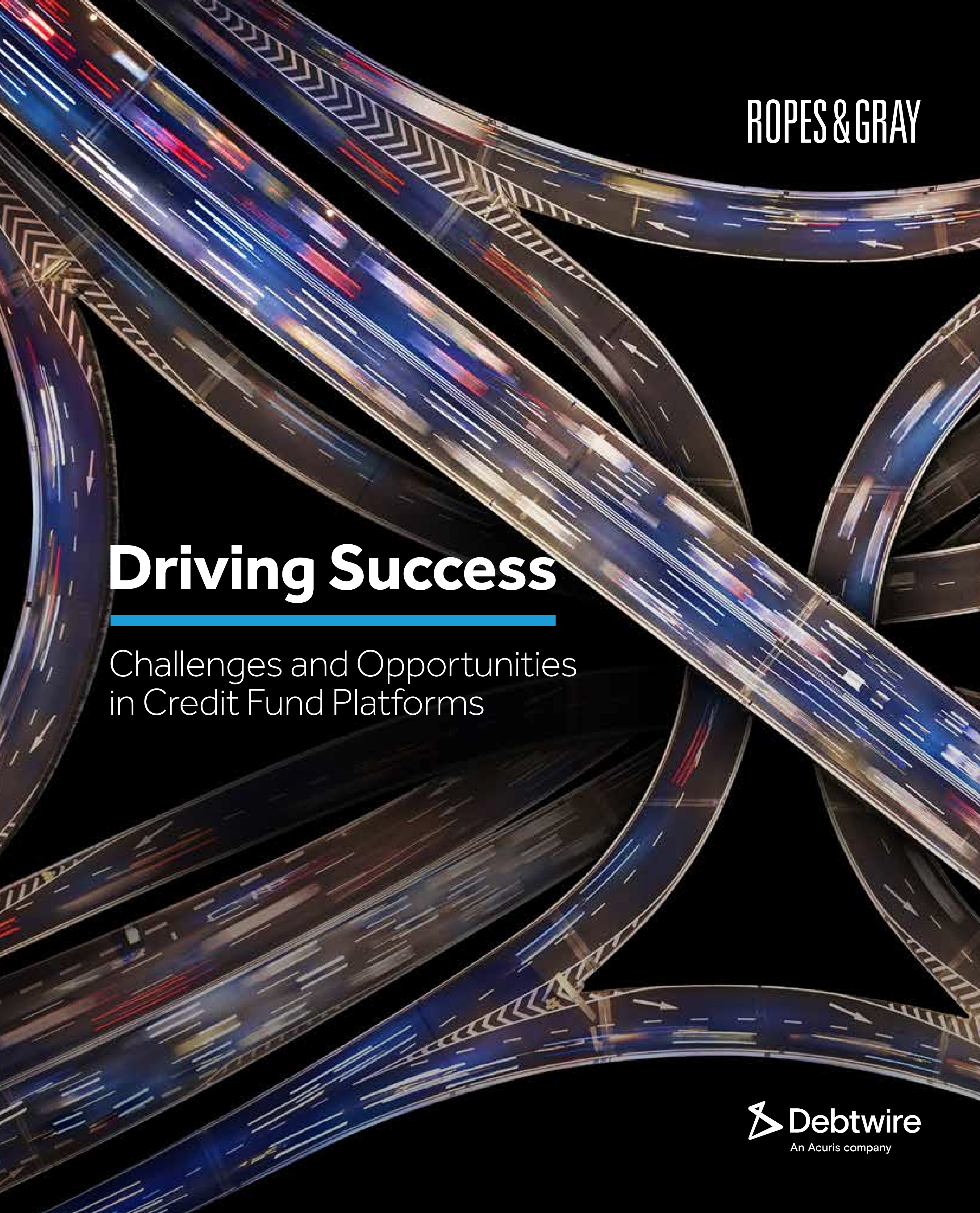
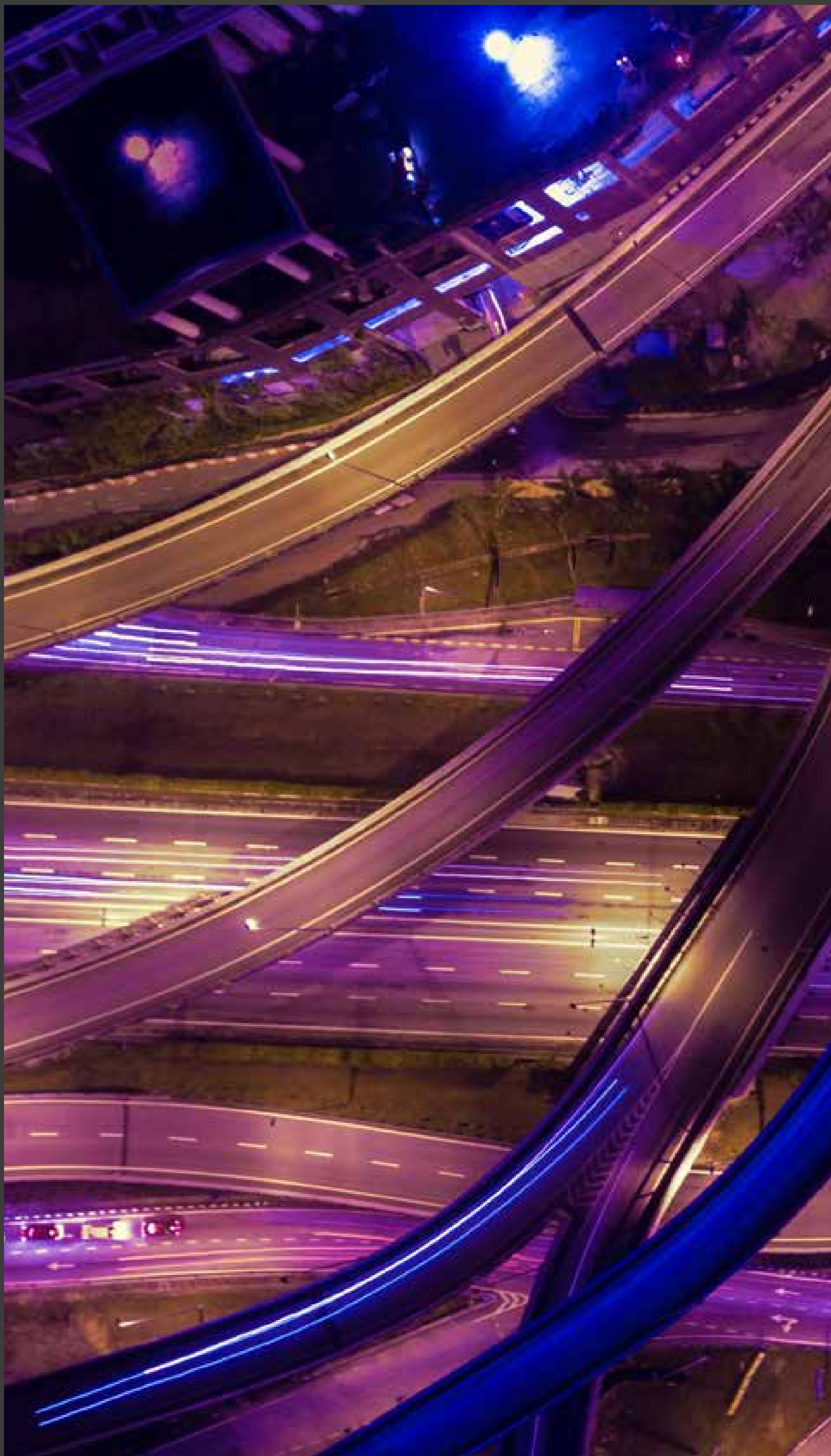


ROPES & GRAY

Driving Success

Challenges and Opportunities in Credit Fund Platforms

Debtwire
An Acuris company



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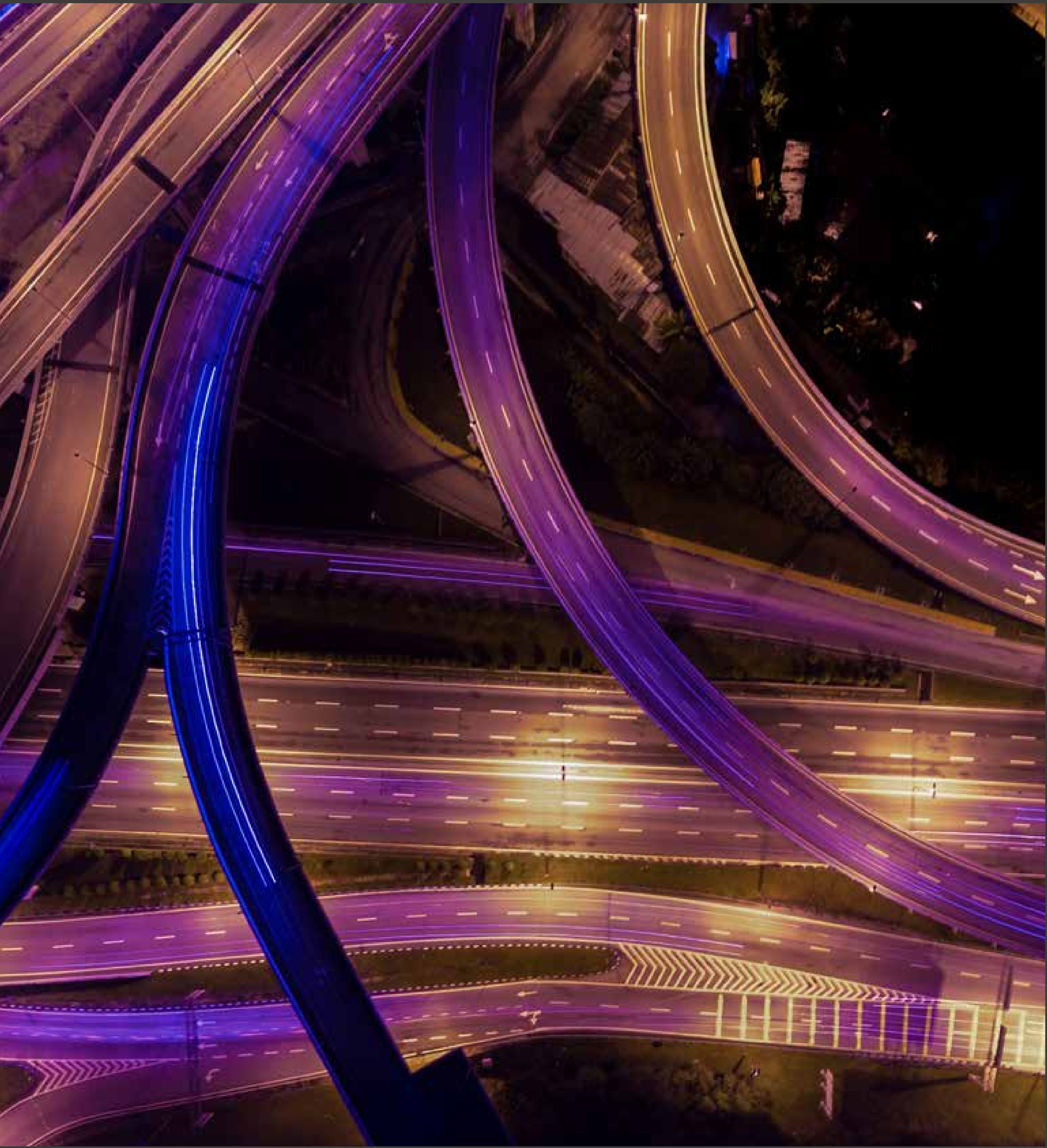


Introduction

Credit fund managers continue to search for growth in an extended low interest environment. They seek to deliver higher returns and capture market share through diversified multi-product platforms offering a range of risk-reward profiles – and they all plan to launch new investment strategies in the next 12 months.

While this approach offers diverse avenues through which to generate income and maintain steady returns in a volatile market, it also opens the door to potential risks and conflicts.

How are credit fund managers navigating today's debt landscape? In the first quarter of 2018, Ropes & Gray, together with Debtwire, conducted a survey of 100 senior-level executives within US- and UK-based credit funds to find out.

The results show that fund manager views on leverage and fund structures are undergoing transition. For example, while some are using leverage to generate long-term returns, more than half have increased their use of leverage for short-term bridging purposes. And most respondents say they plan to use targeted derivatives with embedded leverage as a workaround for recent US tax reform.

Fund structures, meanwhile, are being influenced by a desire for liquidity as well as the maturity of investment assets, as managers and investors seek higher after-tax returns. An increasing number of fund managers are using multiple methods to deal with tax issues related to US origination, with treaty fund/independent agent or business development company structures to address tax sensitivities of tax-exempt and non-US investors. And more high net worth individuals may be investing through non-US corporate vehicles in light of US tax reform and the additional limitations to such individuals on deducting interest and other expenses.

Through it all, credit fund managers are fighting to mitigate risks, as they expand into different credit strategies and fund structures, operating investment platforms with multiple funds and accounts investing alongside each other.

What does the future hold for credit fund managers? According to the majority of respondents in our survey, the biggest concern is straightforward: competition. New entrants could undercut potential returns for established players as they fight to attract investors. Those trying to hold on to the lead will need to navigate increasingly crowded waters.

Methodology

In the first quarter of 2018, Debtwire, on behalf of Ropes & Gray LLP, surveyed 100 senior-level executives within US- and UK-based credit funds. The survey included a combination of qualitative and quantitative questions and all interviews were conducted over the telephone by appointment. Results were analyzed and collated by Debtwire, and all responses are anonymized and presented in aggregate.

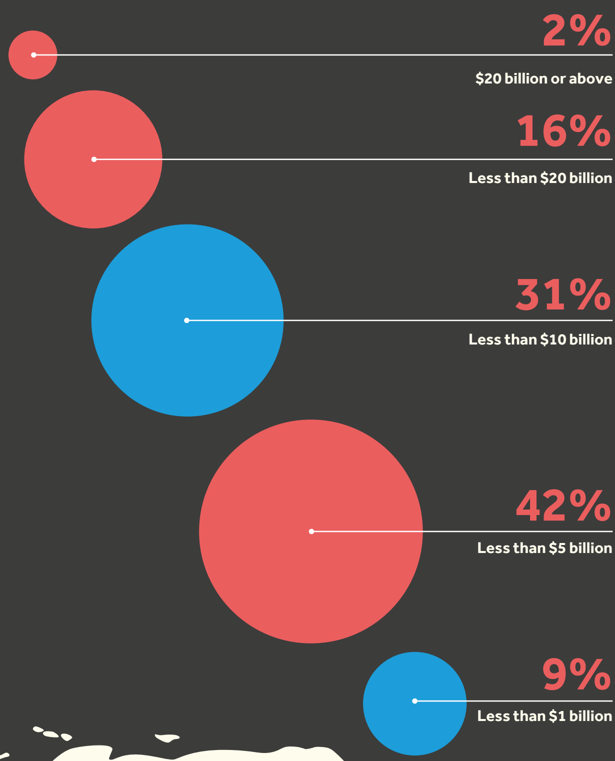
FIGURE 1: **SURVEY RESPONDENTS BY REGION**

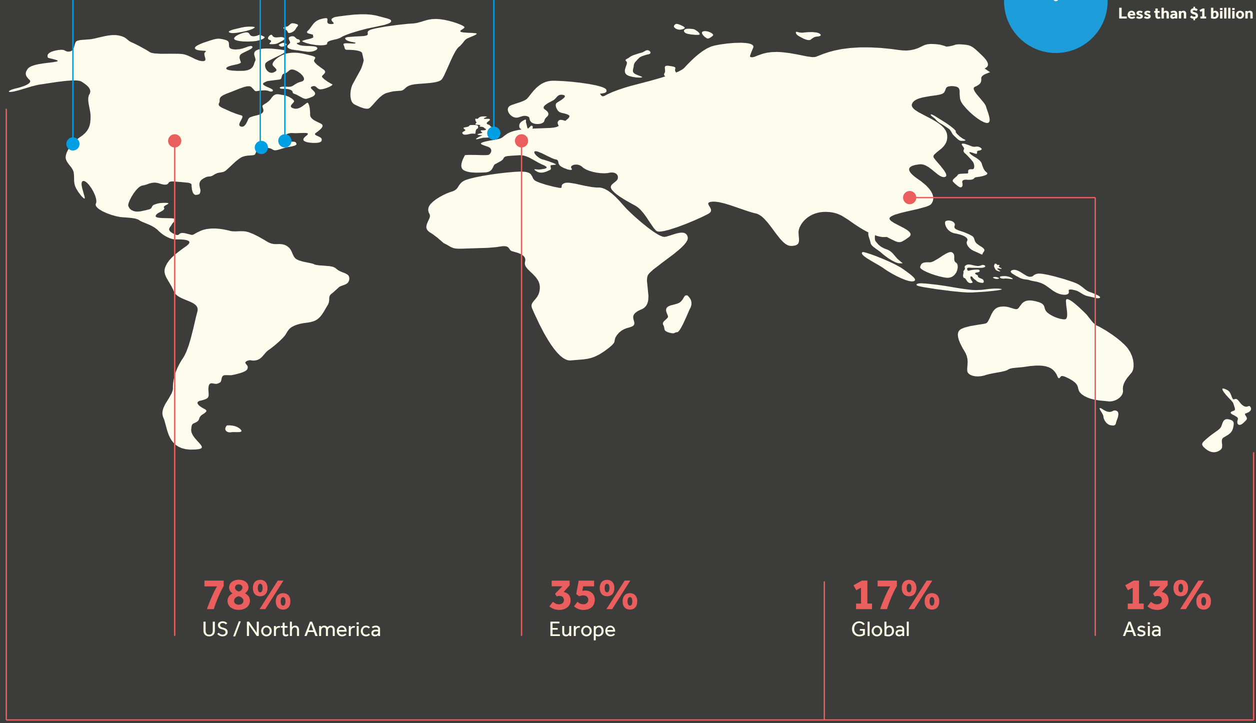
All answers shown in blue on map

FIGURE 3: **GEOGRAPHIC FOCUS OF CREDIT/ DEBT INVESTMENTS** (ALL THAT APPLY)

All answers shown in red on map

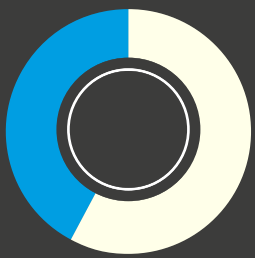
FIGURE 2: **PERCENTAGE OF AUM ALLOCATED TO CREDIT/DEBT**





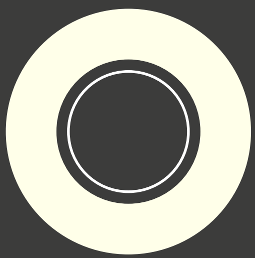
Key findings

Investment strategies



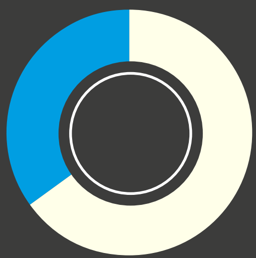
58%

cite general credit opportunities or distressed/stressed debt as their flagship strategy



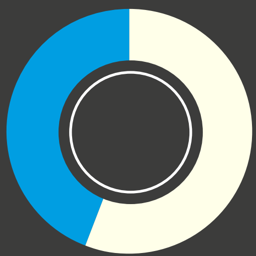
100%

plan to launch new investment strategies in the next 12 months



65%

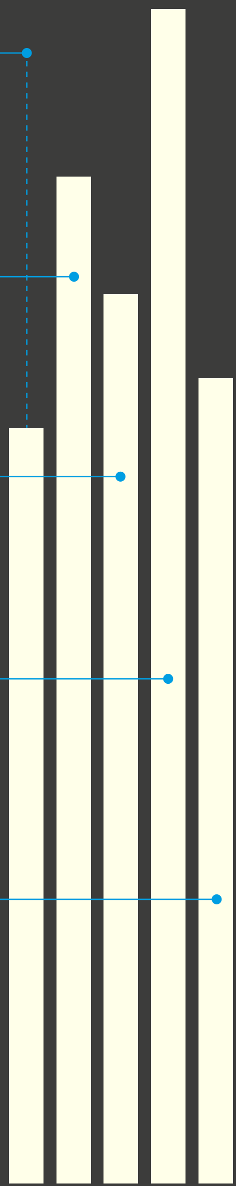
intend to launch a distressed/stressed debt strategy in that time period



56%

plan to launch a strategy focused on senior opportunities

Leverage



45%

use subscription lines for short-term bridging purposes, and another 38% use them for both short-term liquidity and longer-term investment purposes

60%

of respondents use other forms of leverage for long-term investment purposes, while 37% use them to bridge liquidity

53%

have increased their use of leverage for short-term bridging purposes over the past 12 to 24 months

70%

plan to use targeted derivatives with embedded leverage as a workaround for recent US tax reform

48%

will use non-US corporate borrowers to get the economic equivalent of interest deductions under the passive foreign investment company (PFIC) rules

Structuring

64%

plan to use treaty fund/independent agent structures for the first time in the next 12 months, while 58% say the same of business development company structures

71%

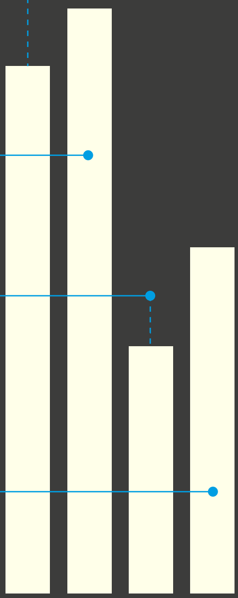
of treaty fund structures rely on the treaties of the investor's fund

30%

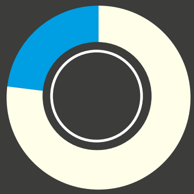
engage in some limited direct origination, with 49% originating no more than three or four annually

42%

use season and sell structures, with 52% of those managers using a 60-day period

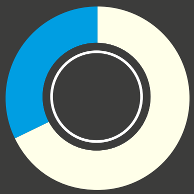


ERISA



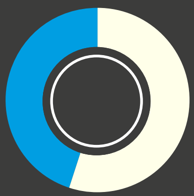
77%

manage plan assets subject to ERISA (45% only manage SMAs/single LP funds, while 32% oversee both pooled funds and SMAs/single LP funds)



68%

permit ERISA vehicles to participate in different levels of the capital structure of the same issuer from their other funds



55%

of those funds that manage plan asset mandates subject to ERISA, structure incentive fees through a realization-based waterfall

Conflicts

63% oversee between one to five separately managed accounts while 37% run over five, making the management of conflicts a priority

37% say pro rata allocations of debt deals are the norm due to the importance of seeking flexibility and parity of performance

42% have a wall in place to address the issues related to material non-public information, while 58% have no wall

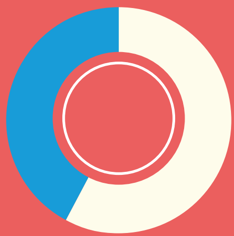
66% allow accounts to invest in different levels of the capital structure of a given company

42% permit cross trading among funds

17% do not restrict same broker trades and 10% do not monitor them

Section 01
Investment strategies

As multi-strategy credit fund platforms become the norm, fund managers are focusing on building out their product offerings, particularly in distressed debt, senior opportunities and direct lending, in the coming year.



58%

cite general credit opportunities or distressed/stressed debt as their flagship strategy

100%

plan to launch new investment strategies in the next 12 months

65%

intend to launch a distressed/stressed debt strategy in that time period

56%

plan to launch a strategy focused on senior opportunities

A MULTI-STRATEGY APPROACH

In the prolonged low interest rate environment, with investors seeking increasing options for returns with different risk-reward profiles, multi-strategy credit fund platforms have gained traction among investment firms seeking to take advantage of increased investor allocation to private debt.

This diversification has helped generate income during different stages of the market cycle, while the ultra-loose monetary policy has created opportunities on the back of dislocations in the capital structure of companies.

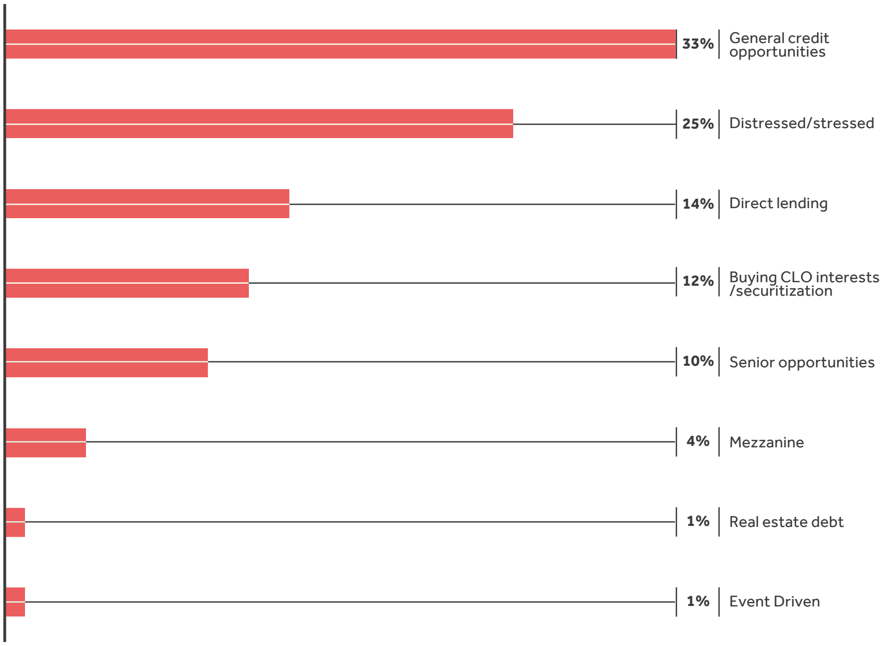
A report published in 2017 by Cambridge Associates[1] shows that investors' target returns from credit can range from mid-single digits to more than 20% depending on the fund's strategy, leading to a wide range of risk-return profiles among investors and strategies.

Those at the higher end of the risk-return spectrum, such as distressed credit and general credit opportunities, had among the highest target returns, ranging from 15% to 20%, while target returns for traditional mezzanine strategies were somewhat lower, between 13% and 17% returns. Investors looking at lower strategies, such as senior debt, could expect between 6% and 15% depending on the strategy and use of leverage.

From an investor perspective, tailored, more focused strategies allow investors the ability to target exposures and manage diversification of their overall portfolio, rather than investing in large multi-strategy funds.

"It is a market reality that big pockets of money look for managers to work with that can offer multiple strategies," says Alyson Gal, a Ropes & Gray partner in the firm's finance and business restructuring groups. "It is cumbersome to look for 15 different managers when you could have one manager with 15 strategies. When managers offer multiple pockets with different strategies, this provides large capital investors with the ability to have a manageable number of relationships, while also creating an appropriate investment mix with different return profiles."

FIGURE 4: **WHAT IS YOUR FLAGSHIP STRATEGY?** (SELECT ONE)



Managers are facing a very competitive fundraising landscape – and expect it to get even more challenging in the future, as the chief operating officer and general counsel of one fund explains: "The market has been very responsive over the past year and specially towards debt funds. There is great demand, especially from Europe, for debt financing and amid this growing demand there has been a continuous increase in the number of investment houses. All these houses are adding to an already squeezed market."

From a manager perspective, soliciting and cultivating new investor relationships therefore continues to be a key focus and concern. Capturing extra dollars being allocated by investors with whom managers have an existing relationship by diversifying business lines has become an appealing way to grow assets under management.

This interest among prospective investors in tailored credit strategies with different risk-reward profiles, and among managers in capturing these investors, is supported by our survey results.

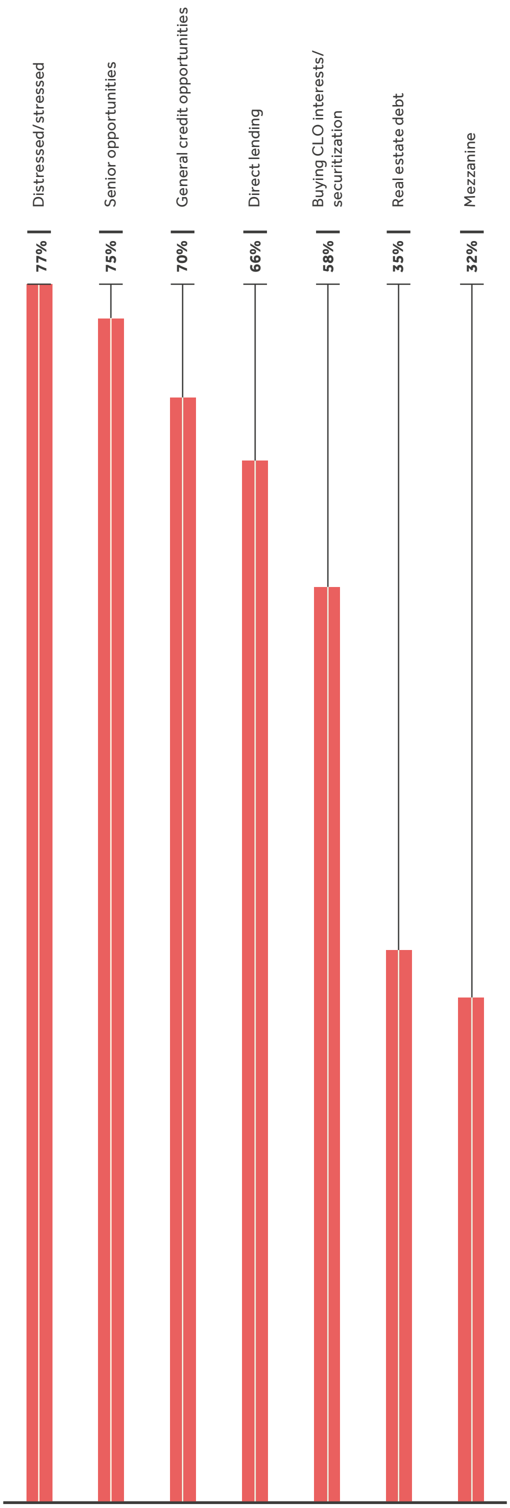
Our survey shows a trend toward specialized/tailored fund strategies being run alongside flagship strategies, with 100% of respondents planning to launch new investment strategies in the next 12 months.

Not surprisingly, given the ongoing search for yield, our survey of 100 senior-level executives within US- and UK-based credit funds shows that general credit opportunities and distressed funds are the most common flagship funds, with 58% of respondents having one or the other as their flagship strategy.

Drilling down into the strategies being managed, distressed debt funds are the most popular, with 77% of respondents including

1 Private Credit Strategies: An Introduction. Cambridge Associates. September 2017. https://www.cambridgeassociates.com/research/private-credit-strategies-introduction/

FIGURE 5: **WHAT STRATEGIES DO YOU CURRENTLY MANAGE?** (SELECT ALL THAT APPLY)



distressed/stressed debt as one of their strategies. This is followed by senior opportunities at 75%, general credit opportunities at 70% and direct lending at 66%.

Notwithstanding these general categories of fund strategies, there can be variation in how managers conceive of a particular strategy.

Credit opportunities, for example, are often characterized as a flexible strategy able to move with market opportunities, one that can encompass a broad range of different types of opportunistic credit depending on the manager. Other credit opportunities funds are more focused, for example, on origination.

Similarly, real estate debt funds can encompass a broad range of different types of lending arrangements and investment strategies, as can distressed or stressed funds, or special situations funds. Moreover, these strategies can be implemented with different orientations, preferences and biases, complicating comparisons and requiring thorough investor due diligence.

While investors are always conscious of potential pitfalls, and continue to focus on the risk-return profiles of funds as an initial key component of selecting a manager, our survey and the Cambridge Associates report reiterate the importance of looking beyond return targets to the investment processes and fund governance structures.

Preqin, in its 2018 Private Debt report[2], notes that private debt dry powder has reached an all-time high, with an estimated $236 billion of undeployed capital. With the potential for increased competition and the reality of more market participants, we expect that the past performance of managers will continue to increase in importance to prospective investors, creating a fundraising dynamic which benefits established managers with track records, but creates a challenging environment for new entrants, causing significant fee and term pressures.

In addition, we expect that as capital waiting for deployment continues to increase, investors will be increasingly focused on pipeline, sourcing and strategy diligence.

"The market is going to get tighter in the next two years and waiting for desirable opportunities will be a great challenge," says the chief operating officer and general counsel of a smaller fund out of New York City. "There are players in the market that have been operating for longer and have better control in the market. With them controlling the market, it will be difficult for smaller operators like us to seize opportunities."

NEW LAUNCHES ON THE HORIZON

Distressed/stressed debt will continue to be a major theme, with 65% of respondents intending to launch this type of strategy over the next 12 months.

"With interest rates on the rise, there should be ample investment opportunities on the horizon for distressed/stressed debt funds," notes Stephen Moeller-Sally, a co-head of Ropes & Gray's Business Restructuring group.

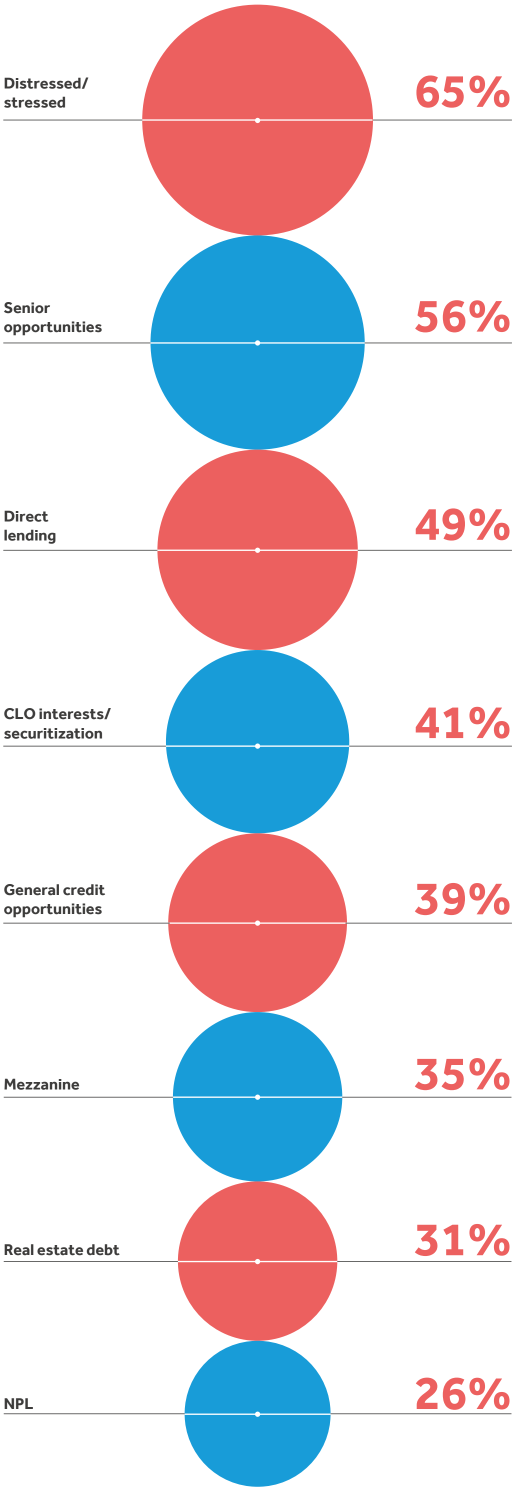
As the managing director of one fund in the survey explains, "I think we'll go for distressed/stressed investment strategies in the future as these will be low risk and we expect the returns to be higher. These companies have suffered a substantial reduction in value, but because of their implicit riskiness, they offer investors the potential for high returns."

Another managing partner comments, "Depending on the existence and performance of the distressed debt market, we will begin investing in this asset class. There is good response of this instrument in Europe and returns will be slow in the beginning but are sure to grow in the long term."

Senior opportunities are close on the heels of distressed/stressed debt strategies as popular new strategies for launch, with 56%

2 Souce: 2018 Preqin Global Private Debt Report. https://www.preqin.com/item/2018-preqin-global-private-debt-report/9/20144

FIGURE 6: **WHICH NEW INVESTMENT STRATEGIES DO YOU PLAN TO LAUNCH IN THE NEXT 12 MONTHS?** (SELECT ALL THAT APPLY)



attracted by the stable, albeit lower, returns. As one manager puts it, "There is a demand for long-term investments. To satisfy this demand, we are considering senior debt opportunities that will provide good exposure to long term instruments."

Almost half of respondents (49%) are interested in increasing their product offerings in direct lending due to the interest of investors in the return profile for originated debt, as well as diversification benefits.

"Direct lending is something we are focusing on and might need to start implementing soon," says one managing director and senior portfolio manager in New York City. "It does not lengthen the process and keeps the information intact, therefore reducing a high amount of risk."

The chief investment officer of a managed fund comments, "Direct lending will be a big part of our future investment strategy. We see the European market as a good direct investment source that will provide opportunities to earn greater returns."

Another adds: "In order to get better returns, we will introduce direct lending within our company's investment profile. It's only going to be a matter of time before we decide to introduce this strategy."

Collateralized loan obligations (CLOs) sit further down the list, with 41% of respondents expecting to enter this space. According to a partner and manager of a structured credit portfolio based in New York City, "The CLO platform is becoming a lucrative investment strategy. It has great high-risk returns that are gaining demand and they are not short on supply. Our analysis is currently in progress and our platform could be introduced within the next 12 months along with other opportunistic strategies."

Another chief investment officer comments, "We won't consider any new investment strategy but we will ramp up our investments in the CLO category. This strategy has some additional opportunities as the demand for it is on the rise."

Another describes it as a potentially "lucrative" investment strategy "gaining demand." As of the end of April, year-to-date CLO issuance in the US was over \$41 billion, compared to \$26 billion from the same period in 2017.[3]

Interest in CLOs is likely to have grown since the survey was originally conducted due to legal changes. The US risk retention rules originally went into effect in late 2016, requiring parties setting up securitizations backed by, among other things, pools of loans to acquire 5% of the securities that they are offering (often referred to as "skin in the game").

Since the rules went into effect, CLO managers have devoted considerable time and effort to locating the capital to fund these required investments, with larger managers finding this easier than smaller ones.

However, a recent DC Circuit Court's ruling exempts the managers of "open-market" CLOs – i.e., CLOs collateralized by broadly syndicated loans purchased in arm's length transactions from third parties – from these risk retention rules. This is likely to boost CLO issuance by allowing managers to structure new CLOs without any investment obligation. Smaller managers should benefit from this change from requirements which locked up capital.

That said, not all CLO managers will necessarily benefit. The court's decision only applies to managers of open-market CLOs and not most middle market CLOs, where the collateral typically consists of loans originated by one or more affiliated credit funds. In addition, the continued existence of European risk retention rules may make some managers less interested in launching European risk retention-compliant CLOs.

3 Souce: S&P Global Market Intelligence. (2018) LCD, US CLO Activity. Retrieved May 4, 2018 from S&P database.

Section 02
Leverage

While subscription lines have become the norm among fund managers, not everyone is using them for the same purposes, or taking the same approach to leverage more generally. Some are using leverage to generate long-term returns while others are primarily looking to bridge liquidity gaps and facilitate more predictable capital calls.

45%

use subscription lines for short-term bridging purposes, and another 38% use them for both short-term liquidity and longer-term investment purposes

60%

of respondents use other forms of leverage for long-term investment purposes, while 37% use them to bridge liquidity

53%

have increased their use of leverage for short-term bridging purposes over the past 12 to 24 months

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plan to use targeted derivatives with embedded leverage as a workaround for recent US tax reform

48%

will use non-US corporate borrowers to get the economic equivalent of interest deductions under the passive foreign investment company (PFIC) rules

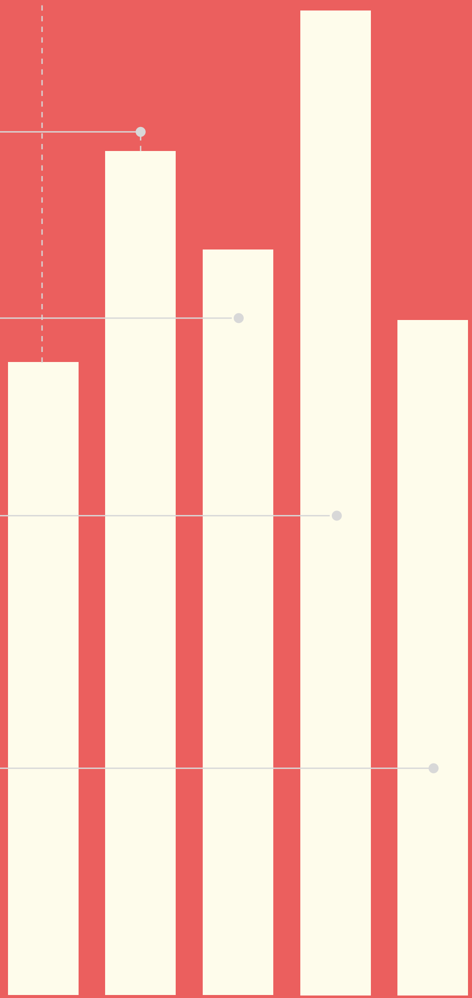
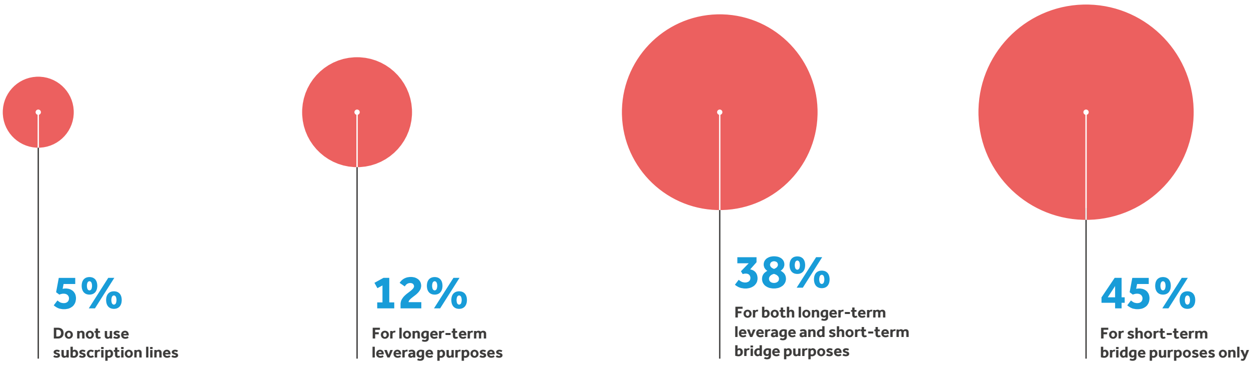


FIGURE 7: **HOW DO YOU USE YOUR SUBSCRIPTION LINES?**



SUBSCRIPTION LINES

Subscription lines – credit facilities that are secured by the right to call capital from investors – have become a standard feature of credit funds, with only 5% of respondents in the study not employing them.

"Subscription facilities are being used more extensively across the board," says Patricia Lynch, a partner at Ropes & Gray, who works on fund financings and leads the firm's US securitization practice. "This is not unique to credit funds; it's happening with a lot of other types of private investment funds as well."

Lynch explains that the trend is driven in large part by convenience: "If you can draw on a subscription facility to fund an investment, you don't have to call capital as often from your limited partners. That makes things administratively easier for the general partner. It also enables the fund to offer its investors a somewhat more predictable schedule of capital calls."

This mechanism may be especially important for credit mandates that deploy capital more quickly or in larger numbers of investments. Indeed, 83% of the survey respondents reported using these facilities at least in part for short-term liquidity purposes, with 53% indicating that their use of short-term bridge financing has increased in the past 12-24 months.

In particular, a number of respondents indicated that the ability to use subscription lines to ensure they can take advantage of investment opportunities was an important one.

As one managing director from Boston puts it, "We see subscription lines as a working capital instrument. The main reasons for their use is to bridge gaps either in liquidity or investment purposes. It seems a relatively inexpensive means of obtaining capital for investments, but we don't use it excessively for long-term investments."

Not all fund managers take the same approach, however. Half of the respondents use their subscription lines to fund investments over the longer-term in addition to, or instead of, for short-term bridge purposes.

One benefit to managers of longer-term draws, according to Tom Draper, a finance partner at Ropes & Gray, can be "a bump in your internal rate of return on equity. If you can draw on a subscription line to buy or originate assets and leave that loan outstanding for, say, six months before calling capital from the investors, the clock doesn't start on the return on equity until the capital's been called. As a result – if these are appreciating assets – you can get a little increase in your rate of return."

While the use of subscription lines and their effect on IRR calculations have generated debate in the context of private equity funds, which historically have not relied on fund-level leverage, use of these lines is more widely accepted in the context of closed-end credit funds, many of which permit use of leverage as part of their investment strategy. For example, Lynch explains, "many credit fund managers expect to lever their funds' investments by having the funds borrow loans secured by their asset portfolios. Early in the life of a fund, when it's still ramping up its portfolio and isn't in a position to obtain this type of leverage, a subscription line can be an important substitute source of funds."

Agreeing on the ways in which a credit fund manager can use subscription line leverage, therefore, can be an important aspect of negotiations between the manager and investors when a new credit fund is launched.

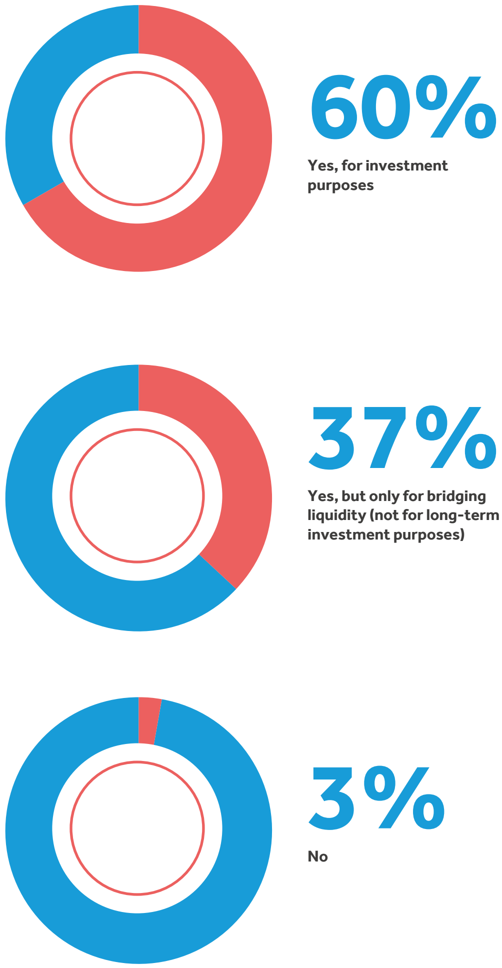
PORTFOLIO LEVERAGE

In addition to maintaining subscription lines, some credit funds regularly incur debt secured by their portfolio assets or use of alternatives, such as derivatives.

Unlike subscription facilities, which often mature within one year, portfolio leverage facilities typically have terms of several years, providing credit funds with a longer-term source of leverage.

According to 60% of respondents, they use leverage other than subscription lines for longer-term investment purposes, while 37% do so for purposes of bridging liquidity.

FIGURE 8: **DO YOU USE LEVERAGE OTHER THAN SUBSCRIPTION LINES?**



As Draper explains, for some managers longer-term portfolio leverage is a key strategy to boost returns in a low interest rate environment: "Many portfolio loans are only paying maybe 6%-7% in interest, if not less, depending on the type of loans the fund is investing in. Meanwhile, for some institutional investors, returns need to be up into the double digits, around 10%-12%, to make an investment in the fund worthwhile."

Open-end funds may achieve longer-term leverage on their portfolios through derivatives, such as loan total return swap facilities with dealer counterparties.

As described by Leigh Fraser, partner at Ropes & Gray, "In a loan total return swap arrangement, the fund does not actually own the loans. It enters into a contract with a counterparty which requires the fund to pay an amount equal to a portion of the principal amount of the loans upfront, plus an ongoing financing charge.

"The counterparty pays the fund any increase in the value of the loans, and the fund pays the counterparty the amount of any decrease. Typically, the dealer would own the loans to hedge its exposure under the swap, although that is often not required. Potential risks from these arrangements include not having actual control over the loan investments (such as the ability to vote) as well as counterparty credit risk."

While use of leverage as a source of returns continues to be a key factor in investor assessment of risk, managers in our survey indicated that the trend they see in their own firms is an increased use of leverage, with 35% of managers increasing their use of long-term leverage, while only 13% have decreased their use of long-term leverage.

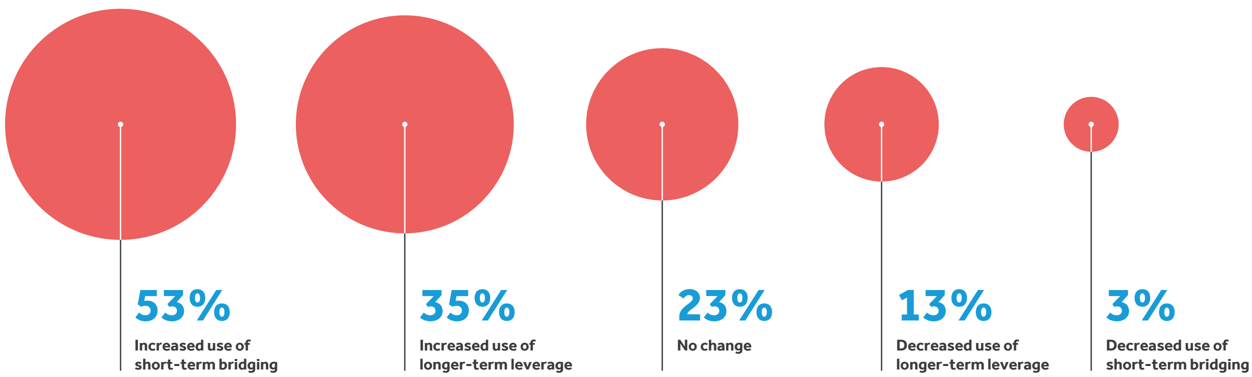
US TAX REFORM

US tax reform, passed in 2017, ushered in one of the most sweeping set of changes in over 30 years. It will have an impact on funds, sponsors and investors.

Most notably, the federal corporate tax rate was cut from 35% to 21% and a new cap on the deductibility of business interest of roughly 30% of EBITDA means that companies will likely re-evaluate the cost of financing with debt as opposed to equity. The cut in corporate tax rates could lead some issuers to raise capital through issuing additional equity or equity-linked securities, as interest deductions provide a less valuable "tax shield."

Others believe the lower corporate tax rates will offset the cap on interest deductions: "Feedback from clients is that, although a bunch of issuers – maybe even most ordinary industrial issuers – are going to be affected by the rule, the overall net effect of tax reform will not necessarily decrease the attractiveness of capitalizing the business with debt because

FIGURE 9: **HOW HAS YOUR APPROACH TO USING LEVERAGE CHANGED IN THE PAST 12-24 MONTHS?** (SELECT ALL THAT APPLY)

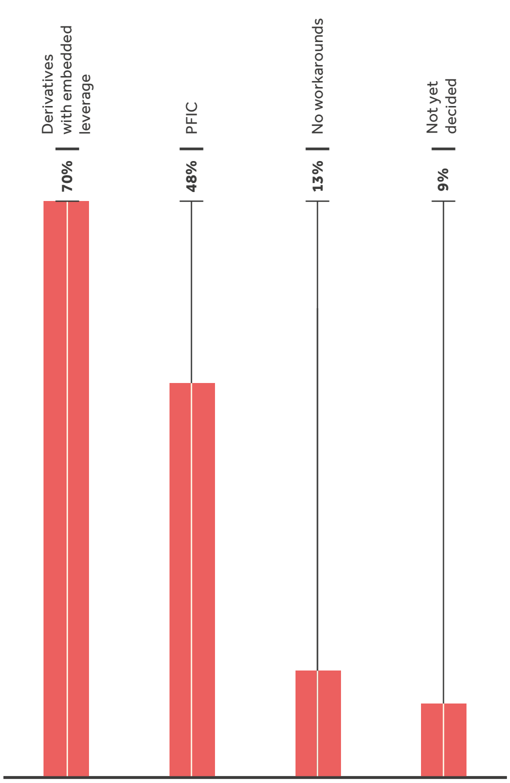


corporate rates went down," says James Brown, a partner in the tax department of Ropes & Gray.

Tax reform also significantly curtailed the ability of investors to deduct their share of various fund expenses, including most management fees.

In terms of the workarounds to these various limitations, 70% of participants in the study target derivatives with embedded leverage, while 48% expect to incur debt and invest through non-US corporate vehicles. Typically, these will be subject to US tax passive foreign investment company (PFIC) rules and be able to offset their earnings by these expenses, unlike their US counterparts, to get the economic equivalent of interest deductions. Only 13% are not preparing any workarounds while 9% remain undecided.

FIGURE 10: **WHAT WORKAROUNDS DO YOU EXPECT TO EMPLOY UNDER THE NEW US TAX REFORM, WHERE FUNDS (OR THEIR TAXABLE INVESTORS) WILL NOT BE ABLE TO DEDUCT INTEREST?** (SELECT ALL THAT APPLY)



Section 03
Structuring

The choice of appropriate fund structures depends on the balance of investor desire for liquidity and the expected maturity of the investment assets, but they can also be influenced by managers and investors seeking to achieve the highest possible after-tax returns. Non-US investors present the most difficult challenges because they are often subject to US taxation on income from loan origination activities conducted in the US, including through a partnership or agent such as an investment advisor. A significant amount of credit fund structuring is designed to address those challenges without adversely affecting US investors.

64%

plan to use treaty fund/independent agent structures for the first time in the next 12 months, while 58% say the same of business development company structures

71%

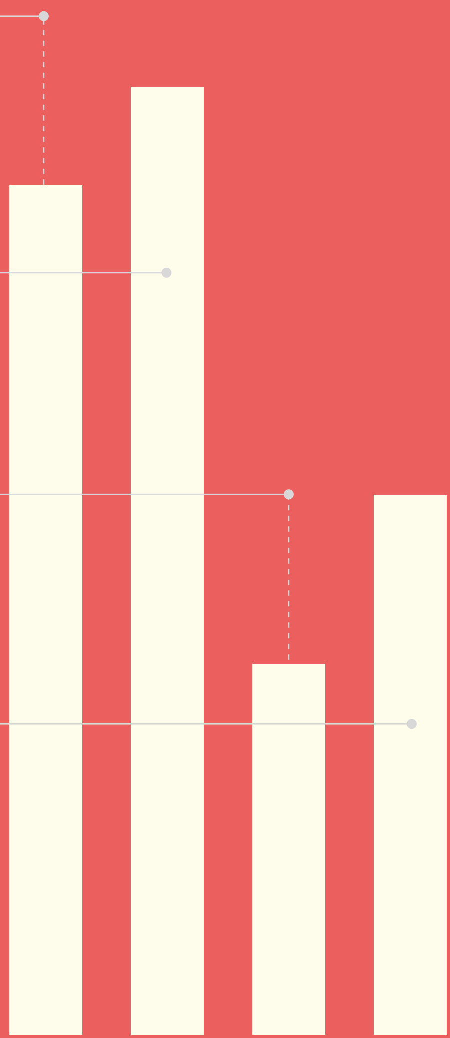
of treaty fund structures rely on the treaties of the investors

30%

engage in some limited direct origination, with 49% originating no more than three or four annually

42%

use season and sell structures, with 52% using a 60-day period



TAX ISSUES AND STRUCTURING STRATEGIES

Structuring credit investments for non-US investors in a practical and tax-efficient manner continues to be a significant challenge.

There is no "silver bullet" solution for protecting non-US investors from US taxation by reason of loan origination. Managers adopt different approaches depending on their investor base, investment strategies, internal infrastructure, and risk profile.

Most participants in the survey are using multiple approaches to address these issues, although the treaty fund/independent agent and business development company (BDC) structures are generating the most interest among managers in our survey, at 68% and 59% respectively.

Independent agent/treaty structures rely on the beneficial tax treatment available to residents of certain treaty jurisdictions. They either rely on the investor's treaty status or the fund is organized so that it qualifies as a treaty resident, commonly in either Luxembourg or Ireland.

In contrast, BDCs rely on treatment as a regulated investment company (RIC) under subchapter M of the Internal Revenue Code, and are not subject to corporate level tax so long as it ensures that it continues to qualify as a RIC, for example by ensuring that 90% of its income is good qualifying income, that it distributes its annual investment company taxable income and meets certain diversification rules.

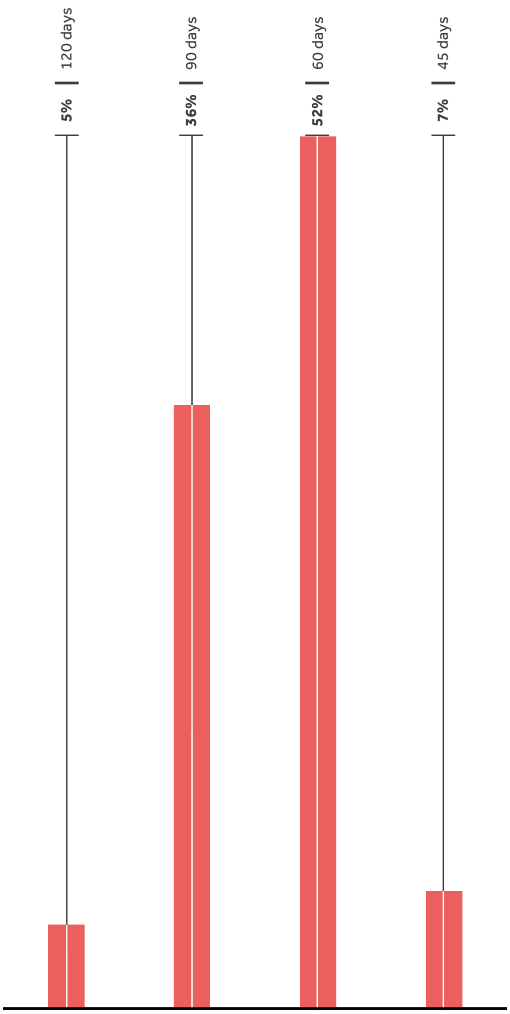
In addition, many real estate credit fund managers use real estate investment trusts (REITs), as these can also shield non-US investors from the adverse tax consequences of engaging in loan origination without incurring corporate taxes.

Perhaps surprisingly given the limitations on its potential for a more broad-based platform solution, slightly over half expressed interest in so-called insurance dedicated funds, which managers acknowledge create numerous practical challenges. These can be difficult to implement for institutional investors but attractive to retail investors.

"In order to have better control over tax we have resorted to the use of insurance dedicated funds. It's an old instrument for investments and it has been brought back to reduce tax impact on returns of investments," says a chief investment officer based in New York City.

This may reflect the general desire to take advantage of multiple distribution platforms to grow assets in a tax efficient manner wherever possible. Insurance dedicated funds are funds offered through insurance companies, and are more popular in the hedge fund market, where they can be used for estate-planning purposes as well as to accumulate value on a pre-tax basis. Many insurance companies have fairly routine platforms, but insurance dedicated funds tend to be additive to fund platforms instead of a central fundraising solution.

FIGURE 11: **WHAT IS YOUR PREFERRED MINIMUM SEASONING PERIOD?**

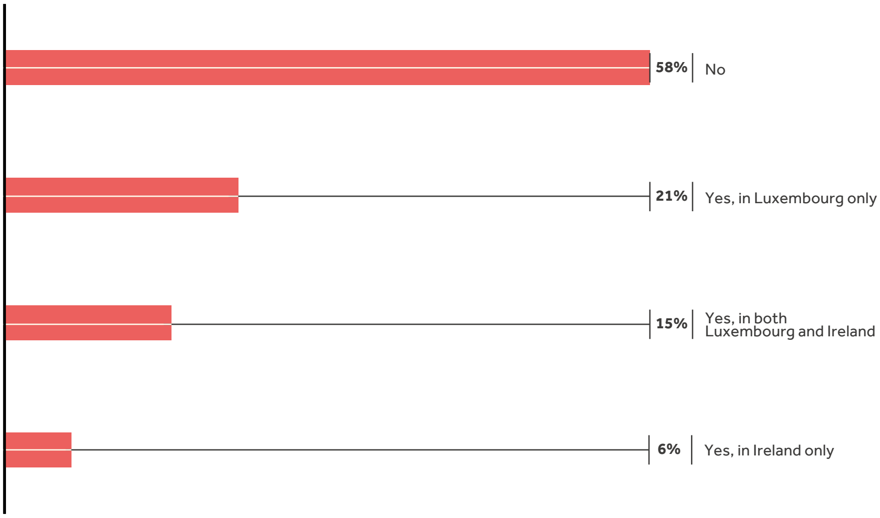


STRUCTURING

In addition, strict restrictions around investor control rights and asset diversification mean that, from a compliance perspective and investor relations perspective, it is important that managers and their legal departments carefully monitor the use of these funds and assess whether the structure fits with the manager's fundraising goals.

Despite the interest, discussed above, among many investors in originated assets, almost a third of managers in our survey are addressing the tax issues related to US loan origination by limiting originations per year, which runs counter to those looking to increase their direct lending origination strategies.

FIGURE 12: **DO YOU FORM VEHICLES IN TREATY JURISDICTIONS?**



TIME WILL TELL: SEASONING

Season and sell structures, which are used by 42% of respondents, involve a vehicle originating a loan with the expectation of offering to sell a portion of the loan to another vehicle after a seasoning period, typically from 30 to 180 days, with 90 days being common. The transfer must take place at fair market value and, for tax purposes, the first vehicle is considered the "original purchaser and owner" of the loans.

According to the survey, while 36% of respondents choose the traditional 90-day seasoning period, 52% prefer a slightly shorter 60-day timeframe. This is not only because the returns between the two vehicles are then typically more similar, but it also reduces the risk of changes in valuations between the origination and anticipated subsequent sale and better utilizes capital of the funds.

However, while we expect this trend toward shorter timeframes will be interesting to many managers, it is important that managers take into account a variety of factors that should be considered in combination with any "seasoning" time period when operating such a platform.

"I think the seasoning period really depends on other factors that would go to the level of separation between the two funds," says Ropes & Gray's James Brown. Factors such as volume or frequency of loan origination, whether originated loans are being sold to third parties, availability of pricing information and quarterly reporting by the portfolio company, as well as the key factor of establishing that there is independence in decision-making between the originating and purchasing funds, are all relevant.

"There is also the legal question as to whether the seasoning vehicle is acting as agent for the offshore fund or as a principal. When it is clearly acting as a principal as opposed to agent then I think you could probably go to a shorter period."

TREATY ARRANGEMENTS: LOCAL, LUX OR IRISH?

Another approach gaining interest among managers and investors alike is the use of treaty structures to manage US tax exposure due to US loan origination. Treaty structures come in different flavors, the most common being either funds that rely on the treaty status of their investors, or funds established in treaty jurisdictions.

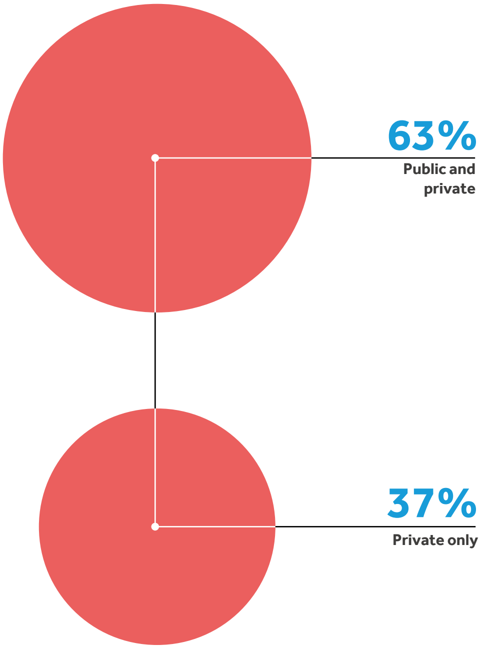
Treaty structures present a number of technical issues, particularly when the basis for benefits relies on the fund's treaty status as opposed to that of the investor. Generally, for the fund (often formed in Luxembourg or Ireland) to be a good treaty resident itself, more than half of its investors must be US residents (or residents of the relevant treaty jurisdiction).

In addition, the fund must meet so-called base erosion tests, which generally limit to whom deductible payments can be made. As to this requirement, Irish ICAVs are popular because they are not subject to Irish tax and therefore do not need to make deductible payments; however, ICAVs are subject to additional regulatory requirements.

Finally, and most importantly, the investment advisor must be an independent agent of the fund. This limits the extent to which small or new managers can use the structure because investors look to a manager's economic independence from the fund as a revenue source. Depending on the investor's risk tolerance, treaty structures also limit the advisor's ability to control the fund or participate economically (e.g., through limitations on equity interest or board control), and can affect the terms of the advisor's termination and compensation.

According to the survey, structures that rely on the investors' treaty status are more widely used in the market than Luxembourg or

FIGURE 13: **IF YOU USE A BUSINESS DEVELOPMENT COMPANY, WHAT KIND DO YOU USE?**



Irish funds where the fund creates its own treaty status, with 71% of respondents using treaty structures reporting this approach.

"When you talk to investors about treaty structures, it's easier for them to understand the benefits of the treaty in their own jurisdiction," says Ropes & Gray partner Jessica O'Mary.

However, the major disadvantage to these structures is that they do not provide a solution for non-US investors in non-treaty jurisdictions (for example, many Middle Eastern, South American and some Asian countries) to access US loan originations on a tax-efficient basis, since all investors must independently qualify for treaty status based on their own jurisdiction.

In contrast, funds structured as good treaty residents (in jurisdictions such as Luxembourg or Ireland) permit capacity for non-US investors regardless of treaty status by the fund establishing its own treaty basis, so long as the other requirements of the structure are satisfied, such as greater than 50% US ownership.

This requirement of US ownership, however, leads to "chicken and egg" problems common in raising credit funds that undertake US loan origination, since the fund structure depends on whether adequate capital from US investors can be raised.

The Luxembourg and Ireland treaties also each have their own quirks. For example, the test for US ownership and base erosion work a bit differently under each treaty. Within the 42% of managers using these structures, 21% are using only Luxembourg as treaty jurisdiction, 6% are using only Ireland and 15% are using both Luxembourg and Ireland.

Brenda Coleman, a partner in Ropes & Gray's tax department notes, "The choice can also be driven by the jurisdiction in which the fund manager wants the fund to build substance. This is important where the fund will be holding debt outside the US where it is relying on a treaty with Luxembourg or Ireland in order to mitigate withholding taxes on payment of interest on that debt to the Luxembourg or Irish holding company."

Ropes & Gray partner Matthew Judd adds that "We see both Luxembourg and Ireland being popular choices for European debt-focused funds, as they each offer a range of fund vehicles with different degrees of regulation to meet investor preferences."

O'Mary also observes that treaty structures have become more widely used: "There is an increasing awareness of, and comfort with, these structures, particularly for separately managed accounts – although, in our experience, managers are increasingly interested in using treaty structures for pooled funds as well." However, says O'Mary, "the Luxembourg and Irish treaty structures are mostly being used in a closed-end fund context, due to the operational challenges with maintaining compliance with treaty requirements when investors are subscribing and redeeming." In contrast, bring your own treaty or season and sell structures lend themselves better to an open-end structure.

Breaking down the survey results, 47% of respondents that use a treaty fund/independent agent do so for pooled/commingled funds only, while 31% use them for both pooled/commingled funds and single LP funds. The remaining 22% employ them on a single LP funds basis only.

BRING IN A BDC?

Business development companies (BDCs) were created by US Congress in 1980, but they came into their own as an alternative source of income for investors as well as capital for private US small and middle market companies.

BDCs are subject to the US Investment Company Act of 1940 ("1940 Act"). These provisions apply to both public and so-called "private" BDCs, and while the restrictions of the 1940 Act were designed to protect investors, they have downsides for both managers and investors. From a manager's perspective, there are increased formation and compliance costs associated with managing a BDC, whether public or private. Some of these costs will be borne by the BDC itself and, consequently, its investors.

That being said, for managers willing to or who have already invested in this internal infrastructure, the launch of a BDC can use existing compliance synergies.

STRUCTURING

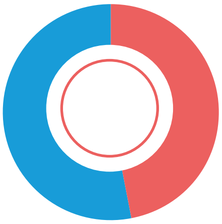
For traditional private fund investors, BDC rules limit the ability of investors to negotiate particular deals and side letters, which they may be used to. They also restrict conflicts by, for example, restricting the ability of a BDC to negotiate investments in the same portfolio companies as other funds managed by the manager. While managers have applied for exemptive orders to address many of these issues, those orders impose conditions on the BDC and restrict the ability of the BDC and its affiliates to engage in certain transactions.

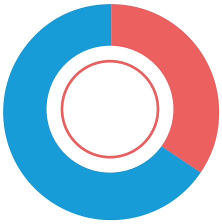
Many larger credit managers consider a public BDC as integral to establishing a broad credit platform. However, interest in public BDCs has ebbed and flowed according to O'Mary: "Interest in public BDCs tends to reflect the market and these vehicles have had volatile performance over time, including trading at a discount to NAV (net asset value)."

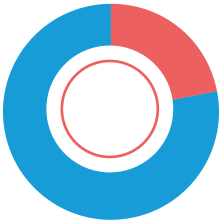
However, increasingly, some credit managers are asking whether private BDCs might be good alternatives for origination strategies, including for non-US investors in particular, following changes in the tax code in 2015 that removed disincentives for non-US investors in BDCs. More than half (58%) of survey respondents expect to use a BDC for the first time in the next 12 months and, of those, 59% would select a public and private BDC platform, while a growing number would just choose the private option.

However, apart from these operational challenges for both managers and investors, other challenges remain in marketing private BDCs as substitutes for private credit funds.

FIGURE 14: **DO YOU USE TREATIES/ INDEPENDENT AGENTS?**







Many institutional investors have buckets for allocating capital to private credit funds, and BDCs do not necessarily firmly fit in those buckets, making non-US investors slow to warm to BDCs.

Recent interesting developments in the BDC market include new exemptive orders as well as recent legislation that reduces the leverage coverage requirement for BDCs from 200% to 150% with the approval of the BDC's board or shareholders.

Managers considering or offering BDCs also may consider tender offer funds and interval funds, closed-end fund structures that are subject to the 1940 Act. Similar to unlisted BDCs, these funds offer limited liquidity at specific intervals.

For tender offer funds, there is no guarantee regarding the interval or the amount of liquidity that will be offered, although it is typical for the offering documents to indicate the likely interval at which liquidity will be offered, subject to the board's discretion. Interval funds, on the other hand, are required at launch to stipulate the interval at which they will make liquidity available (ranging from quarterly to annually) and may offer to repurchase between 5% and 25% of the fund's outstanding shares, as determined by the board at the time of each repurchase offer.

As is the case with BDCs, tender offer funds and interval funds whose shares are registered under the Securities Act of 1933 can be offered to the public, including to retail investors. Tender offer funds and interval funds registered only under the 1940 Act are sold in private offerings. They are not exchange traded, although some managers may seek to convert them to exchange-traded funds at a future date.

Section 04
Conflicts

Many credit fund managers already operate investment platforms with multiple funds and accounts investing alongside each other. The survey confirms that trend is set to continue, with expansion into different credit strategies and fund structures, as well as growth of separately managed account platforms. Managing conflicts is increasingly important, from building walls to cross-trading limitations and same broker trade restrictions. What are the best options to mitigate potential risks?

63%

oversee between one to five separately managed accounts while 37% run over five, making the management of conflicts a priority

37%

say non-pro rata allocations of debt deals are the norm due to the importance of seeking flexibility and parity of performance

42%

have a wall in place to address the issues related to material non-public information, while 58% have no wall

66%

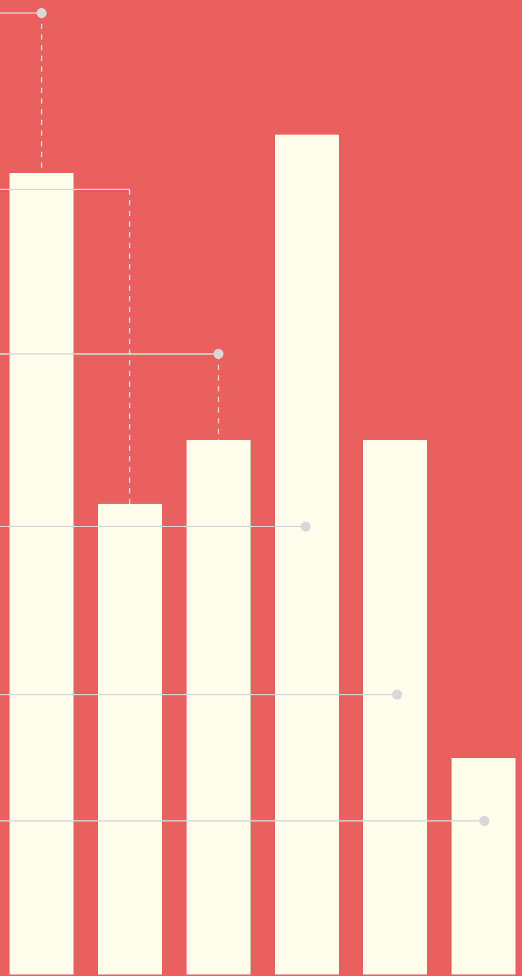
allow accounts to invest in different levels of the capital structure of a given company

42%

permit cross trading among funds

17%

do not restrict same broker trades and 10% do not monitor them



ACCOUNT MANAGEMENT AND FEES

A striking survey result is that every respondent manages at least one separately managed account (SMA), and 63% oversee between one to five, while 37% run more than five SMAs. In addition, at least a third have a more formal SMA platform that is home to six or more SMAs, versus those that have developed a product on a one-off basis for specific larger investors.

This reflects the general tolerance of investors in pooled credit vehicles toward managers raising SMAs, as well as other pooled funds that have overlapping strategies, despite the conflicts. It also demonstrates the growing trend among investors in requesting tailored terms and structures from managers.

These platforms can, however, be challenging for credit managers, particularly for lower returning strategies, given cost pressures around tailored arrangements, as well as the fact that conflicts and operational issues around SMA/single LP fund platforms demand increased investment in compliance and legal monitoring, and operations and other back and mid-office systems.

However, the up-front investment in compliance processes and systems has paid dividends for some managers who have developed substantive AUM in their SMA/single-LP platforms, and our survey shows that other managers hope to capitalize on this trend.

ALLOCATION ISSUES

From a regulatory perspective, one of the main issues regarding SMAs/single LP funds is the allocation of investment opportunities, according to Jason E. Brown at Ropes & Gray.

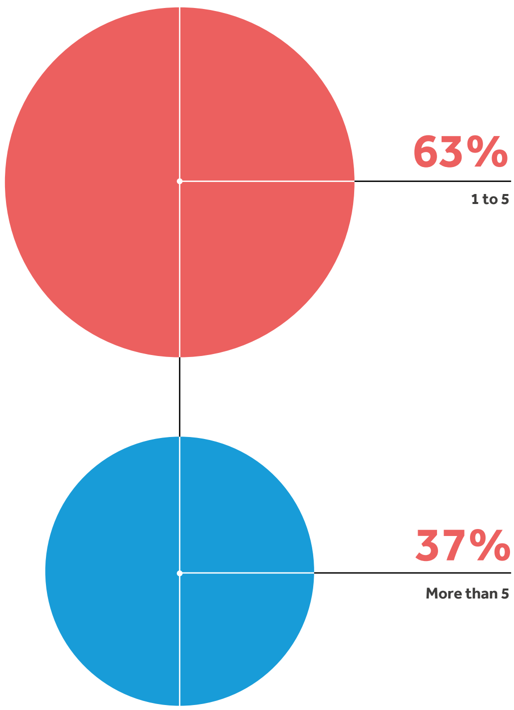
"Managers can manage conflicts by developing solid allocation procedures, methodology and reasonable processes," he says. "Investors want to know whether the SMAs are going to get their pro rata interest. Are they going to come first or second? Might there be a rotational system? There are different ways to do it, but the key is to come up with a reasonable process and to disclose it."

O'Mary of Ropes & Gray adds, "Most investors in credit are familiar with and accept the idea that a manager will be dealing with multiple overlapping accounts. This is particularly important for some managers who want to provide reliable replacements to bank lending, with regular sources of sufficient capital and capital flexible enough to lend in different structures."

However, she adds, "it is important, in capacity constrained strategies, that managers give investors sufficient comfort and some investors may expect increased transparency around issues such as sourcing, pipeline, dry powder and capacity."

"It is also important that managers consider the match between liquidity of the underlying assets and the withdrawal provisions of the funds when allocating assets," adds Ropes & Gray partner Laurel FitzPatrick. "For example, where managers are managing both open- and closed-end funds which may be investing in the same assets, they need to consider the effect redemptions in the open-end fund and the need to raise cash might have on commonly held investments in the closed-end fund. It is important for the manager to think through these issues and adequately disclose them to investors, whether through the offering documents, ADV or otherwise."

FIGURE 15: **HOW MANY SEPARATELY MANAGED ACCOUNTS/SINGLE LP FUNDS DO YOU MANAGE IN PRIVATE DEBT?**



In terms of process to manage the conflicts associated with allocating debt deals, 25% of survey respondents seek to do so on a pro rata basis, with some exceptions and adjustments to pro rata, primarily due to regulatory and operational simplicity and parity of performance.

"Our approach is pro rata, which is easier to handle and requires fewer resources," says a general counsel based in California. A counterpart in New York adds that "big organizations like ours have to be careful while distributing funds – in order to maintain uniformity within the funds and investments, we prefer allocating capital by using a pro rata methodology."

By contrast, non-pro rata allocations are the norm for 37% of managers, due to managers seeking to allocate across platforms where pro rata allocations may not provide for sufficient tailoring of strategies and structures. In addition, 37% operate platforms that may offer comfort to investors in certain strategies by providing some strategies with contractual priority.

"Non-pro rata allocation is common in the credit fund context, given the complex and differing investment objectives of funds within a platform and structural aspects of the issuances," reports Dan O'Connor, co-chief of the securities and futures enforcement practice at Ropes & Gray. "The key to avoiding regulatory issues is having a good system of recordkeeping of pre-execution allocation and a monitoring program that checks deviations from allocations that are not pro rata to the pre-execution allocation."

BUILD A WALL

One significant issue that managers need to address – whether investing in equity while also managing debt platforms, or managing different types of debt strategies – is how to control exposure of material non-public information (MNPI) when handling "private" strategies alongside "public" strategies.

Managers need to decide whether to permit receipt of MNPI, which could benefit the private side of a platform, but restrict the public side. Many establish an information wall to address this conflict, whereby the manager restricts access to the receipt of MNPI so that it does not taint or limit business on the public side of the wall. While 42% of respondents have a wall in place to address MNPI issues, 34% had a wall in place in the past, but have since torn it down.

Walls allow maximum flexibility, with private and public business

FIGURE 16: **WHAT BEST DESCRIBES YOUR APPROACH TO ALLOCATING DEBT DEALS?**

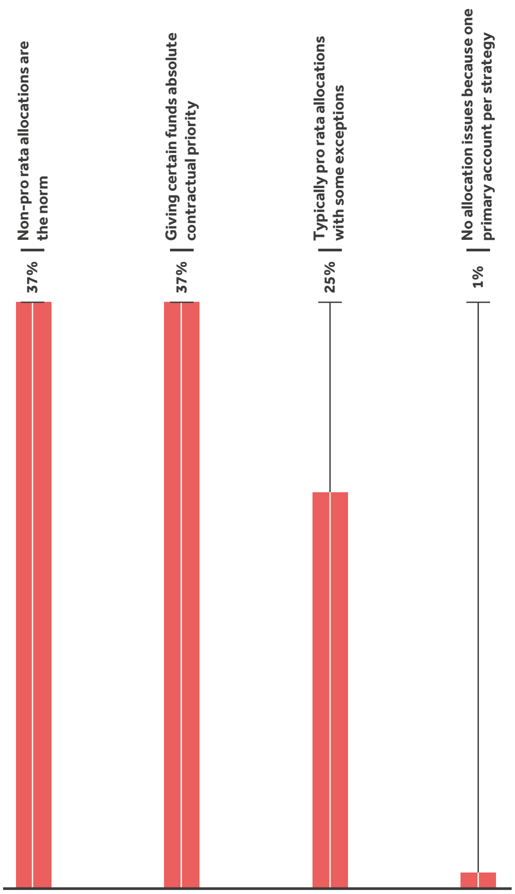
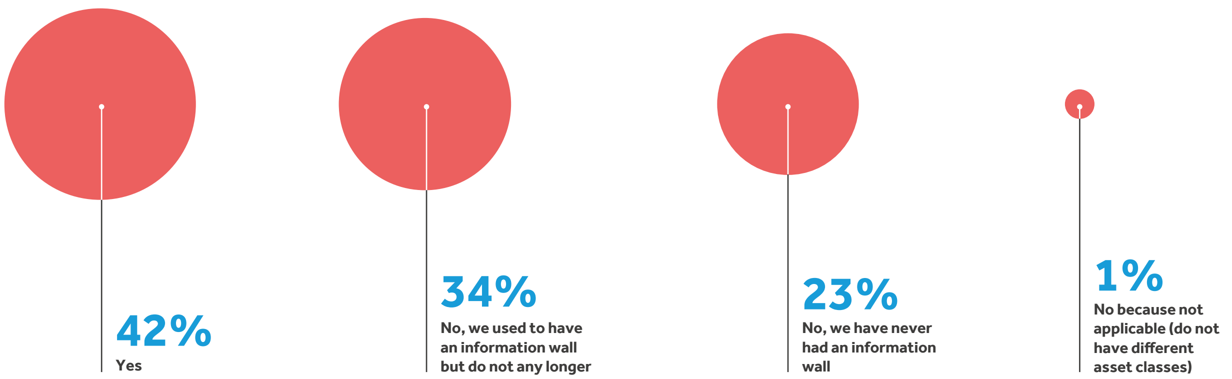
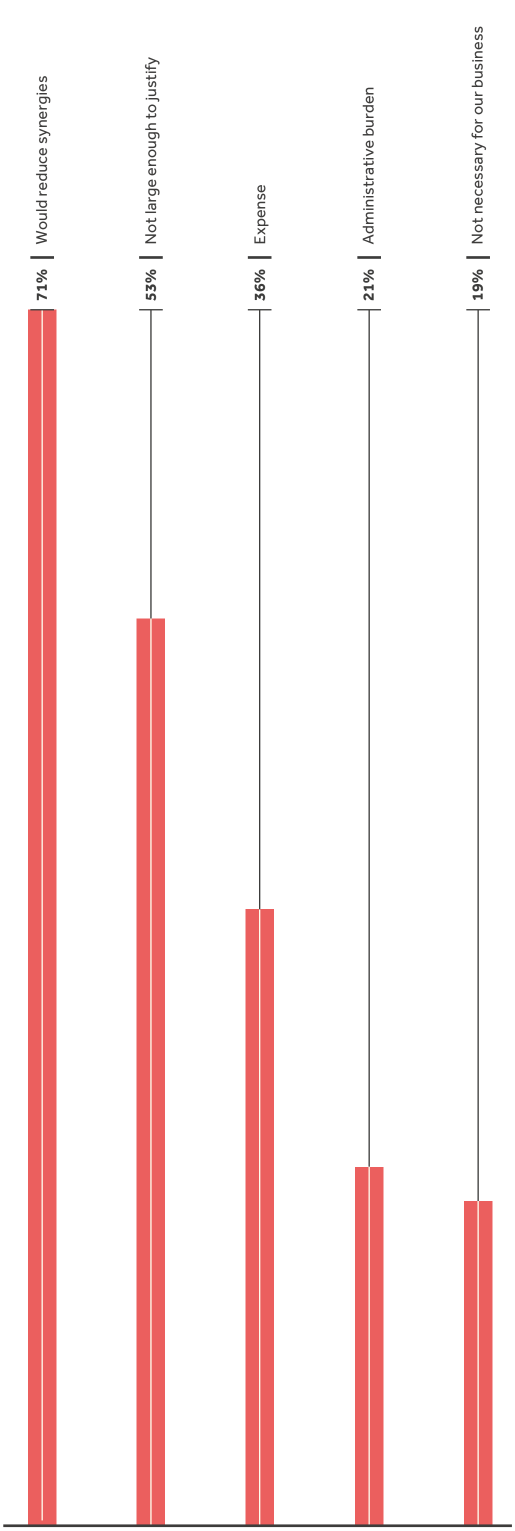


FIGURE 17: **IF YOU HAVE MULTIPLE PLATFORMS COVERING CREDIT AND OTHER ASSET CLASSES (E.G. PRIVATE EQUITY), HAVE YOU INSTITUTED A WALL TO ADDRESS MNPI ISSUES?**



CONFLICTS

FIGURE 18: **WHY DO YOU NOT HAVE AN INFORMATION WALL?** (SELECT ALL THAT APPLY)



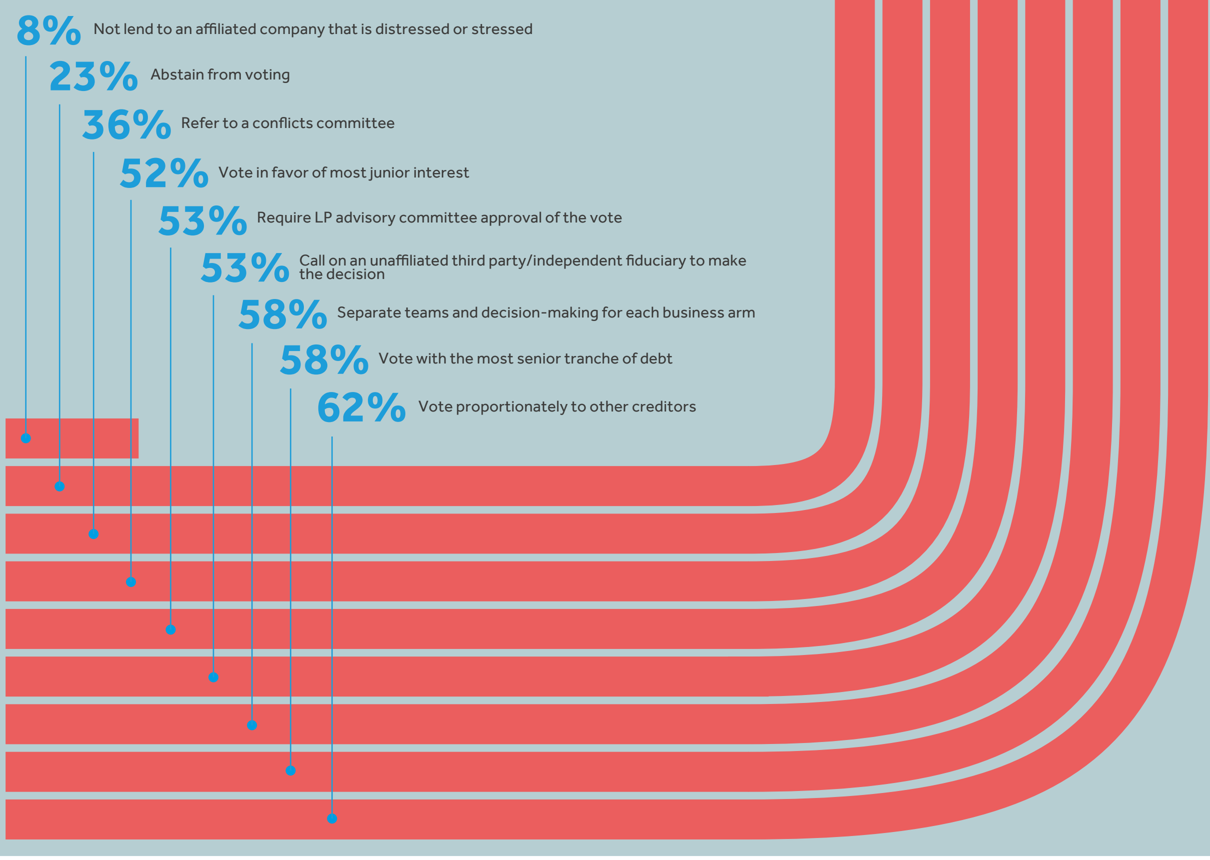
Avoiding conflicts of interest

The survey found that most managers give themselves flexibility to take different approaches instead of one single approach when addressing issues that arise when they are called to vote as a creditor in a distressed or other voting situation that conflicts with an affiliated fund's position in the capital structure. While managers responded that they were using multiple methods of addressing these conflicts, the most common avenue used was to vote proportionately followed by voting with the most senior tranche of debt.

Separate teams and decision-making was favored by 58%, though the ability to use this method effectively may depend on internal structures. (For example, this approach would not work as well if different strategies were managed by the same portfolio management team or in smaller firms.) In contrast, over half of respondents will sometimes vote with the most junior tranche, which suggests there may be flagship or priority funds, while the least popular (8%) was not to lend to distressed portfolio companies. This is perhaps not surprising given the interest in credit managers seeking to manage different strategies alongside one another, and the interest in maintaining stressed or distressed focused fund strategies.

From a regulatory standpoint, the most important consideration is to disclose the conflicts, and the different methodologies that may be used to manage these conflicts.

FIGURE 19: **WHAT DO YOU DO IF THE CREDIT FUND IS CALLED TO VOTE AS A CREDITOR IN A DISTRESSED OR OTHER VOTING SITUATION THAT IS IN CONFLICT WITH AN AFFILIATED FUND'S POSITION IN THE CAPITAL STRUCTURE?** (SELECT ALL THAT APPLY)



operating separately and without restraint, but many managers are choosing to address this conflict in other ways, including avoiding reorganization discussions with debtors as well as not holding different securities in the same portfolio company.

Among those without a wall, 36% say it is mainly due to the additional expense of maintaining a wall, while 53% cite a lack of scale to justify a wall system and 71% say it would reduce synergies between businesses.

For those who choose to forgo a wall, it's important to have robust policies and procedures addressing information access and when trading should be restricted, says Matt McGinnis, a partner in the litigation and enforcement practice group: "Be sure to revisit them frequently. As the types and volume of assets under management grow and get more complex, the MNPI issues likewise get more complex. A manager's policies need to reflect that."

It can be challenging to prove a solid or sufficient wall exists when it's clear some parts of the organization have MNPI and others are trading in that security, according to Dan O'Connor of Ropes & Gray.

"The reality, in many respects, is that regulators focus more on issues of insider trading in a traditional equity setting as opposed to the fixed income setting – although there have been exceptions," he adds. "People often weigh regulatory risk as part of their evaluation of walls and their willingness to implement one."

As to whether attitudes will change as strategies continue to diversify and assets under management increase, Eva Carman, a partner and co-chief of the securities and futures enforcement group at Ropes & Gray, believes that advisors have become more sophisticated about conflicts.

"People are better prepared to handle disclosures, which are essential when making sure that potential conflicts remain benign from an enforcement perspective," she says.

CONFLICT LIMITATIONS

Conflicts can arise from different funds or accounts investing at different levels of a portfolio company's capital structure. As a result, the interests of investors may not be aligned when major decisions are necessary, for example in stressed or distressed situations.

"When a portfolio company is insolvent, the interests of the in-the-money and out-of-the-money creditors will diverge, as will the interests of investors in fully-covered vs. fulcrum securities," notes Stephen Moeller-Sally.

Some manage this conflict by restricting the ability of different funds and accounts to invest at different levels in the same portfolio company. However, this may impede growth of businesses, given the interest expressed by respondents in expanding their credit platforms to multiple different types of debt fund strategies and diversifying their business and product offerings, as well as the desire of managers to maximize time and effort spent understanding particular portfolio companies and maximizing synergies.

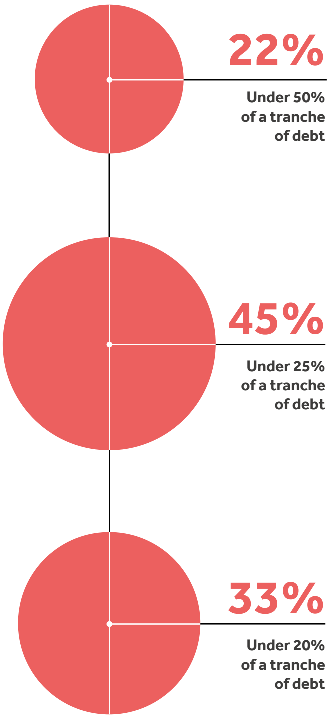
The survey shows that 66% of respondents allow accounts to invest in different levels of the capital structure of a given company. Many are taking a flexible approach by not adopting strict restrictions or guidelines and instead referring conflicts to a conflicts committee for decision-making.

Others are giving investors comfort and managing regulatory concerns by implementing more structured approaches.

For example, they may limit the ability of certain funds or accounts to acquire more than a certain percentage of a tranche of equity or debt. They may also seek to validate the terms of a transaction by requiring a third-party lender to extend credit on the same terms, or requiring a third-party to be the lead or a larger lender, in order to mitigate conflicts or appearance of conflicts.

"We have clients that will prohibit their credit affiliates from buying the debt of portfolio companies of the

FIGURE 20: **IF YOU MANAGE CONFLICTS BY RESTRICTING PARTICIPATION IN A TRANCHE OF DEBT ISSUANCE, WHAT LIMIT DO YOU IMPART?**



private equity affiliate, or they will want to make sure that the amount of debt purchased is sufficiently low so that the credit affiliate won't have control over the negotiation of the terms if the debt goes into default," says Jason E. Brown at Ropes & Gray. "There are also firms that won't necessarily impose limits, but they will say we can't be the lead lender. Someone else has got to take the lead, determine the terms and what happens in a default."

On restricting participation in debt issuances, the survey shows that restrictions are typically around 20% to 25%, although some managers restrict participation to as low as 5% to 10%, of a debt tranche. In certain cases, some funds may also require LP advisory committee approval, or disclosures, for material conflicts.

CROSS TRADING CONCERNS?

Cross trades are more common in the credit industry than in many other types of strategies such as private equity.

This is particularly true with managers attempting to rebalance portfolio company exposures across multiple types of accounts, including closed-end and open-end funds, and funds at different phases of their lifecycle.

However, a manager's interest in managing the operational and conflict issues related to cross trades depends on the number and type of funds and accounts, types of fund mandates, and risk tolerance and appetite for investing in operational support to manage such conflicts.

The survey shows a split among respondents in their approach to these issues: 58% of respondents do not routinely permit cross trading. As the head of investment and co-manager of a portfolio based in Boston puts it, "cross trading leads to internal arrangements that could attract attention from regulatory bodies and therefore attract sanctions and fees."

Despite these concerns, 42% of respondents permit cross trading among funds and accounts. As Ropes & Gray partner Jason E. Brown explains, while not all accounts – most notably mutual funds, BDCs and Employee Retirement Income Security Act (ERISA) accounts/funds – allow unrestricted cross trades for other accounts, there is nothing inherently wrong with a cross trade.

"It's important for the manager to ensure that the cross trade is in the best interests of both accounts, and the manager must confirm that the price at which the cross is happening is in fact the fair market value," he says. "Disclosure is also important. It doesn't have to be at the time of the cross trade, but it could be just general disclosure in a PPM (private placement memorandum)."

According to the survey, firms that allow the practice of cross trades employ a variety of methods to develop fair valuations to support the price at which cross trades are permitted and to approve the conflicts. In most cases, they turn to a third party for validation of price and do not depend solely on an internal manager's model.

Fifty-five percent permit cross trades with approval from the LP advisory committee which can be a complex process and suggests that cross trades may be allowed, but this method may be used only rarely or in extraordinary transactions for those strategies.

Fifty-five percent also permit cross trades with a third-party fiduciary approval, which may be a more practical solution than LP approval and suggests fairly widespread implementation of mechanisms that permit independent boards or representatives to approve conflicted transactions among a class of managers.

These sentiments are echoed in the survey by a managing director in New York City: "[For us] it's a rare event when there is a need for cross trading. When the need arises, there is a confirmation process that needs to be carried out and it needs to come from the LP advisory committee."

On a regulatory front for cross trades in the credit space, the US Securities and Exchange

FIGURE 21: **DO YOUR INTERNAL POLICIES PERMIT CROSS TRADING AMONG FUNDS?**

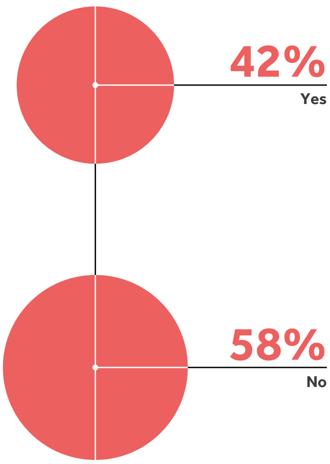
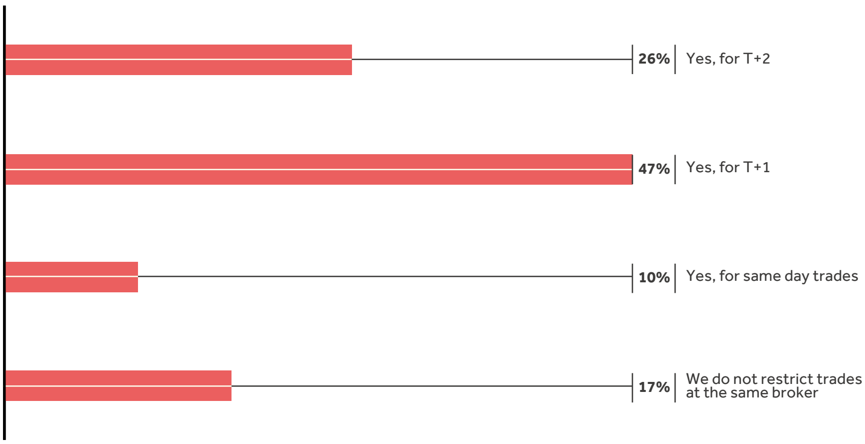


FIGURE 22: **DO YOU RESTRICT TRADES IN THE SAME INSTRUMENT AT THE SAME BROKER (AND SUBJECT THEM TO YOUR CROSS TRADE POLICY)?**

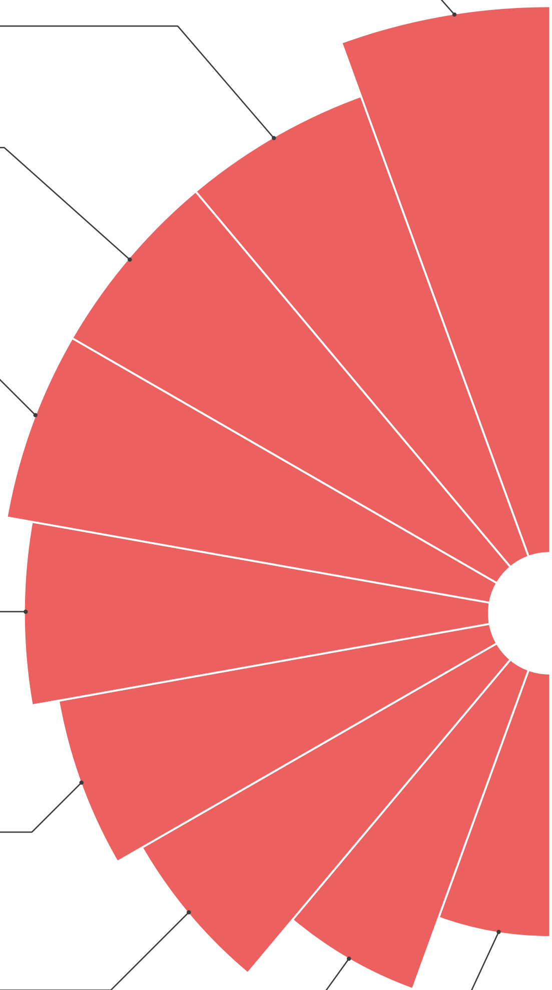


Commission (SEC) enforcement division has turned up the heat on cross trading across asset classes and is increasingly using data analytics to identify potential improper cross trading activity that warrants further scrutiny. The SEC staff may be looking at periods as broad as T+3 in analyzing trends around whether there have been impermissible cross trades. However, in their internal compliance monitoring, we found that many respondents in the study are looking at T+2 or T+1 in their own surveillance monitoring.

Partner Dan O'Connor at Ropes & Gray notes that the SEC concept of a cross trade is not confined to moving securities from account A to account B: "It also covers picking up the phone or using your broker to sell and then repurchase all in one transaction," he adds. "The SEC looks at those transactions as cross trades and there has been enforcement in a number of cases."

However, the findings show that 17% of participants do not restrict same broker trades and 10% do not monitor them at all, which suggests the industry could be more sensitive to the issue.

FIGURE 23: **IF YOUR INTERNAL POLICIES PERMIT CROSS TRADING AMONG FUNDS, WHAT SUBSTANTIATION OF VALUATION DOES YOUR FIRM REQUIRE FOR CROSS-TRADE VALUATIONS?** (SELECT ALL THAT APPLY)



Valuation by more than one independent valuation agent
67%

One independent broker quote
55%

Independent third-party fiduciary approval of transaction
55%

LP advisory committee approval
55%

More than one independent broker quote
50%

Use valuation committee of internal personnel including portfolio manager
45%

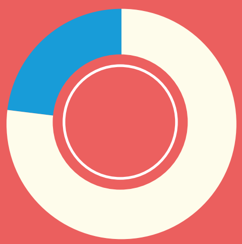
Valuation by one independent valuation agent
40%

Use valuation committee of internal personnel other than portfolio manager
29%

Rely on portfolio manager valuation
19%

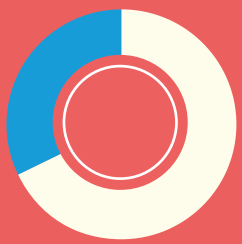
Section 05
ERISA

The Employee Retirement Income Security Act of 1974 (ERISA) sets standards and requirements for pension and health plans in private industry, giving a degree of protection to those on the plans. How are fund managers navigating the restrictions and limitations imposed by ERISA?



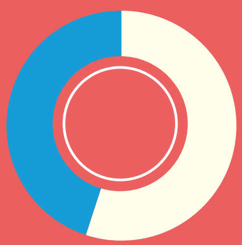
77%

manage plan assets subject to ERISA (45% only manage SMAs/single LP funds, while 32% oversee both pooled funds and SMAs/single LP funds)



68%

permit ERISA vehicles to participate in different levels of the capital structure of the same issuer from their other funds



55%

of those funds that manage plan asset mandates subject to ERISA, structure incentive fees through a realization-based waterfall

ERISA PLAN ASSET FUNDS

Investing with ERISA money has always had its own set of challenges but its increased flow into credit funds has highlighted these issues. Historically, there has been some sensitivity to managing pooled vehicles as ERISA funds given the increased fiduciary duties.

A chief investment officer based in New York City points out that "ERISA vehicles are governed by a separate set of policies and, per those policies, they are not allowed to participate in different levels of the capital structure of other funds. As we have a higher risk-adjusted strategy for ERISA vehicles, we have chosen not to allow investment in other funds that belong to us."

According to the survey, of the 77% of respondents who manage plan assets subject to ERISA, 45% only manage SMAs/single LP funds that are ERISA clients, while 32% oversee both pooled funds and SMAs/single LP funds as ERISA vehicles.

Managing ERISA plan asset funds does require understanding of the rigid requirements ERISA has imposed around managing conflicts and devotion of compliance resources.

However, of those funds that manage plan asset mandates, only 27% report that they have a process in place to ensure that none of the securities purchased for plan asset funds or separate accounts are restricted under the terms of the relevant offering materials from being held by ERISA investors.

Another complication that raises ERISA concerns can be created when credit funds managers hold securities at multiple places in the same capital structure, as they commonly do, according to Josh Lichtenstein, a partner in the tax & benefits department at Ropes & Gray.

"For example, imagine your ERISA fund is holding senior secured debt for a company and another one of your funds – maybe subject to ERISA, maybe not – holds junior debt," he adds. "Anytime you have to make a decision about how you exercise your creditor rights with respect to the senior secured debt, you have to only be thinking about the impact it will have on your ERISA account, not on any other position you hold. That can become challenging if, say, the ERISA account holds a very small position in the senior secured debt. By exercising its rights, it would increase the likelihood that the more junior debt held by the other account could lose its value."

Around two-thirds (68%) of the survey respondents permit ERISA vehicles to participate in different levels of the capital structure from their other funds.

Lichtenstein also notes that ERISA prohibits cross trading very broadly, which means that credit managers are prohibited from engaging in season and sell or other popular syndication strategies.

In addition, a sometimes overlooked ERISA issue relates to realization-based or private equity-type waterfalls, which can become a problem for ERISA accounts because the manager can determine when to sell an investment, and at what price. ERISA fiduciaries are generally not allowed to have control over the timing or the amount of their fee, which can make a fee structure based on direct sale decisions problematic.

Lichtenstein points out, however, that this does not necessarily apply to a credit fund, if the realization events are confined to the collection of the interest payments with respect to its debt holdings. If the manager does not have control over the occurrence of the realization events, then the conflict is not present.

According to the survey, of those funds that manage plan asset mandates subject to ERISA, 55% structure incentive fees for plan asset mandates through a realization-based waterfall, while 44% structure incentive fees through a NAV-based or hedge fund-style waterfall.

FIGURE 24: **DO YOU MANAGE "PLAN ASSET" MANDATES SUBJECT TO ERISA?**

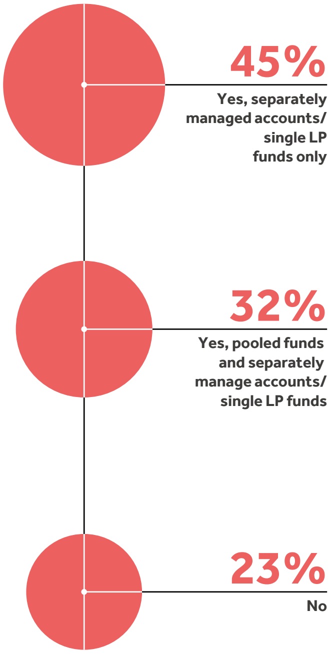
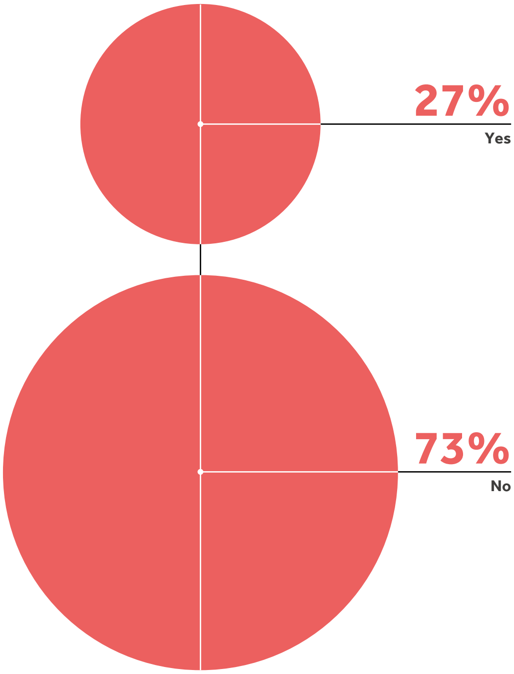


FIGURE 25: **DO YOU HAVE A PROCESS FOR ENSURING THAT NONE OF THE SECURITIES YOU PURCHASE FOR PLAN ASSET FUNDS OR SEPARATE ACCOUNTS ARE EXPLICITLY RESTRICTED FROM BEING HELD BY ERISA INVESTORS?**



Section 06
Outlook and conclusions

Looking to the next 12 to 24 months, the biggest concern – as cited by 71% of respondents in the survey – is increased competition and competitors. This will continue to put tremendous pressure on new entrants to the market, and those without a track record may struggle to attract investors for new products or may be at a disadvantage when negotiating terms.

"We are currently operating in a highly competitive market and, to survive, we need to keep delivering new products and strategies that would attract investors," says the chief investment officer of one investment firm.

Respondents note a decline in demand, with 61% listing it as a hurdle. This may be due to concerns that current record investor demand may abate. Managers are also concerned that they may not be offering products that will be the next in demand strategy. To better meet investor needs, 43% of respondents plan strategic changes to their product offering in the future.

"In order to remain active in the market, we will widen our product range so that we can diversify our income generating options and provide more options for our investors and customers," says the managing director of investment at one firm. More problematic is the ability to find attractive opportunities, according to around half (51%) of the respondents.

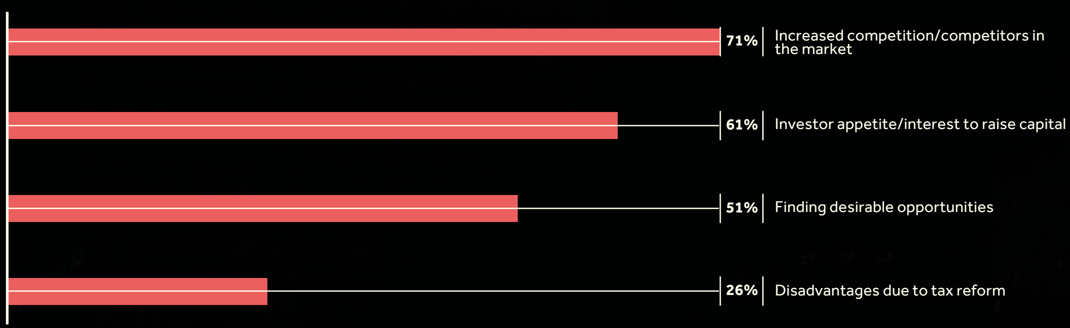
These changes will not just be confined to the product side of development; technology will also have a key role to play.

As one managing director notes, "We are looking at machine assisted learning and automated data analytics. These systems will be the first step towards our transformation and these changes will further assist in developing new products and strategies for the organization."

Despite the challenges, respondents remain largely optimistic about the health of the market in the future, as the chief investment officer and co-portfolio manager in New York City points out: "Market conditions are improving and the market has passed its recovery stage and reaching into the realization or maturity stage. Investments are providing returns and there is a potential demand for additional investments."

A managing director of a fund based in California adds: "The market has improved since the beginning of 2017, when markets did not start off on a good note after the economic turmoil of the year before. There is a desire to invest in private debt along with a rise in the number of new funds being launched. All of this improvement in the market is giving impetus to investment houses."

FIGURE 26: **WHAT ARE THE MAIN CHALLENGES FOR PRIVATE DEBT FUNDS IN THE NEXT 12-24 MONTHS?** (SELECT ALL THAT APPLY)



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Ropes & Gray offers cutting-edge advice encompassing all aspects of the formation and operation of credit funds, including stressed/distressed, special situations, structured finance, real estate debt, and direct lending funds. Our experience across the funds spectrum and in a wide variety of lending and financing transactions allows us to craft tailored solutions for credit fund managers across all parts of their business lifecycle. Our work covers fund formation and management company matters; fund operations and regulatory compliance; ERISA advice to US and non-US managers on complex structuring, prohibited transaction and other ERISA matters; credit fund borrower financing transactions; fund investments and debt transactions; distressed, special situations and restructuring matters; and litigation and enforcement matters.

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