.

<u>Terms of subscription facilities</u>

- 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 (**NAV**) 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 to 2017 recommendations

Although some speculated after the publication of the 2017 Guidance that fund investors would insist on the wholesale adoption of the recommendations in the guidance 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 credit facilities remain substantially unchanged.

There are a couple of key reasons for this measured response. First, certain recommendations included in the 2017 Guidance suggested 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 have slashed funds' 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 have dramatically curtailed 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 even in 2017 many funds were 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 2017 recommendations seemed equally misplaced. The concern, for example, that a fund might pledge the assets of its limited partners as collateral for its subscription facility, was 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. Even at the height of the panic in the financial markets that accompanied the outbreak of the COVID-19 pandemic early in 2020, although we saw several new facilities include financial maintenance covenants based on the NAV of the fund, we did not see amendments or new facilities require a pledge of the fund's investment assets. The understanding in this market is that, although banks might look at the investments of the fund as a secondary source of payment, lenders are, at the end of the day, unsecured creditors of the fund with respect to all assets other than its uncalled capital commitments. The ILPA's 2017 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, was merely a reflection of a market practice that existed 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 2017 Guidance is that, although the financial press has at times suggested that the interests of fund managers and fund investors are inevitably opposed to 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, in recent years we have seen two major trends in negotiations between fund managers and investors on the use of subscription facilities. The first 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). The ILPA goes one step further and, consistent with its 2017 Guidance, recommends in its latest 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. This approach, however, is by no means the norm. A recent survey conducted by our firm covering 100 buyout funds showed that only 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 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. Where time restrictions on borrowings do exist, the prevailing market trend seems to be for an actual or implicit limit of 180 days.

The other major trend in investor demands, and by far the most impactful, has been greater disclosure. In response to requests from investors, many of which pre-dated the release of the 2017 Guidance, 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. There has also been more disclosure in recent years 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 recommendation in the 2017 Guidance 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.

The 2020 ILPA guidance on transparency

Although fund managers' disclosure of the impact of subscription facilities on IRR calculations has increased in recent years, there is still considerable variation from one manager to another in how unlevered IRR is calculated on a *pro forma* basis. While certain managers calculate it assuming that all of the capital associated with a particular investment 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. Investors have, from time to time, expressed frustration at the complications that these variations in methodology pose for their attempts to compare the performance of different fund managers, while managers for their part complain of the work involved in preparing *pro forma* calculations that meet the expectations of all of their investors, many of which are inconsistent in terms of the scope and format of the disclosure requested.

In an attempt to address these issues and to provide some uniform disclosure criteria for investors and managers alike, in June 2020, the ILPA issued follow-on guidance on the use of subscription facilities. The new guidance (**2020 Guidance**) entitled "Enhancing Transparency Around Subscription Lines of Credit"[3] is meant to be read in conjunction with the ILPA's 2017 Guidance and focuses on recommended quarterly and annual disclosures to be provided by fund managers to investors.

The 2020 Guidance argues that, while transparency as to the use of subscription facilities has generally increased in recent years, the frequency and means for providing this transparency varies widely. This leaves investors with the task of making sense of the varying types of information provided and fund managers with the challenge of responding to additional information requests from investors. The 2020 Guidance thus recommends standardisation around disclosures of the use of subscription facilities by laying out specific recommendations on what information should be disclosed by fund managers on a quarterly and annual basis.[4] In the ILPA's view, the adoption of this more standardised approach to disclosure will be beneficial for both fund managers and investors.[5]

The ILPA's recommended quarterly disclosure includes (either as part of the partner's capital account statement or otherwise):

- information regarding the size and balance of the facility;
- the individual limited partner's and the general partner's unfunded commitments financed through the facility;
- the average number of days outstanding of each drawdown on the facility; and
- net IRR with and without use of the facility.

As additional disclosure, the 2020 Guidance recommends a schedule of cash flows alongside the partner's capital account statement and schedule of investments.

The ILPA's recommended annual disclosures include (as a supplement within the annual reporting package and in addition to the quarterly disclosure described above) the following information:

- lead bank;
- facility limit;
- maximum allowable borrowing term (in number of days);
- facility expiration;
- renewal option;
- collateral base;
- interest rate;
- upfront fee rate;
- unused fee rate;
- additional fees;
- total paid fees;
- current use of proceeds from the facility; and
- a clearly defined methodology for calculating net IRRs (both with and without the use of the facility).

Outlook

It is clear that the ILPA's recommendations in their 2017 Guidance were not adopted wholesale. Nor did the guidelines limit 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 operate, the 2017 Guidance if anything facilitated the growth of subscription facilities.

In this context, the 2020 Guidance represents a potentially promising development, in that it could encourage managers and investors to adopt a uniform set of disclosure conventions that would streamline future discussions around the use of subscription facilities. It is too early to tell, however, to what extent fund managers will actually follow the 2020 Guidance. Many fund managers have already developed practices and preferences around their disclosures to investors and may be reluctant to move to a more standardised approach. Many investors, meanwhile, have developed specific criteria for the information that they expect to receive with respect to the subscription facilities of the funds in which they invest, and they may, in certain cases, prefer these criteria to the approach recommended by the 2020 Guidance. If the market response to the 2017 Guidance can serve as an indicator, fund managers are likely to take the recommendations of the 2020 Guidance into account but ultimately to adopt whatever approach to disclosure makes the most sense for their particular funds and investor base. Regardless of the details, however, fund managers are likely to continue to provide investors with greater disclosure about the terms and use of their funds' subscription facilities, including, increasingly, by providing calculations of both a levered and an unlevered IRR.

In terms of other potential market trends that respond to investor concerns, it is 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.[6] 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 the 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.

One development that has been interesting to observe over the past year has been that the investor concern that an over-reliance on subscription facilities could pose systemic risks for the financial system as a whole has so far not been borne out. To the contrary, the fund finance market has fared very well during the 2020 economic crisis. When borrowers and their portfolio companies were in need of liquidity, particularly during the early months of the COVID-19 pandemic, they reaped the benefits of having subscription lines in place. Our firm at times saw spikes in drawing requests, but these requests were honoured by the lenders and alleviated the pressure on investment funds that were seeking emergency liquidity to inject into stressed portfolio companies. By extension, these draws also spared investors from what might otherwise have been a flood of capital call requests. Some borrowers were also able to arrange funding for their portfolio companies by adding these companies to their existing facilities as qualified borrowers or by entering into new NAV-based facilities that could be tapped to provide liquidity to existing investments. Traditional lenders largely continued to provide new facilities (or increases to existing facilities), albeit at a slower pace than prior to the crisis and in some cases with a focus primarily on existing clients, and where there were delays in bank lenders providing facilities to new clients, other institutional lenders saw this as an opportunity to increase their market share. Apart from temporary increases in pricing to account for the shift in supply and demand, and in certain cases the addition of NAV-based financial covenants, loan documentation has remained largely unchanged throughout the crisis.

Overall, therefore, the fund finance markets seem to have adapted to address the most pressing concerns that investors have expressed in recent years. While investors do generally want to be kept informed about the ways that fund managers avail themselves of subscription facilities, and some are insisting on formal restrictions to prevent fund-level debt from being used in ways that could be detrimental to investors, most recognise the benefits to such facilities when used responsibly by fund managers to provide short-term liquidity and ensure more predictable capital calls. Meanwhile, 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. The full text of the guidance is available here: https://ilpa.org/wp-content/uploads/2017/06/ILPA-Subscription-Lines-of-Credit-and-Alignment-of-Interests-June-2017.pdf.
2. As noted below, it is possible that the ILPA meant to refer to committed capital, rather than uncalled capital.
3. The full text of the guidance is available here: https://ilpa.org/wp-content/uploads/2020/06/ILPA-Guidance-on-Disclosures-Related-to-Subscription-Lines-of-Credit_2020_FINAL.pdf.
4. The 2020 Guidance also provides suggestions for investors seeking to estimate their liability related to fund subscription facilities, based on the information provided by managers, and recommends that general partners provide investors with as much predictability as possible with respect to capital calls. The latter recommendation is not limited to capital calls in the context of subscription facilities.
5. Although the guidance offers a template, it specifically states that the template is for illustrative purposes and the intention of the guidance is for general partners to provide the recommended disclosure rather than depicting the exact format of the disclosure.
6. 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
Tel: +1 617 951 7940 / Email: patricia.lynch@ropesgray.com
Patricia Lynch co-leads the firm's U.S. fund finance team, representing asset managers on subscription facilities, credit fund leverage facilities and loans to management companies. In addition, Patricia leads the firm's U.S. securitisation practice and advises on a wide range of structured finance transactions, including loan securitisations, receivables-backed variable funding note facilities and whole-business securitisations.

Patricia Teixeira
Tel: +1 212 596 9043 / Email: patricia.teixeira@ropesgray.com
Patricia Teixeira is a counsel in the finance group and regularly advises fund clients on a variety of fund-level financings, including bilateral and syndicated subscription facilities, asset-based facilities, leverage facilities for credit funds, management lines to investment advisors, and employee co-investment loan programmes.

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